

# EMPLOYEE OWNERSHIP: AN ECONOMIC DEVELOPMENT TOOL FOR ANCHORING CAPITAL IN LOCAL COMMUNITIES

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### INTRODUCTION

Many traditional types of economic development incentive programs do not help anchor capital and quality jobs in local communities.<sup>1</sup> In addition, employee ownership legislation, as it is presently structured in the United States, does not usually advance positive economic development goals. Employee ownership mechanisms often promote the interests of management<sup>2</sup> and most of the employee ownership fostered by our tax incentive system<sup>3</sup> does not provide for sufficient employee control of corporate investment decisions to keep quality jobs and businesses in any particular community. There are, however, a wide range of circumstances under which employee ownership can be used effectively to create and preserve local capital and jobs.

The purpose of this article is to explore the broad range of positive uses of employee ownership as an economic development tool. In a variety of situations, the use of different employee ownership mechanisms, such as cooperatives,<sup>4</sup> employee stock ownership plans ("ESOPs"),<sup>5</sup> and combinations of

1. See *infra* text accompanying notes 11-13.

2. See *infra* text accompanying notes 14-23.

3. See *infra* text accompanying notes 14-29.

4. A "worker cooperative" is a form of business organization which can take a variety of legal forms. Worker-owned cooperatives generally apply the principle of "one vote per person" rather than "one vote per share" but may or may not allow members to own unequal amounts of equity. The two predominant models of worker cooperatives in the United States are the "Rochdale" model and the "Mondragon" model. The Rochdale model usually involves ownership of one share per person which can cause share prices to become prohibitively high. The Mondragon model separates membership rights from equity rights by means of separate internal accounts. See C. ROSEN, *EMPLOYEE OWNERSHIP: ISSUES, RESOURCES & LEGISLATION, A HANDBOOK FOR EMPLOYEES AND PUBLIC OFFICIALS* 14-15 (1981).

Many worker cooperatives are formed pursuant to state business incorporation laws rather than cooperative corporation statutes which are often designed for agricultural or consumer cooperatives. Though a large number of states do not statutorily define worker-owned cooperatives, worker-owned cooperatives are defined in Michigan, New York, Massachusetts, and in the Internal Revenue Code. I.R.C. § 1381(a) (CCH 1986); I.R.C. § 1042(c)(2) (Supp. II 1984); MASS. GEN. L. ch. 157A, §§ 1-11 (1982); MICH. COMP. LAWS ANN. § 450.732(2)(f) (West Supp. 1986); N.Y. COOP. CORP. LAW §§ 81-94 (McKinney Supp. 1986).

"Eligible Worker Owned Cooperatives" ("EWOCs"), which are defined in I.R.C. § 1042(c)(2) (Supp. II 1984), are eligible to provide contributing stockholders with three of the types of tax deductions also provided for ESOPs (defined *infra* note 5): 1) rollover of capital gains received from the sale of stock to an EWOC owning at least 30% of the corporation's stock after the transaction, I.R.C. § 1042(a), (b)(2) (CCH 1986); 2) transfer of and a 14-year extension of time for payment of estate tax liability to the EWOC if sufficient stock is contributed, I.R.C. § 2210(c)(1) (CCH 1986), I.R.C. § 6166(a) (CCH 1982); and 3) exclusion from an estate for 50% of the proceeds realized on an estate's sale to an EWOC, I.R.C. § 2057(a)-(c) (CCH 1986). See *infra* note 2.

A producer cooperative is a company that is wholly owned, except for any mortgage rights that lenders own, by the people who work in it. A membership share in a cooperative represents

the same type of rights as a share of stock with the following variations: 1) a cooperative share cannot be sold except by a departing member to a new member or back to the cooperative; and 2) each member holds only one voting share, although equity interests of members may differ based on accumulation in individual capital accounts. By contrast, in a stock corporation, voting is based on one vote per share of voting stock on whatever matters that class of stock has voting powers.

Parts of the preceding definitional discussion have been adapted from and update Olson, *Union Experiences With Worker Ownership: Legal and Practical Issues Raised by ESOPs, TRASOPs, Stock Purchases and Cooperatives*, 1982 Wis. L. REV. 729, 733 n.3 (1982).

5. An Employee Stock Ownership Plan ("ESOP") is defined in I.R.C. § 4975(e)(7) (CCH 1986). It is a qualified stock bonus or stock purchase plan, pursuant to I.R.C. § 401(a) (CCH 1986), designed to encourage employers to give or sell stock to their employees through a trust, (called an "ESOT"), in exchange for tax advantages. Many plans that are called ESOPs are really only stock bonus plans under I.R.C. § 401(a) (CCH 1986), fashioned as ESOPs. Statutory ESOPs must meet the additional requirements of I.R.C. § 4975(e)(7) (CCH 1986) and are usually established by parties who wish to take advantage of leveraging features, the right to use a money purchase pension plan along with a stock bonus plan, or the higher tax-free contribution limits available under I.R.C. § 415(c)(6) (CCH 1986). ESOP qualifications and limitations on contributions are defined in the Internal Revenue Code regulations and in the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1001 (1982).

ESOPs offer employers many advantages. Employer contributions to the ESOP are completely tax deductible if the contribution does not exceed 15% of the compensation paid each year to stock bonus plan participants or 25% of such compensation where there is both a stock bonus plan and a money purchase plan or a separate pension plan. I.R.C. § 404(a)(3)(A), (a)(7) (CCH 1986). When an ESOP is used by a corporation to borrow money, this contribution limit is 25%, even if the ESOP is the only plan, and applies only to those contributions used to repay principal. Thus, additional contributions used to repay interest are also deductible. I.R.C. § 404(a)(9) (Supp. II 1984). In addition, the employer pays no social security or FICA tax on stock contributed to a qualified ESOP on a payroll deduction. I.R.C. §§ 501(a), 3401(a)(12) (Supp. II 1984).

An employer can use an ESOP to obtain investment capital, create a market for her stock, cash out and pass on the company to her employees or hand-picked successor, limit pension obligations, or convert a pension plan to an ESOP. See R. FRISCH, *THE TRIUMPH OF ESOP: THE FABULOUS NEW INSTRUMENT OF CORPORATE FINANCE* 7-8, 10-11 [hereinafter R. FRISCH, *TRIUMPH OF ESOP*]; see also R. FRISCH, *THE MAGIC OF ESOPs AND LBOs* (1985) [hereinafter R. FRISCH, *MAGIC OF ESOPs*]. Employers can also use a leveraged ESOP to borrow money and repay the loan with untaxed (pretax) dollars. For a discussion of leveraged ESOPs, see Olson, *supra* note 4, at 734 n.4 (1982). Furthermore, employers who use ESOPs may benefit from increased productivity. See M. CONTE, A. TANNENBAUM & D. MCCULLOCH, *EMPLOYEE OWNERSHIP* 2-3, 23 (1981); R. LEVERING, M. MOSKOWITZ & M. KATZ, *THE 100 BEST COMPANIES TO WORK FOR IN AMERICA* ix (1984); Olson, *supra*, at 734 n.4; Note, *ESOP Tables: A Survey of Companies With Employee Stock Ownership Plans*, 6 J. CORP. L. 551, 614 (1981).

Retiring business owners can use ESOPs as a means of estate planning and tax deferral or avoidance. By contributing sufficient stock to an ESOP, a stockholder can transfer her estate tax liability to the ESOP. The ESOP then has 14 years after her death to pay the estate taxes. I.R.C. § 2210(c)(1) (CCH 1986); I.R.C. § 6166(a) (1982). If a stockholder sells stock to an ESOP after which the ESOP owns more than 30% of the corporate stock, the seller can rollover long-term capital gain into any domestic corporate security without paying taxes until the replacement security is sold. I.R.C. § 1042(a)-(b) (CCH 1986). If the replacement security passes into an estate upon death, it receives a stepped-up basis. I.R.C. §§ 1016(a)(21) (CCH 1986); I.R.C. § 1023 (1982). The Code also allows exclusion for 50% of the income realized from an estate's sale of stock to an ESOP. I.R.C. § 2057(a)-(c) (CCH 1986). See also R. Midkiff, "ESOP and the Other Choices in Estate Planning for the Owner of a Closely-Held Business," Remarks at the ESOP Association Regional Seminar 125-203 (Oct. 1986) (on file with the New York University Review of Law & Social Change). Legislation is under consideration to limit

these or other corporate structures,<sup>6</sup> further the interests of workers, unions, businesses, and local communities. Employee ownership helps anchor capital in local communities because employee-owners usually reside in the community in which they work and their interests, as residents and employee-owners, coincide with those of the community. Employee ownership is therefore a valuable tool for aiding economic development strategies which value both the geographic stability and the quality of employment opportunities created. The quality of these new employment opportunities should be measured by the

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the estate tax deduction to the lesser of \$750,000 or 50% of the taxable estate. S. 591, 100th Cong., 1st Sess. § 2 (1987); H.R. 1311, 100th Cong., 1st Sess. § 2 (1987).

Employees, or their beneficiaries, actually receive their vested stock from the ESOP upon termination of employment. See *infra* note 44. Through an ESOP, an employee may acquire stock without payment or at a lower than market price. The employee pays income tax only on employee contributions for the stock, not necessarily on its market value. If she pays nothing for the stock, there is no tax on it until it is distributed. I.R.C. §§ 401(a), 402(e) (CCH 1986); I.R.C. § 501(a) (1982). Upon distribution there are tax advantages available to the employee as well. I.R.C. §§ 402(a)(1), 402(e) (CCH 1986); I.R.C. §§ 402(a)(5), (a)(6) (1982, Supp. II 1984 & CCH 1986).

ESOPs, however, are exempt from several important ERISA protections: 1) ESOP funds are invested "primarily" in employer securities and are exempt from the 10% limitation rule on investment of pension funds in employer securities, ERISA §§ 407(a), (b)(1), (d)(3)(A), 29 U.S.C. §§ 1107(a), (b)(1), (d)(3)(A) (1982); 2) an ESOP is *not* subject to the funding requirements of a pension plan, I.R.C. § 412(h) (1982); and 3) an ESOP, as a defined contribution plan, is not covered by Pension Benefit Guarantee Corporation Insurance, ERISA §§ 4021(A), (b)(1), 4022, 29 U.S.C. §§ 1321(a), (b)(1), 1322 (1982). See Ludwig, *Conversion of Existing Plans to Employee Stock Ownership Plans*, 26 AM. U.L. REV. 632, 643 nn. 62, 63 (1977).

A union can use an ESOP to set up a worker-oriented and worker-controlled company, see *infra* text accompanying notes 62-77, or to obtain more information and greater control over a company in which its members do not own a majority of stock.

Lenders and corporations seeking to borrow money find ESOPs attractive because commercial lenders can exclude 50% of the interest earned on ESOP loans from their income. I.R.C. § 133(a), (b)(1), (c) (CCH 1986). Frequently, this tax saving is split with the customer — reducing interest rates to as low as 75% of prime in some cases. Corporations receive tax deductions for cash dividends paid to ESOP participants or for dividends paid on ESOP stock used to retire ESOP debt. I.R.C. § 404(k) (CCH 1986). Corporations which terminate pension plans to obtain access to excess assets in overfunded plans are subject to a 10% excise tax *except* when the excess assets are used to fund an ESOP. I.R.C. § 4980(c)(3) (CCH 1986).

The preceding definitional discussion has been adapted from and updates Olson, *supra* note 4, at 732 n.1, 734 n.4.

6. Until the Tax Reform Act of 1986, Pub. L. No. 99-514 (West 1986), there was no simple way to provide for one vote per person in an ESOP and maximize its tax benefits because of: 1) a variety of complications involving the definitions of best common stock and voting pass through requirements under I.R.C. § 409 (Supp. III 1985); 2) limits, based on income, on contributions to individual accounts under I.R.C. § 415 (1982, Supp. II 1984 & CCH 1986); and 3) confusion over the fiduciary duties of the trustee directed to vote by participants under ERISA, § 404, 29 U.S.C. § 1104 (1982). Consequently, a variety of mechanisms were devised to produce a hybrid called a "coop-ESOP" or a "democratic ESOP." See, e.g., Republic Container, *infra* text accompanying notes 62-64.

The Tax Reform Act of 1986 has resolved some, but not all, of these problems. Under the new I.R.C. § 409(e)(5) (CCH 1986), one vote per participant is allowed. But until the relationships and meanings of all these rules are construed together, practitioners should be cautious and may want to rely on the older, more complicated hybrid methods which have received approval from the IRS.

number of jobs created, the probability that these jobs will generate additional employment, and the jobs' level of wages, type of benefits, and permanency.

This article will illustrate how employee ownership can be used to anchor capital and jobs in local communities by describing employee ownership projects which have received assistance from the Midwest Employee Ownership Center ("MEOC")<sup>7</sup> or its consultants, acting independently. MEOC is a private, nonprofit corporation created by and composed of representatives from labor, business, and government. Its role is to educate labor, business, and government about employee ownership, analyze the appropriateness and feasibility of employee ownership in any given enterprise, and assist in the establishment and structuring of employee-owned businesses. MEOC limits its use of employee ownership as an economic development tool to circumstances which fit within a set of principles<sup>8</sup> aimed at protecting workers, unions, and local communities and promoting the preservation and development of profitable businesses. As a private agency, MEOC has the flexibility needed to react quickly and creatively to new developments.

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7. Originally called the Michigan Employee Ownership Center, MEOC expanded its services to Ohio in 1986 and in May, 1987, officially became the Midwest Employee Ownership Center.

8. The MEOC Policy Statement includes the principles which guide MEOC's actions:

1. Employee ownership can be advantageous to communities, labor and business because it anchors capital development in local communities, provides jobs, and is a means for keeping companies in business in local communities which might otherwise not remain there.
2. Workers in companies with employee ownership should have voting rights which are structured in a democratic fashion to give employees meaningful participation in the decision making process of their companies, and which are in proportion to the investment the employees have made in the company's future.
3. Employee ownership plans should be designed to protect the interests of active employees, with suitable provisions being made to protect the value of the investment of retiring or terminating employees.
4. Employee ownership is not an alternative to unionization, and MEOC will not support employee ownership efforts designed to weaken or destroy unions.
5. It is a MEOC goal to enable minorities and women to obtain the benefits of employee ownership and the skills to run these businesses successfully. MEOC will aid only those businesses that have or adopt policies of non-discrimination (on the basis of race, religion, sex, creed, color, age and handicap) in hiring and other employee practices.
6. Employee stock ownership is not an alternative to an adequately funded pension plan and MEOC will not assist employee ownership efforts that would terminate existing pension plans and replace them with company stock.
7. Important considerations in allocating MEOC's resources to a project will be: (1) the total number of jobs which may be retained or created in local communities, including jobs at suppliers and customers, and (2) the ability to create alternative products or markets for local companies.
8. Government assistance to enterprises considering employee ownership can be instrumental in determining whether employee ownership becomes a reality. MEOC will respond to requests for information or technical assistance from government bodies or legislators regarding legislation impacting employee ownership.
9. Employee ownership may not always be appropriate. The Center will determine on a case-by-case basis whether employee ownership in any given situation is both financially feasible and will conform to the principles set forth above.

Based on my experiences as general counsel for MEOC and as a consultant in the employee ownership projects discussed in this article, I propose that all government bodies consider modeling their employee ownership policy on Michigan's recent legislative and administrative initiative.<sup>9</sup> Michigan's legislation defines employee ownership as employee control of businesses and provides for a number of programs that encourage employee ownership.<sup>10</sup> I conclude that in order to serve the economic values proposed above, federal, state, and local legislators should consider requiring employee ownership and control of businesses as a prerequisite for many, if not all, economic development and employer tax credit, deduction, and incentive programs.

## I

### CONVENTIONAL ECONOMIC DEVELOPMENT PROGRAMS MAY NOT KEEP JOBS AND CAPITAL IN LOCAL COMMUNITIES

Governmental bodies generally lack the capacity to supervise and control economic development programs involving tax abatements, industrial revenue bonds, and other direct subsidies to corporations. This appears to be the case even when legislation provides the governmental body legal recourse to protect it against businesses leaving the community.<sup>11</sup> As a result, these types of economic development programs cannot ensure that companies will continue to invest capital or provide employment in a particular community.

For example, in a small northern Michigan community, MEOC worked with a union group which was offered the opportunity to purchase all or part of their company. While MEOC analyzed the offer, it learned that the local community economic development authority was reluctant to finance a deal involving the present owners of the company because these owners had previously obtained community economic development funds to purchase \$600,000 worth of modern equipment for use in the local factory. The community economic development authority's reluctance proved to be well-founded. The owners of the company, though denied permission by the economic development authority, moved the equipment to a Detroit area facility. Without this equipment, the viability of the northern plant is at risk and the community's investment has not served to upgrade its business facilities.

The use of employee ownership may have prevented the company's withdrawal of capital from the community. For instance, had the economic development loan for the equipment also given the employees some direct ownership in the equipment or the company, the employees might have had

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9. MICH. COMP. LAWS ANN. §§ 125.1251-.1252 (West 1986); MICH. COMP. LAWS ANN. §§ 125.1602-.1603 (West 1986); MICH. COMP. LAWS ANN. §§ 450.751-.759 (West Supp. 1986); MICH. COMP. LAWS ANN. §§ 450.801-.815 (West Supp. 1986).

10. See *infra* text accompanying notes 105-109.

11. See, e.g., Letter from Joseph P. Kwiatkowski, Prosecuting Attorney, to Cheboygan County Economic Development Corporation (Feb. 20, 1986) (on file with the New York University Review of Law & Social Change).

the power to use direct or legal action to force the management to live up to its agreement with the community and keep the equipment in the northern facility. Although the businesspeople and politicians on the economic development commission considered legal action against the company, they are the only ones with the authority to act on the violation. Unlike the employees, the members of the commission may not feel compelled or inclined to force a disinvestment debate. In this case, the threat of legal action caused the parent company to pay off the bond — eliminating any leverage the community may have had over the company.

Economic development strategies which focus on luring a few specific industries to a community can also result in the loss of capital and jobs. In recent years, for example, some state economic development officials have placed great emphasis on attracting high-technology, computer-based companies. California pursued such a strategy, only to come up empty handed when the Atari Company closed a large production facility in California and moved it to Hong Kong and Taiwan.<sup>12</sup> Some communities have engaged in destructive competitive bidding wars in an effort to attract businesses. These communities have suffered deterioration of their tax base and infrastructure without significantly increasing their ability to procure businesses because many other communities were bidding or because tax abatements were not significant factors in the corporate location decision.<sup>13</sup>

In contrast, employee-owners' self-interest frequently coincides with that of the community-at-large. Employee-owners' stake in a project can induce them to use *every* effort to maintain a local enterprise while another owner might not bother. Since employee ownership exists in a broad range of companies, as an economic development strategy it does not require a state or community to take the high risks involved in focusing public resources on a specific, limited industrial or commercial sector.

## II

### EMPLOYEE OWNERSHIP CAN BE ABUSED SO THAT IT SERVES ONLY THE INTERESTS OF OWNERS OR MANAGEMENT

In only ten to fifteen percent of the more than 8,000 employee-owned companies in the United States do the employees own a majority of the stock.<sup>14</sup> Even in these companies, the employees rarely control the voting rights over the stock.<sup>15</sup>

Under the current law, ESOPs in closely-held companies need not pass through voting rights in ESOP stock to employee-participants on most is-

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12. N.Y. Times, June 5, 1986, at D4, col. 4.

13. See B. BLUESTONE, B. HARRISON & L. BAKER, *CORPORATE FLIGHT: THE CAUSES AND CONSEQUENCES OF ECONOMIC DISLOCATION* 64-74 (1981).

14. C. ROSEN, K. KLEIN & K. YOUNG, *EMPLOYEE OWNERSHIP IN AMERICA: THE EQUITY SOLUTION* 1 (1986).

15. *Id.*

sues.<sup>16</sup> Corporate management and company owners are able to transfer ownership without control to employees. As a result, corporate management and company owners often create ESOPs to serve their own purposes regardless of the effect on local capital and jobs.<sup>17</sup> Under these circumstances, employees risk receiving less than fair value for their stock because of appraisal manipulations.<sup>18</sup>

*Business Week*, in its article "ESOPs: Revolution or Ripoff?,"<sup>19</sup> examined events at Scott & Fetzer Co., Dan River, and other companies to show how ESOPs were used to arrange leveraged buyouts for management or to avoid corporate takeovers without providing employees with any visible incidents of ownership. In the Scott & Fetzer Co. case, intervention by the United States Department of Labor ("USDOL") helped stop a management ESOP proposal which would have left employees with "less than a fair allocation of stock."<sup>20</sup> The USDOL found that the price "the ESOP proposed to pay for the stock on behalf of employees was too high . . . and that the ESOP loan was not made solely for the benefit of the ESOP participants."<sup>21</sup> At Dan River, the employees' ESOP bought 70% of the company and received Class A common stock at \$22.50 per share. Management and ESOP consultants, however, bought 30% of the company, mostly in Class B common stock at \$2.06 per share. Control over election of the corporate board rests with the Class B shareholders.<sup>22</sup> The ESOP stock is voted by the ESOP trustee, who is directed by a management-controlled committee.<sup>23</sup>

Under the 1986 Tax Reform Act,<sup>24</sup> employees even in closely-held companies have obtained increased legally mandated voting rights on major corporate issues such as mergers, acquisitions, and sales of substantially all assets.<sup>25</sup> Partial employee ownership can, therefore, provide some aid for workers seeking to anchor capital in their communities.<sup>26</sup> Usually, employees need to have control for this benefit to be realized. A noncontrolling interest, particularly in a closely-held firm, normally does not give minority stockholders the ability to influence company decisions. Nevertheless, when a noncontrolling interest is combined with the information and rights the ESOP participants have as

16. I.R.C. § 409(e)(3) (CCH 1986); see also *infra* note 44.

17. See *infra* text accompanying notes 19-23.

18. Such manipulation will become more difficult, but not impossible, now that I.R.C. § 401(a)(28) (CCH 1986) requires use of an independent appraiser in ESOP valuations (except for publicly traded securities).

19. Hoerr, *ESOPs: Revolution or Ripoff?*, Bus. Wk. 94, 94-97 (April 15, 1985).

20. *DOL Allows Revised Plan, Fuels Debate Over Government's Role*, 5 LABOR AND INVESTMENTS 1, 4 (Sept. 1985).

21. *Id.*

22. Hoerr, *supra* note 19, at 97.

23. *Id.*

24. Pub. L. No. 99-514 (West).

25. I.R.C. § 409(e)(3) (CCH 1986).

26. See *infra* text accompanying notes 71-77, 83-100.



employees,<sup>27</sup> the ESOP participants may be able to save their jobs in the face of a proposed sale, moving, or closing of a facility. As the Eberhard Food case will illustrate,<sup>28</sup> the protection of retirement plan participants under ERISA<sup>29</sup> can provide minority employee-owners, their unions, and their communities with additional leverage to anchor capital and jobs.

### III

#### FEDERAL POLICY NEEDS TO MAKE EMPLOYEE OWNERSHIP A STRONGER TOOL FOR LOCALLY CONTROLLED ECONOMIC DEVELOPMENT

Federal government policy clearly encourages employee ownership.<sup>30</sup> Federal policymakers are also attempting to curb the abuse of employee ownership mechanisms.<sup>31</sup> But these policymakers have not taken the step necessary — endorsing the expansion of employee voting rights — to make employee ownership a strong tool for locally controlled economic development.

Congress' use of ESOPs as part of the bailout programs for Chrysler<sup>32</sup> and several railroad companies,<sup>33</sup> including Conrail, exemplify the government's effort to use employee ownership as a condition for federal assistance.<sup>34</sup>

The outcome of the Chrysler bailout has been favorable even though the company is no longer owned by its employees. During the 1979 Chrysler loan guarantee negotiations, members of the United Automobile, Aerospace and Agricultural Implement Workers of America ("UAW") were forced to accept stiff concessions.<sup>35</sup> In return, as mandated by the Chrysler Corporation Loan Guarantee Act of 1979,<sup>36</sup> UAW members and other Chrysler employees received stock under an ESOP.<sup>37</sup> A total of \$162.5 million worth of Chrysler stock was purchased for the ESOP participants between 1981 and 1984.<sup>38</sup> In 1985, after Chrysler regained financial stability, the UAW negotiated a termination of the ESOP.<sup>39</sup> At that time, the stock price was around \$44½ per

27. I.R.C. § 409 (Supp. II 1984 & CCH 1986); ERISA, 29 U.S.C. §§ 1021-1053, 1101-1145 (1982, Supp. II 1984 & Supp. III 1985).

28. See *infra* text accompanying notes 88-100.

29. I.R.C. § 409 (CCH 1986); 29 U.S.C. § 1001 (1982).

30. See, e.g., *supra* notes 1-6; *infra* notes 32, 33 and accompanying text.

31. See *infra* notes 44-47 and accompanying text.

32. Chrysler Corporation Loan Guarantee Act, 15 U.S.C. §§ 1861-1875 (1982).

33. Regional Rail Reorganization Act, 45 U.S.C. §§ 701-797m (1982).

34. See *supra* notes 4, 5.

35. Telephone interview with Frank Musick, Assistant Research Director, International United Automobile, Aerospace and Agricultural Implement Workers of America (Feb. 20, 1986) [hereinafter Interview with Musick]; *Chrysler Union Ratifies Contract Concessions*, N.Y. Times, Feb. 2, 1980, at 27, col. 1.

36. 15 U.S.C. §§ 1861-1875 (1982).

37. Interview with Musick, *supra* note 35; Judith Miller, *Congress Approves a Compromise Plan on Aid to Chrysler*, N.Y. Times, Dec. 21, 1979, at A1, col. 6.

38. Interview with Musick, *supra* note 35.

39. *Id.*

share.<sup>40</sup> Consequently, each full-time employee who had been employed during the plan's four year existence netted approximately \$8200.<sup>41</sup> This short-term benefit represented a partial payment to UAW members for their earlier concessions.<sup>42</sup> Thus, as a result of using an ESOP as part of the bailout, the employees obtained something for their previous sacrifice and the government retained Chrysler employees as taxpayers.

Since Congress enacted the first ESOP tax deductions and credits in the 1970's, observers have been concerned about ESOPs used primarily for the benefit of corporate management and company owners rather than plan participants.<sup>43</sup> In response, Congress has amended ESOP legislation to provide employees with more financial protections.<sup>44</sup> For example, Congress recently

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40. *Id.*

41. *Id.*

42. *Id.* During the period in which the ESOP existed, it held as much as 15% of Chrysler's voting common stock. *Id.* Most UAW Chrysler members never liked the ESOP program because they viewed it as a concession to a company that had not demonstrated any particular interest in employee involvement. *Id.* When Chrysler stock prices increased, the majority of UAW members wanted and needed the cash to offset the effects of several years of work under a concessionary contract. *Id.* To keep their stock in the ESOP would have meant taking a chance that the value would collapse again and, under an ESOP, workers generally do not receive the cash value of their stock until they reach retirement age. *See supra* note 5.

Some UAW members wanted to retain their share of voting stock in order to prevent the corporation from investing in offshore operations. Interview with Musick, *supra* note 35. Under other circumstances, the majority of UAW members might have taken this view. If Chrysler had not been on the brink of dissolution, if labor-management relations involved more mutual trust, if the change in stock price had not been so dramatic or if the concession package had been less drastic, the employees might have chosen to act more like owners. However, the majority voted to get their funds safely out of Chrysler while the getting was good. *Id.*

43. *See, e.g.,* THE UNITED STATES COMPTROLLER GENERAL, REPORT TO THE COMMITTEE ON FINANCE UNITED STATES SENATE, EMPLOYEE STOCK OWNERSHIP PLANS: WHO BENEFITS MOST IN CLOSELY HELD COMPANIES? (June 20, 1980); *see also supra* notes 16-23 and accompanying text.

44. Under the Tax Reform Act of 1986, ESOP stock which is not publicly traded must be appraised annually on a uniform basis by an independent appraiser. I.R.C. § 401(a)(28)(B) (CCH 1986). One vote per participant is allowed but not required. I.R.C. § 409(e)(5) (CCH 1986); *see also supra* note 6. Major corporate issues for which voting rights must be passed through for nonpublicly traded stock are "approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all assets of a trade or business or such similar transaction as the Secretary may prescribe in regulations." I.R.C. § 409(e)(3) (CCH 1986).

One hundred percent vesting for eligible plan participants is now required in five to seven years. I.R.C. § 411(a)(2) (CCH 1986); ERISA § 202(B)(1), 29 U.S.C. § 1053(a)(2) (1982). ESOP participants have a right to demand their plan distributions in stock unless the company is "substantially" employee owned, in which case distributions are in cash. I.R.C. § 409(h) (CCH 1986). When the stock is not publicly traded, participants have a "put option" — the right to sell the stock back to the company for cash. *Id.*

Senior plan participants can also diversify their holdings under the new tax law. Any ESOP participant who has reached age 55 and has participated in the plan for 10 years is entitled annually, during a 5-year election period, to direct diversification of up to 25% of her account balance. After age 60, she is entitled to direct diversification of up to 50% of her account balance. The diversification requirement can be met by a distribution of that portion of the account balance for which diversification is elected or cash in lieu thereof. Under this rule, if stock is distributed in satisfaction of the diversification requirement, the put option rules

ended the Tax Credit Employee Stock Ownership Plan ("TRASOP") program,<sup>45</sup> which had utilized approximately 90% of the tax cost while providing only a small percentage of employee ownership in firms.<sup>46</sup>

The enactment of ESOP tax deductions and credits, the use of ESOPs as part of the bailout programs for imperiled companies, and the elimination of the TRASOP program show that Congress is experimenting with employee ownership. The evidence demonstrates that Congress is focusing more of its attention on the needs of the ESOPs' employee participants. But while Congress has encouraged and is demonstrably concerned about the use of employee ownership, it has not acted to expand significantly employee voting rights. Present federal policy does not favor employee control over stock. Congress and many employee ownership experts are reluctant to expand employee voting rights for two main reasons: 1) they are concerned that employees will not act wisely as stockholders; and 2) they believe that employers will not offer stock plans unless they can retain control over the companies.<sup>47</sup> These arguments, however, are not convincing.

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apply. Amounts which are distributed in satisfaction of the diversification requirement may be rolled over to an Individual Retirement Account or other qualified plan. I.R.C. §§ 401(a)(28)(B), 402(a)(5)(D) (CCH 1986).

The Tax Reform Act of 1986 allows early distribution to be used as an alternative to diversification of account balances. I.R.C. § 401(a)(28)(B) (CCH 1986). As a result, ESOP distributions to participants under age 59½ may not be subject to forward averaging rules. The 10-year forward averaging rules for lump sum distributions from qualified plans have been limited to 5-year forwarding. I.R.C. § 402(e)(1) (C.C.H. 1986). There is also a limit on the number of times forward averaging can be used.

45. TRASOP provisions expired on December 31, 1986. I.R.C. § 41 (CCH 1986). A TRASOP was a type of ESOP created by the Tax Reduction Act of 1975, Pub. L. No. 94-12, § 301(d), 89 Stat. 36 (1975) and the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1525 (1976). A TRASOP was also known as a "tax credit employee stock-ownership plan," defined in I.R.C. §§ 401(a), 409A(a) (CCH 1986). An ESOP had to meet additional requirements to qualify as a TRASOP, particularly vesting and voting right requirements. I.R.C. § 409A(a)(3) (Supp. II 1984) (amended 1986). A single company could have had either an ESOP or a TRASOP, or both.

Congress designed TRASOPs to induce employers to try ESOPs as a type of employee benefit plan. Initially, Congress gave employers the right to claim up to an additional 1.5% investment tax credit by making contributions to a qualified TRASOP. Employer contributions to a qualified TRASOP automatically permitted an employer to increase its investment tax credit from 10% to 11%. The other .5% was added if it was matched by voluntary employee contributions to the TRASOP. I.R.C. § 48(n) (Supp. II 1984) (repealed 1986). In 1983, TRASOPs became based on payroll instead of investment tax credits. An employer's allowable tax credit was based on its contribution to the tax credit employee stock ownership plan. At the time, the tax credit could not exceed .5% of covered payroll. For 1985, 1986, and 1987, it was to have been .75% of covered payroll. Economic Recovery Tax Act of 1981 (ERTA) § 331, 26 U.S.C. § 44G (Supp. V 1981). These were also called PAYSOPS. However, under the 1984 Tax Reform Law, the PAYSOP tax credit was kept at .5%. I.R.C. § 41 (Supp. II 1984).

The preceding definitional discussion has been adapted from and updates Olson, *supra* note 4, at 733 n.2.

46. Of the \$9.9 billion in lost tax revenue used in ESOP tax deductions and credits from 1977 to 1983, 90% was in TRASOP tax credits. GOVERNMENT ACCOUNTING OFFICE, EMPLOYEE STOCK OWNERSHIP PLANS INTERIM REPORT ON A SURVEY AND RELATED ECONOMIC TRENDS 42-43 (1986).

47. *Proposed Tax Changes Ignite ESOP Debate*, 5 LABOR AND INVESTMENT 1, 4-5 (June

First, studies have shown employee owners to be responsible stockholders who are more interested in long-range profitability than in short-term returns.<sup>48</sup> Second, Congress' ESOP tax incentive package is so attractive it seems unlikely that companies would ignore the potential financial benefits of using employee ownership as a vehicle for corporate finance and as an employee incentive plan. Moreover, the ESOP abuses Congress wants to stop are probably perpetrated by those who would refuse to use ESOPs if Congress required that plan participants be given a voice in corporate management. MEOC, for instance, works only with employers who agree to give employees a voice in corporate affairs at least commensurate with their investment in the company. MEOC has found that most companies, when presented with evidence that employees are good stockholders, comport with this requirement. If ESOPs and other economic development tax incentive programs required companies to give employees voting stock with pass through or one vote per person voting rights on all issues, it would help avoid ESOP abuses and foster economic development projects which keep productive capital and jobs in local communities.

#### IV

#### THE MIDWEST EMPLOYEE OWNERSHIP CENTER: FOCUSING THE USE OF EMPLOYEE OWNERSHIP ON LOCAL ECONOMIC DEVELOPMENT

When the Michigan Governor's Office for Job Training first developed its guidelines for allocation of Job Training Partnership Act funds, it decided to distribute the funds among five priority areas, one of which was employee ownership.<sup>49</sup> Staff members from the Michigan Department of Labor ("MDOL") and Michigan Department of Commerce ("MDOC") involved in formulating these priorities met with representatives of labor and business to discuss the creation of a nonprofit organization which could provide education and technical assistance on employee ownership to workers, unions, companies, and communities faced with job loss from plant closings.<sup>50</sup> This group formed the organizing committee which created the Midwest Employee Ownership Center ("MEOC").<sup>51</sup>

Many members of this organizing committee, as representatives of labor, business and government, had helped the United Steelworkers of America ("USWA") prevent McLouth Steel from shutting down in 1982.<sup>52</sup> Partially

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1985); R. JACKALL & H. LEVIN, *WORKER COOPERATIVES IN AMERICA* 245-256 (1984); C. ROSEN, K. KLEIN & K. YOUNG, *supra* note 14, at 6-7, 9-11.

48. C. ROSEN, K. KLEIN & K. YOUNG, *supra* note 14, at 6.

49. Interview with Eugene Paslov, Director, Governor's Office for Job Training (Jan. 1985).

50. I was one of the initial organizers of these meetings and drafted many versions of the policy statement created by the group.

51. *See supra* note 7.

52. *See infra* text accompanying notes 71-75.

due to that experience, the organizing committee felt that a private, nonprofit organization supported by labor and business was essential to create models of employee ownership acceptable to a wide range of parties, to secure funds, to augment government programs, and to seek publicity and projects in order to make employee ownership available in a timely manner.

The organizing committee wanted to use employee ownership only in cases where it made economic sense and did not violate the solidarity of labor. The committee wanted employee ownership to provide employees with fair representation in corporate governance processes. The committee did not oppose the use of employee ownership to avert plant closings, but did not want its use limited to such situations.<sup>53</sup>

MEOC was created and received its first funding in 1984.<sup>54</sup> MEOC's board, which is composed of representatives from labor, business, and government, allows MEOC to play a unique economic development role. A resource center, MEOC has organized and hosted national and regional conferences on employee ownership for unions, employers, bankers, and economic development officials. MEOC works with companies and employee groups at all levels of the economy because it receives project referrals from unions, business owners, local economic development officials, community organizations, and lenders as well as the Michigan Departments of Commerce and Labor. MEOC's community development projects, for example, range from a small, six to ten person start-up employee cooperative to a 120 person buyout of a business from a community organization. MEOC has worked with unions trying to obtain partial employee ownership or execute complete buyouts of both profitable and unprofitable companies employing hundreds of workers, with retiring business owners who wish to sell companies to their employees, and with employers who need cash to capitalize their companies.<sup>55</sup>

MEOC's statement of principles<sup>56</sup> gives it a clear philosophical bottom line on social equity questions. Yet MEOC also has a pragmatic attitude about "sav[ing] and creat[ing] jobs and businesses in [local communities]."<sup>57</sup> MEOC's expertise in the theory and mechanics of cooperatives, ESOPs, cooperative-ESOP combinations, and other types of worker participation and employee benefit plans reflects and demonstrates its pragmatism. MEOC's staff and retained consultants have a diverse range of skills and experience, including labor and corporate law, politics, business ownership and management, commercial lending, newspaper reporting, teaching, and low-income community organizing. As a result, MEOC's staff and consultants have varying attitudes and philosophies about employee ownership which enable MEOC to deal with different kinds of clients. MEOC is able to offer practical business

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53. See *supra* note 8.

54. MEOC is currently supported by federal, state, and foundation sources and by fees for service.

55. See *infra* text accompanying notes 62-100.

56. See *supra* note 8.

57. *Id.*

advice to more idealistic clients and can persuade no-nonsense business clients to accept strong worker participation systems as a part of employee ownership plans.

## V

THE USE OF EMPLOYEE OWNERSHIP IN A WIDE RANGE OF  
CIRCUMSTANCES DEMONSTRATES THAT IT HELPS  
ANCHOR LOCAL CAPITAL AND JOBS

The following examples of employee ownership projects, many of which have received assistance from MEOC or some of its staff or consultants as private consultants, demonstrate that employee ownership is a flexible economic development tool. For instance, a cooperative may provide the best structure for a small start-up company which does not initially need tax shelters and cannot afford the administrative expense of an ESOP.<sup>58</sup> In another situation, an ESOP may be the most appropriate means for employees to save their jobs and company while giving a parent company desirable tax incentives.<sup>59</sup> And a coop-ESOP may be the best tool for unionized employees to purchase and obtain control of a profitable subsidiary.<sup>60</sup> The examples also show that employee ownership is one of the most effective ways to anchor productive capital and jobs in a community.

In a number of the projects described below, employee ownership is not the ultimate outcome. In some of these projects, the ultimate outcome is not yet known. But in each case, efforts to obtain employee ownership have succeeded in creating or saving jobs, or returning jobs to the people who previously held them. Though some officials, who spend their economic development dollars on the creation of new "Silicon Valleys" may not appreciate this aspect of economic development, it is critical to those communities whose livelihood depends on the struggling low-technology industries which form the bedrock of the United States economy.<sup>61</sup>

From the viewpoint of employee ownership purists, many of these projects are not successful because they did not bring about actual employee ownership or because employee ownership did not give employees complete control. Yet if employee ownership is viewed as a tool of economic survival, most of these projects are successful since they have helped struggling workers keep their jobs.

Employee ownership is only one valuable tool people can use to fight for economic justice and survival. To use it successfully one must be realistic about its limits, its varied uses, and the extent to which people are interested in

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58. See Franklin Forge, *infra* text accompanying notes 65-70; Southwest Detroit Construction Cooperative, *infra* text accompanying notes 78-79; Coop Print Shop, *infra* text accompanying notes 80-81.

59. See Eberhard Foods, *infra* text accompanying notes 88-100.

60. See *supra* note 59; Republic Container, *infra* text accompanying notes 62-64.

61. See AFL-CIO COMMITTEE ON THE EVOLUTION OF WORK, THE FUTURE OF WORK 7-13 (1983).

ownership and control of the workplace. For those employees who are willing to assume its responsibilities, employee ownership offers a practical means for asserting control over their economic futures.

*A. Corporate Divestiture of a Profitable Company: One Of the Best Opportunities For a Worker Buyout*

*1. Republic Container*<sup>62</sup>

LTV Steel Corporation's divestiture of its profitable subsidiary, Republic Container,<sup>63</sup> presented Republic Container's employees with an ideal opportunity to buy the company and prevent job loss. Mike Cable, President of the United Steelworkers of America ("USWA") Local 5712, recognized this opportunity and aggressively led a worker buyout effort. As a result, the employees out-bid and out-maneuvered competitors who sought to buy the business.

In 1985, LTV Steel decided to sell all the companies in its manufacturing division. Many of these companies, including Republic Container, were profitable and had been captive markets for LTV's steel. Unlike many companies acquired by their employees,<sup>64</sup> Republic Container was not threatened with bankruptcy. During its twenty-seven years of operation, Republic Container turned a regular profit making steel barrels for Union Carbide, Dupont, Monsanto, and other customers.

After learning that LTV Steel was seeking a buyer for Republic Container, the local president of the USWA sought information on the sale and competing offers, made the union's interest in the sale known, and organized the employees to form a buyout association. All Republic Container employees, including nonunion workers and the plant's general manager, became members of the buyout association. The State of West Virginia granted \$30,000 to the buyout association for consultants to study the feasibility of the employee buyout plan. When the consultants advised that the buyout could succeed, the association then obtained a \$61,000 grant from Kanawha County to pay the lawyers, business consultants, and appraisers needed to implement the buyout. The association retained me as counsel and Chuck Jacobs, as business consultant, to represent them in negotiations with LTV Steel and the lenders and help structure the deal. I also assisted the union and employees establish the buyout association as an entity which involved all employees in decisions about the structure of the ESOP, the new corporation, and the revisions in their compensation package.

In September, 1985, sixty-six Republic Container employees purchased

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62. The facts of the following discussion are drawn from my involvement in the transaction.

63. Situated in Nitro, West Virginia, Republic Container is and has been a producer of fifty-five gallon drums used largely by the chemical industry.

64. Companies acquired by their employees when threatened with bankruptcy include Hyatt-Clark Industries and Rath Packing.

the company from LTV Steel. The purchase was accomplished through the use of an employee stock ownership plan which holds all the stock of the company in a trust for the employees. Stock gives the employees two benefits: voting rights and money rights. Employees are entitled to vote in the election of the company's board of directors and on other matters resolved through voting. When employees retire, they are paid the value of their shares.

Republic Container is a new kind of ESOP that gives each employee one vote. By creating two classes of stock, voting and nonvoting, only one share of voting stock, with a value set at \$1 per share, is allocated to each employee. 3000 shares of nonvoting stock, with an initial 1985 appraised value of about \$475.00 per share, are gradually being allocated to the employees' ESOP accounts over the next seven years. The amount of nonvoting stock an employee receives is based on annual wages not exceeding \$20,000 per year. The value of an employee's ESOP stock, however, depends on the fortunes of the company. If Republic Container prospers, the value of the stock is likely to increase. If the company falters, retiring employees may find that the shares in their account are worth less than they had anticipated. At the end of 1986, the typical employee's vested ESOP account was worth approximately \$3,000.

Republic Container employees did not have to make any out-of-pocket payments as part of the purchase or put up personal property as collateral for the loans used to purchase the company. Republic Container was sold for \$1,424,000, an amount raised by two loans: \$924,000 from the National Bank of Commerce and \$500,000 from the West Virginia Economic Development Authority. The Bank of Nitro lent the new company an additional \$600,000 for working capital. The loans are to be repaid out of company profits over the next seven years.

As part of the buyout, employees agreed to take a one-year wage adjustment of \$1.25 per hour. Union wages after the cut ranged from \$9.20 to \$11.60 per hour. Wages will rise, under the union contract, an average of 42.5 cents per hour each year over the next four years.

In January, 1986, Republic Container employees elected their first board of directors. The board has final authority to operate Republic Container and to hire and fire employees, including management employees. Due to a compromise reached prior to closing the buyout sale, voting and nonvoting directorships were allotted to certain groups. Among the five voting directors, one represents the lenders, one represents management, and one is a member of the USWA. The only restriction on the other two voting directors is that they cannot be employees of Republic Container. The one nonvoting director must be a member of the USWA.

During its first four months of operation after the buyout, Republic Container cleared a \$78,000 profit, higher than that originally projected. The company also paid off, on schedule, \$64,000 it owed to lenders.

In sum, the purchase of Republic Container by its own employees demonstrates that an organized and knowledgeable union can successfully



purchase a profitable company. Relying on Republic Container's solid financial history, ESOP financial incentives, and a carefully tailored employee stock ownership plan, the employees persuaded lenders to support them. Consequently, Republic Container jobs and profits remain anchored in Nitro, West Virginia.

*B. Corporate Divestiture of an Unprofitable Subsidiary: A Worker Coop Organized to Avert a Plant Closing*

*1. Franklin Forge*<sup>65</sup>

Unprofitable subsidiaries are often offered for sale to employees. Employees should approach such opportunities with care and predicate their actions on feasibility studies conducted by skilled consultants who know when to say "no" to a bad deal. The feasibility and success of the Franklin Forge worker buyout depended on a number of factors including the strength and skill of both the workers and management, the community's need for the plant, the fact that the workers initiated the buyout, and the parent corporation's motivation to sell at a low price and make the deal work.

Located in West Branch, Michigan, Franklin Forge was a subsidiary of Capitol Manufacturing, a company in the oil field equipment business. Franklin was and continues to be one of Capitol's suppliers. During most of the years it was owned by Capitol, Franklin lost money. These losses resulted mainly from Capitol's cost structure and lack of experience in the forging business. Yet because Capitol was quite profitable prior to 1982, Franklin's losses did not become important to Capitol until 1983 and 1984.

In early 1984, Franklin Forge employees sensed that the company's continuing losses threatened their future. The union, International United Automobile, Aerospace and Agricultural Implement Workers of America ("UAW") Local 1874, organized a jobs committee to explore how they could save their jobs. After investigating Franklin's financial condition, the employees determined that purchasing the company was the best way to protect themselves.

At the same time, Harsco Corporation, which owned Capitol Manufacturing, decided to sell Franklin due to the increasing significance of Franklin's losses. Harsco could not close Franklin without a buyer because it had a take-or-pay contract with the gas utility that ran a gas line to Franklin. Since the contract was in effect for at least another year and no other buyer seemed interested in the less than desirable West Branch manufacturing location, Harsco knew that the employee's offer was the best it would get.

The employee effort to buy Franklin began in earnest when UAW International Representative Jack Laskowski sought assistance from MEOC and its general counsel. The employees subsequently formed a buyout association,

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65. The facts of the following discussion are drawn from my involvement in the transaction.

retained me as counsel, and commissioned a feasibility study. The employees recognized that they needed strong management to make Franklin profitable and asked the company's former manager to be the plant's new manager and chief executive officer. He had managed the plant for several years, was well-acquainted with the forging business, and was well-respected by local businesses and lenders.

Franklin's recent losses made it difficult to raise the money to finance the buyout. Union members made numerous calls to lenders and worked hard to raise funds from employees and various government bodies. The perseverance and positive attitude of the buyout association impressed the lenders. The National Bank of Detroit ("NBD"), for example, became involved in finding other lenders to join it in financing the deal.

In addition to raising money, the buyout association worked hard to educate themselves and the community on the concept of employee ownership. Aided by MEOC, the association developed its own employee ownership education program. As a part of this program, the Industrial Cooperative Association ("ICA"),<sup>66</sup> MEOC, the NBD, and the Michigan Department of Labor led education sessions attended by those involved in the buyout and interested community members.

As a result of the buyout association's efforts, Franklin Forge is now a worker cooperative. Each worker owns one voting membership share and a proportionate share of capital in the company's internal equity accounts. The workers were able to purchase their membership shares, which initially cost \$5000, with loans primarily from the Industrial Cooperative Association Revolving Loan Fund and the Farmers and Merchants Bank of Hale. These loans required downpayments of \$250 and payments of \$1 per working hour for three years to settle the \$4,750 balance. Other lenders whose help was essential to finance the buyout included the State of Michigan, Ogemaw County, the National Bank of Detroit, the seller, and Franklin's chief executive officer. In the fall of 1986, employees invested an additional \$2,000 each to cover working capital costs caused by a rapid increase in business.

Although Franklin Forge sustained heavy losses in its first year of operation as a cooperative, its sales are currently increasing at a higher rate than anticipated.<sup>67</sup> Franklin, in fact, expects to become profitable in 1987.<sup>68</sup> Even more impressive than Franklin's move towards profitability is the number of jobs the buyout has created. In 1984, when the employees first contemplated a buyout, Franklin employed twenty people and had eighty-two on a seniority list.<sup>69</sup> At the time of the buyout, management projected that Franklin would employ thirty-eight workers by the end of the first full year of operation. Af-

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66. Based in Somerville, Massachusetts, ICA provides technical assistance on employee ownership nationwide.

67. Telephone interview with the President and Chief Executive Officer of Franklin Forge (Feb. 11, 1986).

68. *Id.*

69. A seniority list is an agreement, usually with a union, to take (with some outside limi-

ter six months of operation, Franklin already had thirty-eight employees and by the end of twelve months, it employed fifty-four people. By December of 1986, Franklin employed sixty-eight people.<sup>70</sup>

*C. The Use Of Partial Employee Ownership To Avert Plant Closings: Out Of the Teeth Of Bankruptcy*

*1. McLouth Steel*

In December, 1981, McLouth Steel Corporation, located in Trenton and Gibraltar, Michigan, an area downriver from Detroit, filed for protection from its creditors under Chapter 11 of the Bankruptcy Code. McLouth, a steel manufacturer with over 2,000 employees, soon faced a situation which threatened even its short-term survival. A bankruptcy court ruling had given McLouth's secured creditors the right to close the company at virtually any time.<sup>71</sup>

In response, the union representing McLouth's employees, the United Steelworkers of America ("USWA"), took extraordinary actions to keep McLouth open. The USWA enlisted the support of the local political leaders of the downriver communities as well as the area's state and congressional representatives. The union also organized a march in Washington, D.C., using local high school bands, as part of its campaign to obtain federal assistance.<sup>72</sup>

At the same time, however, the secured creditors were unable to find a buyer for the company despite a worldwide search conducted by Lazard Freres. Confronted with the impending closing of the plant, the International Union's District Director became interested in the idea of employee ownership as a vehicle to save the facility and the employees' jobs. With funds voluntarily donated by McLouth's employees and major suppliers, consultants studied the feasibility of an employee buyout. Although the consultants determined that an employee buyout was feasible, the sellers decided not to pursue this alternative after Chicago industrialist Cyrus Tang expressed interest in purchasing the plant.<sup>73</sup>

Tang reached an agreement with the company and its secured creditors to purchase McLouth's steelmaking assets for \$60 million with mostly notes and income debentures. Tang also agreed to make a capital infusion of \$15 million, \$10 million of which was a subordinated loan from Tang. In addition, after over three months of intense negotiations, Tang and the USWA agreed to a labor contract under which USWA members obtained a 15% ownership in-

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tations) certain actions including, but not limited to, rehiring laid-off workers by dates of original hire.

70. Interview with George Andros, Representative, International United Automobile, Aerospace and Agricultural Implement Workers of America (Mar. 5, 1987).

71. *In re* McLouth Steel Corp., 20 Bankr. 688 (Bankr. E.D. Mich. 1982).

72. Telephone interview with Harry Lester, Director, District 29, United Steelworkers of America (Mar. 1986).

73. *Id.*

terest and a 15% profit sharing plan.<sup>74</sup>

While the new company, McLouth Steel Products Corporation, was profitable in its first year of operation, worsening conditions in the United States' steel industry have jeopardized the company's future. In February, 1987, the State of Michigan, McLouth, and the USWA engaged Touche Ross & Company to study whether the company's operations could be successfully restructured.<sup>75</sup>

## 2. *Wickes Engineered Materials — U.S. Graphite*<sup>76</sup>

During the summer of 1983, the Wickes Corporation was in the midst of bankruptcy proceedings. Wickes Engineered Materials, manufacturers of mechanical carbon products for highly sensitive military and industrial uses, was one of the companies Wickes wished to either sell as a going concern or liquidate. Representative employees, the local UAW, the City of Saginaw, and Saginaw County economic development representatives, took the initiative themselves and hired consultants to work on finding investors and buyers.

The consultants considered the possibility of putting together an employee buyout but decided that finding another buyer would be preferable. The consultants focused their efforts on seeking another buyer because the employees did not want the responsibility of being majority owners.

Initially, none of the potential buyers found by the consultants made an acceptable bid for the plant. However, before the bankruptcy was final, a group of investors was organized. These investors worked out a plan to give the employees a 20% ownership interest in the new company, U.S. Graphite. The employees were also given stock options for another 15% of the stock.

The buyout was completed in 1984. U.S. Graphite is currently operating successfully with its complement of 223 employees.

## 3. *Summary: Partial Employee Ownership*

Whether or not employee ownership of a minority interest gives employees a strong voice in the company depends on how the rest of the stock is split. At McLouth Steel, the employees are not likely to ever have a strong voice as stockholders because their ownership is limited to 15%. In the case of U.S. Graphite, the employees own 20% of a company controlled by several other major owners. At some future time, they may obtain an additional 15% of U.S. Graphite's stock.

Until employees gain control of a company, partial employee ownership can be disillusioning to employees with high expectations. For instance, the status of management and employee relations usually remains unchanged.<sup>77</sup>

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74. *Id.*

75. *Id.*

76. I was one of those hired as counsel to the Wickes Engineered Materials Employee Buyout Association.

77. C. ROSEN, K. KLEIN & K. YOUNG, *supra* note 14, at 6-11, 90-93.

To maintain and boost morale, wise managers should implement programs, (such as semi-autonomous work groups), even in companies only partially owned by the employees, which allow workers to participate in management decision making.

#### *D. Low Income Community Business Start-Ups*

##### *I. Weatherization and Retrofit Maintenance — Southwest Detroit Construction Cooperative<sup>78</sup>*

In 1981, a nonprofit corporation called Weatherization and Retrofit Maintenance ("WARM") was formed in a low-income, multi-racial neighborhood in southwest Detroit. Directed by a board composed primarily of representatives from church and community organizations, WARM intended to provide both low-cost, energy-saving home repairs to low-income homeowners, and job training to unemployed area residents.

After WARM's first year of operation, its staff and trainees decided that the trainees should form a cooperative to do the actual construction work. They believed that such a cooperative would allow the trainees to become self-sufficient business owners and permit WARM to concentrate on job training and business development.

The trainees formed the Southwest Detroit Construction Cooperative ("SWDCC"). SWDCC's membership fee is \$1000 and each member has one vote. With a downpayment of \$50, a person can obtain a provisional membership which includes full voting rights. Payroll deductions are used to pay off the remaining \$950. However, only those who have paid the full membership fee are entitled to a share of the equity distributions.

To help the trainees assume the responsibilities of running the cooperative, the WARM staff worked with a small group of trainees for two years. Together, they reviewed and adopted the cooperative's bylaws, which I drafted. With the assistance of the Industrial Cooperative Association and the Congress for a Working America,<sup>79</sup> they developed a business plan. The WARM staff also assisted the trainees with management, bidding, and construction skills. During these two years, while one coop member studied to become a licensed builder, the other members continued to work as employees on WARM's construction contracts.

Now that the coop has a licensed builder, MEOC is helping it sever its current relationship with WARM and define their future contractual relationship. Although the coop may continue to share WARM's office space and contract its bookkeeping services, the coop is to be run as an independent entity.

MEOC is also helping WARM continue its effort to develop jobs and

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78. The facts of the following discussion are drawn from my involvement in the transaction.

79. Congress for a Working America is a nonprofit organization which aids local communities save jobs. It has chapters in New York City and Milwaukee.

businesses. In contrast to MEOC, which, as a regional technical and educational assistance center, provides legal and business analysis, technical back-up assistance, and educational information, WARM is a neighborhood-based agency which uses its local contacts to determine market openings for small businesses and find prospective cooperative participants. WARM provides start-up projects in low-income communities with basic organizational, management, and production skills. In management or union-organized projects, such skills are usually already present. For business start-ups in low-income neighborhoods, a neighborhood development agency like WARM is essential.

## 2. *Madison Square Cooperative — Coop Print Shop*<sup>80</sup>

Madison Square Cooperative is a community economic development organization which was organized in a largely black, low-income neighborhood in Grand Rapids, Michigan. Since its founding in 1979, Madison Square has successfully developed low-income cooperative housing, the income from which Madison is using to develop jobs and businesses.

Madison Square began a construction cooperative much like the one WARM organized. The cooperative failed, however, because Madison Square's skilled builder could not single-handedly teach the trainees construction skills, supervise the actual construction work, and manage the cooperative's finances. Based on that experience, Madison Square has begun developing a printing cooperative to which it is dedicating more management, training, and marketing assistance than it was able to give the construction cooperative.

In creating Coop Print Shop, for whom MEOC will provide subsidized legal and financial technical assistance, Madison Square is acting as a kind of "social entrepreneur." After finding trainees interested in joining the cooperative and obtaining training, Madison Square exercises its influence with suppliers to obtain materials at favorable rates, co-signs loans for equipment, and uses its community ties to find customers for the new business. Madison Square is also managing the cooperative's bookkeeping functions until the coop is on firm footing. Furthermore, Madison Square has obtained job training funds in order to subsidize the on-the-job training it has arranged for the cooperative. Subsidized on-the-job training will permit the cooperative to meet its initial start-up costs while enabling workers, who will receive wages of \$10 per hour, to make their membership share downpayments.

It is too soon to know if this "incubator" model will succeed in establishing a fully independent printing company. What is significant about this model, is that it evolved from an attempt to create a new employee-owned company without proper support and guidance. To permanently solve the problem of chronic neighborhood unemployment, Madison Square is now devoting considerable time and resources to train coop members to first be work-

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80. The facts of the following discussion are drawn from my involvement in the transaction.

ers and then owners. This "incubator" model is also being strongly promoted by the Center for Community Services ("CSS") in New York.<sup>81</sup> However, CSS, an endowed organization, has more resources to invest in such projects than does a poor people's organization such as Madison Square. Thus, it is interesting that both have reached the same conclusion about what a start-up worker cooperative in a low-income community needs.

### 3. *Focus Hope — Cycle Tec*<sup>82</sup>

Focus Hope is a civil rights organization which was established in Detroit in the early 1960s. Based in a predominantly black, working-class, and low-income neighborhood, Focus Hope runs a variety of community service and self-help programs, including maternal and infant health programs, infant feeding programs, food programs for the elderly, and youth employment and job training programs.

In 1980, Focus Hope discovered that Excello Corporation was moving out of a production facility near Focus Hope's headquarters. Father William Cunningham, Focus Hope's Executive Director, persuaded Excello to give Focus Hope the building. The machinists training program run by Focus Hope occupied one-third of the building, but to cover utility costs in the winter Focus Hope needed to find a tenant for the other two-thirds of the building. Focus Hope learned that General Motors ("GM") was looking for a domestic company that could handle warranty work rebuilding transmissions. GM was uncertain as to whether a domestic company could do this kind of work at affordable rates, but Father Cunningham convinced GM Chairman Roger Smith to use Focus Hope's new facility and hire local community people as workers. The domestic company GM was looking for is now called Cycle Tec.

Cycle Tec is one of four companies owned by Motor City Minority Development, Inc. ("MCMD"), a wholly-owned, for-profit subsidiary of Focus Hope. Cycle Tec, which is the first and most developed of these four ventures, presently employs 120 previously unemployed minority men and a few women. Most of these people are trained to disassemble and rebuild transmissions at Cycle Tec. Their wages range from \$4.00 to \$6.50 per hour.

Cycle Tec has thus far been quite successful. As of July, 1985, Cycle Tec's annual sales were \$4 million and in September, 1985, its annual sales reached \$6 million. However, Cycle Tec is still run primarily by outside staff. Two Focus Hope staff members act as Cycle Tec's general manager and finance manager while GM staff constitutes its engineering management.

Focus Hope's goal is that Cycle Tec will eventually be owned and man-

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81. R. Surpin, *Enterprise Development and Worker Ownership: A Strategy for Community Economic Development* (1984) (unpublished manuscript) (on file with the New York University Review of Law & Social Change).

82. The facts of the following discussion are drawn from my involvement in the transaction.

aged by members of minority groups, that it will stay in the community, and that it will not become the basis for enriching a few managers at the expense of the workers. Focus Hope believes Cycle Tec's future minority management should be adequately rewarded but not be allowed to enrich themselves at the expense of the company or of the community. Focus Hope has devised a formula to achieve these goals that gives MCMD 34% of the stock, the management 33%, and the employees 33%. The employees' share will gradually increase (to 40 or 60%) as their stake in the company and knowledge about its operations grow. A 67% vote is necessary to fix or to change management compensation.

MEOC consultants worked with Focus Hope's staff and corporate counsel to develop the mechanics of this model. Focus Hope may use an ESOP to execute the formula's design. Focus Hope wants the ESOP to be one in which the employees buy stock, not one in which free stock contributions are made, because Focus Hope's philosophy is that people value things they have paid for much more than things given to them.

*E. Union Survival Strategies: Employee Ownership Efforts With Positive Results Even Where No Employee Buyout Occurs*

*1. Overview*

In contrast with the circumstances at McLouth Steel<sup>83</sup> and U.S. Graphite,<sup>84</sup> where employee ownership was used to protect jobs and companies from bankruptcy, the Federal Forge and Eberhard Foods cases discussed below show how unions used employee ownership efforts or rights to defend themselves from potentially antagonistic new owners. Federal Forge and Eberhard Foods show that even the pursuit of employee ownership can help unions survive in situations that might normally result in their demise.

*2. Federal Forge<sup>85</sup>*

In 1984, Federal Forge was a subsidiary of Walco National and employed 300 workers in its Lansing, Michigan plant. That year, the UAW Local 724 learned from Walco's annual report that Walco planned to sell all its metal forming plants. Concerned, the union's unit bargaining committee and their UAW International Representative came to a MEOC union conference interested in a possible employee buyout.

The union's uneasiness stemmed from its belief that sale of the forge plants, particularly to the chief executive of the Walco Metal Forming Group, would result in the closing of Federal Forge. It feared that either Walco, in preparation for the sale, or the new buyer, would consolidate the Lansing operation with an out-of-state plant and move all 300 jobs to another state where

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83. See *supra* text accompanying notes 72-75.

84. See *supra* text accompanying notes 76-77.

85. The facts of the following discussion are drawn from my involvement in the transaction.



the labor rate was \$4.00 less per hour.<sup>86</sup> In part, the union based its apprehension on Walco's past actions. For example, Walco had recently closed Federal's sister plant in Lansing and refused to rehire the laid-off workers at Federal. As a result, many long-time employees were denied their full pension benefits. In addition, when union representatives, both Walco stockholders, attended a stockholders' meeting to inquire about the impending sale, the meeting was adjourned as soon as they entered the room.<sup>87</sup>

With MEOC's assistance, the employees formed a buyout association that included members of the union bargaining committee and some local plant managers. The buyout association commissioned consultants to conduct a feasibility study and made Walco an offer to purchase the facility. Walco insisted that the offer be one to purchase stock because it was interested in finding a buyer who would take over substantial pension and potential legal liabilities. When the buyout association offered to purchase the stock, Walco rejected and refused to counteroffer what it considered a low bid.

In January, 1985, while the buyout negotiations continued, the union contract expired. Walco imposed unilateral cuts in pay and benefits in March, leading the union to authorize a strike. During the tense negotiations that followed, the union requested a first right of refusal to buy Federal should it be put up for sale. The negotiations were put on hold, however, when Industrial General offered to buy Walco National. Industrial General was not interested in using an employee buyout of Federal as part of its financing package.

The buyout association began to reassess its plan to purchase Federal. Since 1984, Federal's sales had fallen precipitously. A consultant reexamined the feasibility of a buyout and concluded that unless Federal generated an additional \$10 million of sales, the forge was not worth buying even though its facilities and equipment were in good condition.

Then, in September, 1985, the union was approached by an investor group with a strong background in forge management. The investor group, which had previously turned around an unprofitable forge company, expressed interest in working with the employee buyout association to purchase Federal Forge. The investor group had access to \$15 million worth of business it wanted to bring to the Federal facility.

Negotiations reopened between the buyout association, which now also represented its management partners, and Industrial General. The association made a more artfully crafted version of its original offer. Although it was rejected, Industrial left the door open for counteroffering. What remains a subject of disagreement is whether the buyer or the seller should bear the burden of contingent pension and legal liabilities. The employee group's financial advisor believes that the employees should not increase their offer to cover the gap because they could not afford the debt service unless the investor group

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86. Interview with James Kissane, Representative, International United Automobile, Aerospace and Agricultural Implement Workers of America (Oct. 1984).

87. *Id.*

could bring in cash and a guarantee of the increased business. To date, the investor partner has not offered to invest cash.

Since negotiations were reopened, Industrial General has begun to take a new interest in Federal Forge. In December, 1985, Industrial General announced that it planned to invest \$1 million in Federal Forge in the next year. Furthermore, the new 1986 union contract gave the union a first right of refusal to buy Federal Forge if Industrial General decides to sell.

By developing an employee buyout strategy to supplement traditional collective bargaining, the union was able to prevent its jobs from being moved out of state. The union still hopes that either under better leadership from Industrial General, inspired by the interest of competitors in the plant, or under a partnership between the employee buyout association and the investor group, Federal Forge will be restored to its full capacity.

### 3. *Eberhard Foods*

Eberhard Food Stores is a supermarket chain located in Western Michigan that employs 600 people. In 1980, L.V. Eberhard, Eberhard Food Stores' eighty-year old chief stockholder, ended his employees' pension plan and created an employee stock ownership plan.<sup>88</sup> The employees' union, United Food and Commercial Workers Local 951, had successfully opposed such proposals in three previous contract negotiations by striking. In 1980, however, the union did not make an issue out of the proposal because it feared a strike would shut the company down.<sup>89</sup>

The ESOP was unpopular with the union because it did not give employees any voting rights until after they retired.<sup>90</sup> Instead, a trustee appointed by the board of directors, which Mr. Eberhard controlled, voted all the ESOP's stock.<sup>91</sup>

By 1984, the ESOP was obtaining a majority share of the company.<sup>92</sup> Mr. Eberhard split the company's stock in an apparent effort to retain control.<sup>93</sup> This maneuver gave each ESOP participant one share of voting and one share of nonvoting stock for each share of voting common stock in the plan.<sup>94</sup>

In response, the ESOP participants and the union sued the company on numerous theories including breach of fiduciary duties, prohibited transactions, and common law fraud because the employees, as beneficial owners of

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88. Telephone interviews with Michael McMillan, Recorder, United Food and Commercial Workers Local 951 (Oct. 13, 1986, Dec. 23, 1986, and periodically from 1984-1986) [hereinafter Interviews with McMillan].

89. *Id.*

90. *Id.*

91. Employee Stock Ownership Plan of Eberhard Foods, Inc. §§ 2.37, 10.2, 10.8 (1980 Restatement) (on file with the New York University Review of Law & Social Change).

92. Interviews with McMillan, *supra* note 88.

93. Letter from Eberhard Foods, Inc. to Employees (Oct. 22, 1984) (on file with the New York University Review of Law & Social Change).

94. *Id.*

the stock, were not informed prior to the stock split nor allowed any voice or vote regarding the stock split.<sup>95</sup>

Although the employees' ESOP does not give the employees the right to vote their stock on most issues, it has given them power in two ways. First, the ESOP has given the union members standing in court to sue the company as ESOP participants over basic corporate reorganization issues. Second, because the employees were able to maintain the lawsuit, which has created tremendous potential liabilities, the union has been able to deter prospective parties from buying Eberhard Foods and reopening the stores as nonunion facilities. To employees and unions in the grocery business, the threat of a buyout by nonunion operators is real: such buyouts have occurred before.<sup>96</sup>

Late in 1986, the union entered into a one-year contract with Eberhard<sup>97</sup> and on December 1, 1986, agreed to settle the lawsuit on the following basis:<sup>98</sup> 1) the ESOP's original stock structure is to be restored, which will eliminate the nonvoting shares; and 2) the current employees and ESOP participants, (the majority of whom are union members), will have the right to vote on any sale of the business as a whole or any significant liquidation of assets, including sales of individual stores.

This settlement gives the employees control over the future disposition of Eberhard Foods — a form of job security that is virtually unheard of in conventional collective bargaining. Thus, even a bad ESOP can be used by a union to keep a company from closing a facility and reopening it as nonunion. By using their ERISA rights<sup>99</sup> and the leverage of the new tax law,<sup>100</sup> these employees saved their jobs.

95. Local 951, United Food & Commercial Workers International Union v. Eberhard Foods Corporation, No. 85-963 (W.D. Mich. filed Oct. 7, 1985).

96. Kroger sold six unionized stores in Flint, Michigan to Kessel, which reopened them as nonunion. Kroger also sold twenty Detroit area stores to Foodland, which reopened them as nonunion. Telephone interview with Michael McMillan, Recorder, United Food and Commercial Workers Local 951 (Mar. 1, 1987).

97. See Interviews with McMillan, *supra* note 88.

98. *Id.*

99. I.R.C. § 409 (Supp. II 1984 & CCH 1986); 29 U.S.C. §§ 1021-1053, 1101-1145 (1982, Supp. II 1984 & Supp. III 1985). In their lawsuit against the company, the employees claimed that, pursuant to MICH. COMP. LAWS ANN. § 450.1615 (West 1973), they had the right to vote on the stock split which gave each ESOP participant one share of voting and one share of nonvoting stock for each share of voting common stock. The employees accused L.V. Eberhard, the ESOP's administrator, of violating his fiduciary duty under ERISA, 29 U.S.C. § 1104 (1982), when he engaged in the stock split without notifying the employees. They also alleged that the ESOP trustee, the National Bank of Detroit, had breached its fiduciary duty under ERISA, 29 U.S.C. § 1104 (1982), by consenting to or acquiescing in the board of directors' actions. Local 951, United Food & Commercial Workers International Union v. Eberhard Foods Corporation, No. 85-963 (W.D. Mich. filed Oct. 7, 1985).

The lawsuit apparently caused enough concern among the defendants that they agreed to settle the case on terms favorable to the unionized employees.

100. See *supra* notes 4, 5.

## VI

CONCLUSION: MICHIGAN'S 1986 EMPLOYEE OWNERSHIP  
LEGISLATION — A STEP IN THE RIGHT DIRECTION

In 1979, Michigan adopted legislation<sup>101</sup> authorizing the Michigan Department of Labor ("MDOL"), with assistance from the Michigan Department of Commerce ("MDOC"), to provide information and technical assistance to aid in the development of employee owned-companies. Because this law was seen as an alternative to plant-closing legislation, no funding was provided for its implementation. Nonetheless, Jim Houck, a staff member of the MDOL Industrial Training Division, was assigned to administer the legislation. Houck and his colleagues accumulated a library of materials and a list of professional resources. They provided information and assistance to those interested in employee ownership.<sup>102</sup>

Michigan's 1979 legislation, which endorsed the use of employee ownership, expired in 1985.<sup>103</sup> However, due to the increased interest in employee ownership during that six-year period and recommendations made by the MDOL, MDOC, and MEOC staff and consultants, which they gleaned from their experience with some of the employee ownership projects discussed above, a series of new employee ownership bills proposed by Representative Perry Bullard became effective in October, 1986.<sup>104</sup> The new legislation requires a more participatory definition of employee ownership to obtain the benefit of Michigan's programs than that required by federal law for lucrative ESOP tax deductions and credits.

The 1986 legislation continues to provide the education and technical assistance provided under the 1979 legislation. More importantly, the 1986 legislation defines an employee-owned corporation as "a business operation that is controlled by, and designed to maintain control by, its employees, and in which control is distributed among its employees according to a democratic formula . . . ."<sup>105</sup> The legislation gives a more precise definition of employee

101. MICH. COMP. LAWS ANN. § 450.751-.759 (West Supp. 1979).

102. Houck, *Employee Ownership in Michigan: The Emerging Role of the State*, 22 INDUS. & LAB. REL. REV. 15, 16 (1985).

103. MICH. COMP. LAWS ANN. § 450.751-.759 (West Supp. 1979).

104. *See supra* note 9.

105. MICH. COMP. LAWS ANN. § 450.732(2)(c) (West Supp. 1986). To fall under this definition of an employee-owned corporation, the business must be one of the following:

(i) a business operation the management rights of which are represented by voting stock that may be owned only by: employees of the operation, a nonprofit community development corporation, or an employee-owned stock ownership plan in which not less than 50% of the employees participate in each portion of the plan. The operation shall be controlled by a board of directors which is selected by the shareholders on the basis of 1 vote per shareholder or on the basis of 1 vote per share;

(ii) a corporation operating pursuant to a cooperative plan as described in section 99 of Act No. 327 of the Public Acts of 1931, being section 450.99 of the Michigan Compiled Laws;

(iii) a business operation in which not less than 3/4 of each class of voting security is owned by an employee stock ownership trust set up under an employee stock owner-

ownership that encourages employee voting participation. It also allows for a broad range of financing arrangements<sup>106</sup> and forms of business organization;<sup>107</sup> provides for a revolving loan fund for feasibility studies, for working capital or for fixed asset loans to employee-owned companies;<sup>108</sup> and empowers economic development corporations and industrial development commissions to use their bonding authority to provide financing for employee-owned companies as defined in the statute.<sup>109</sup> Furthermore, Michigan has not limited the use of its financial assistance in this area to plant closing situations. Legislators consulted with MDOL, MDOC, and MEOC staff and consultants, who are aware of the types of situations in which employee ownership can be used to anchor capital and jobs in local communities.

To increase the positive uses of employee ownership and to guarantee more community control over companies, all government bodies — federal, state, and local — should consider using Michigan's definition of acceptable employee ownership and putting employee ownership requirements on many, if not all, economic development financing mechanisms. This strategy would alleviate the problems that presently beset employee ownership legislation and traditional economic development financing programs. Legislators should also consider providing technical assistance to employee ownership projects designed to keep businesses locally controlled.

Although it is too soon to know the results of the 1986 Michigan legislation, I believe that to anchor capital and jobs in local communities, significant employee control over major investment and divestment decisions in companies must be a precondition for economic aid. In the alternative, governmental bodies should provide for tight regulations over ESOP voting rights, except for those that have been bargained collectively between the company and a union or an independent employee association, to guarantee that employees who give up voting rights in order to save jobs will get something in return for enabling the employer to partake of lucrative tax incentives.

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ship plan as defined in the internal revenue code, 26 U.S.C. § 4975(e)(7), if that employee stock ownership plan requires pass-through of all voting rights possessed by voting securities as the securities are allocated to accounts of individual participants;

(iv) a worker cooperative;

(v) an industrial cooperative.

If a business operation adopts a plan by which it will become under this section an employee-owned corporation within 5 years after the adoption of the plan, it shall be considered an employee-owned corporation.

*Id.*

106. See *infra* notes 108, 109.

107. MICH. COMP. LAWS ANN. § 450.732(2)(c) (West Supp. 1986).

108. MICH. COMP. LAWS ANN. § 450.804 (West Supp. 1986).

109. MICH. COMP. LAWS ANN. §§ 125.1602, 125.1603 (West Supp. 1986).



## RESPONSE

BOB BAUGH:\* Corey has mentioned before that, outside of winning a lottery, your best chance of accumulating significant capital in the United States is probably through an employee ownership plan. That seems a fitting reference because current legislation in the State of Oregon has enabled the government to use lottery proceeds to establish a fund to aid economic development goals. Briefly, I'd like to outline our definition of economic development and how it became a priority goal in the State of Oregon, and then respond to some of Corey's propositions about worker ownership.

Our experience, unlike Corey's, is largely a result of plant closures. I believe that some of the growth of the national interest in worker ownership is a response to the economic crisis of the 1980's. This is certainly the case in Oregon. The idea of employee ownership is not to achieve Lemon Socialism or Lemon community ownership, but rather, as Deborah has put it, to anchor capital in the community. We found that too many closure decisions were being made by large, multi-national corporations not based in the community, without a stake there, and that the reasons for closing were unrelated to the profitability of a particular operation.

Our first attempt to pass a comprehensive piece of legislation dealing with plant closings was unsuccessful, but it made us stop and think about exactly what we meant by economic development. We had to break down the components of that definition and see which of those pieces could stand on its own merit. This resulted in a study, published in mid-1982, entitled *Reclaiming Oregon's Economy*, in which we took a long, hard look at what is economic development.

Today, economic development is the buzz word in every single state and yet it means very different things to different people. As residents, trade unionists, and economic consumers of the State of Oregon, these different meanings could have a dramatic effect on us. For example, in North Carolina, economic development means keeping and protecting right to work laws and low wages to attract industries. In Oregon, along with most other states in the nation, what it has meant for too many years is attracting tourism and high tech industries. Unfortunately, this vision of our economic future has been developed at the expense of dealing with the basic industries within a state. And 85% of all job creation, according to all the studies I've read, do come from existing industries within a state. So if industrial attraction is your only scheme, you're going to be dead in the water.

Our study included a three-part statement of economic development objectives. First and foremost was the preservation, maintenance, and expansion

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\* Oregon Economic Development Department, Division of Productivity/Innovation and Business Retention.

sion of the existing industries within the state. Second, was a continued effort at diversification of the Oregon economy keying in on industrial attraction. Because we are a major port on the West Coast, this means dealing with the Pacific rim nations, and there have been a lot of attempts to attract Japanese industry, in particular, to the State of Oregon. The last piece was to inventory our human, financial, and natural resources in the state, in order to develop a strategy consistent with our current and future needs.

Throughout the next two sessions of our legislature, from 1983 to 1985, we used this study to try and implement portions of the original plant closure bill and other ideas. As mentioned earlier, in 1984 and 1985, we had the major lottery game manufacturers put an initiative on our ballot. They spent about a hundred thousand dollars and dedicated the money towards economic development. Out of these efforts came a package of bills including Senate Bill 666, the Stabilization and Conversion Act of Oregon. It provided two million dollars to do feasibility studies and to provide a pool of seed capital for businesses to start up or to take over closing operations.

The bill established certain priorities for how that money would be spent. The first preference was to encourage worker ownership and worker-sponsored community ventures. The legislation was never designed to bail out private owners. In fact, the bill requires a change of ownership to qualify for the funding and it gives preference to worker ownership. This emphasis differs significantly from some of the projects that Corey has talked about where the original owner may retain a majority of the shares in the company and management of the operation. Like him, however, our bottom line is keeping people employed and keeping communities economically stable. In this respect, we see worker ownership as only part of the strategy. If a community requests a feasibility study on the possibility of employee ownership and that request spurs a private offer that will keep the plant in operation, we consider that ultimately a success.

Finally, the bill targets money for specific geographic areas and for specific basic industries in the State; primarily the fishing, agriculture and wood products industries. I'm currently serving as an economic development commissioner on the sub-committee overseeing this portion of the fund.

One very important aspect of the worker ownership issue that I don't think Corey addressed at much length involves the confrontations that can arise between worker cooperatives and unions. To illustrate this, I always use the story of the worker cooperative at Vancouver Plywood. The shares to become a member of the cooperative at Vancouver cost between seventy-five and a hundred thousand dollars. Not only was the cost prohibitive, but the total number of shares was limited, so a worker could only join the co-op if someone already a member died or retired.

Be that as it may, the cooperative was very successful and the members eventually hired a hundred and fifty non-member employees to handle the expanding business of the co-op. These employees soon found, however, that



they were being excluded from the better paying jobs. When the employees tried to organize, the board of directors, the members of the co-op, voted to fire every one of them. This story is typical of an all too common experience and accounts for some of the traditional antagonism toward worker ownership by the trade union movement.

Fortunately, this problem doesn't come up very often any more. The model that Corey described earlier, where membership or ownership in an ESOP prevents other people from getting in, has really been rejected. There are very few cases where you have an operation structured like the New York City cab medallions, where there are only so many to go around and each one costs too much for anyone to buy outright, so you end up working for somebody else.

The real issue now is defining the role of the trade union when you don't have the traditional labor-management adversarial type of relationship. We dealt with this problem in Oregon by putting together two conferences in conjunction with the legislation that I've already described. The first was a community conference which explained the purposes of the legislation, how worker ownership operates, and which models best protect the interests of both the workers and the community.

The second conference was for the trade unionists and confronted the issue of how they should deal with worker ownership. This conference brought out an interesting dichotomy. Employers were pushing ESOPs for the tax advantages, while the workers wanted education on the issue of control. It was important for us to address these issues because we didn't want to see any more situations like South Bend Lathes, where the company ended up being totally owned by the workers, but they went on strike against themselves because they had ownership without control of the operation. I totally agree with Sherman Kreiner that the control issue is critical. Too often worker ownership in this country has nothing to do with real ownership. It only has to do with owning some shares.

I strongly disagree with Corey's contention that control is not very important to most workers in most employee ownership companies because they are focused principally on the financial benefits of ownership—the dividends. Lane Plywood is a good case in point. The workers at Lane were minority owners, holding 40% of the company stock, but having no control over the operation. For many years the company was very successful and the workers were content with the situation. Then the board of directors decided to sell the company against the workers' wishes and suddenly the control issue became crucial to the workers. When the dividends are rolling in and everything is running smoothly, control may not seem very important to workers, but when circumstances change, control will become an issue.

Despite Corey's surveys to the contrary, I don't think that when workers say they aren't interested in control, it means that they really hate having it. However, when there are so many decisions to make, control often becomes a

lost issue in the bargaining process with the owners. Hopefully, in five or ten years, when we have a much larger sample of employee ownership businesses that were not started up as a reaction to an owner who wanted to give up the business tomorrow, we will also have a larger number of people getting involved for reasons that give control a much higher priority.

## RESPONSE

PETER PITEGOFF:\* At the Industrial Cooperative Association (ICA), we work nationally to provide a wide-range of assistance to worker-owned companies. Our approach is inter-disciplinary and involves coordinating the various areas of expertise and disciplines necessary to provide a full range of assistance in the operation and organization of worker-owned industries. These disciplines include lawyering, business analysis, education and organizing, policy development with local governments, and financing. Essentially, what we're trying to do is provide business expertise from a labor perspective. Translated into legal work, this means practicing a range of corporate law from both a labor perspective and a community perspective.

Just as Bob did, I would like to talk a little about our conception of economic development, which differs from that of some of the other speakers today, and then I'd also like to address the control issue. In thinking about our definition of economic development, it was clear to me that a lot of economic development initiatives don't reach the people who need them most. One of the focuses of ICA's work is on communities that are distressed, that are home to low-income people and minorities. These are the people who are most in need of empowerment through development of economic rights and enterprises. This is clearly a narrower subset of economic development and employee ownership than Corey was talking about.

The definition we use is not unlike PACE's. It means companies that are owned and controlled by their workers, where the workers elect the majority of the board on a one person/one vote basis, and where profits are distributed on the basis of each worker's labor. We work hard to set up governing systems that will make democracy work within this democratic shell, which is no easy task.

The strength of the PACE approach is that it is proactive. Too often employee ownership is rife with or accompanied by crises and concessionary bargaining situations where employees have little control. While it's important that unions respond in those situations, employee ownership may not always be the best response. It might be more effective for labor to respond more proactively, using employee ownership for actual organizing objectives. For example, in the construction trades right now, the International Union of Bricklayers is helping to develop masonry worker cooperatives. In this way, they're creating a union presence in areas that they might not otherwise be able to influence to a great degree. The union is capturing some of the energy of its members who already might be interested in forming this type of cooperative, while assuring that the union will have a role in the cooperative's devel-

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\* Counsel for the Industrial Cooperative Association, a technical assistance organization operating out of Somerville, Massachusetts.

opment. This strategy may be replicated in other construction trades or even in other areas of the union movement.

In terms of strategy, ICA differs from the Michigan Employee Ownership Center and PACE in that we have a very explicit national strategy. We're providing back-up assistance to local organizations. The only way that we can be effective in leveraging the capacity of our small staff in Massachusetts is to work through local organizations that have a legitimate local base and a presence to continue the education and organizing necessary to make a democratic corporation effective. We've worked through unions, local and international, that have some existing relationship and credibility with the project; through community-based organizations; through local governments that help create the support and environment that will bring resources to bear on worker ownership projects. We've worked with coalitions that are set up in various regions of the country, explicitly designed to help promote job development through worker ownership.

One part of our agenda very clearly is to create new economic institutions or to convert existing ones, such as corporations, that will be democratic social institutions, respecting the rights of workers as personal rights, not capital rights. A worker in a corporation is governed by that corporation and, from our perspective, has a personal right to control that corporation, just as a worker has a personal right to get the fruits of his or her labor in the form of profit-sharing. That's clearly an ideal to start from — it's a pure model that has been adapted for practical purposes in many situations. It's also a principle that I think is important to keep us on track—to keep us from simply broadening ownership without gaining more control or more empowerment for individuals.

While it is important to ICA to add to the model building of others, our main objective is to work for our clients and to do whatever is necessary to help empower them. Depending on its form, employee ownership is not always appropriate. If we have a choice of where to put our limited resources, we'll put them where there's a chance that some sort of real democratic employee ownership will result. There are other organizations and other strategies that we hope will complement this narrower strategy in certain situations.

I'm pleased to see a new discipline emerging in the law. It's a discipline that once again combines a variety of legal disciplines. It involves corporation law, tax, securities, business planning, commercial law and labor law. There is a wide range of issues that needs to be pulled together under a narrower rubric of employee ownership and control, not the least of which is how to democratically define employee ownership itself.

## DISCUSSION

RICK SURPIN,\* MODERATOR

RICK SURPIN: I think Corey Rosen has some additional points he'd like to make on the issue of employee ownership and how it relates to control of the operation.

COREY ROSEN: I just want to raise two points. First of all, we've been talking about economic development primarily in terms of preserving jobs or preserving economic structures. It seems to me economic development should also be concerned with expanding markets in the United States and expanding economic activity in general. Otherwise, working to keep one plant open only means that a plant somewhere else closes down. Without economic expansion, the market and the total number of jobs will remain static. The best way to stimulate new economic activity is through the creation of new businesses, and the best way to create new businesses is to make more capital available to more people.

A basic organizing principle of the United States was the broad ownership of capital. However, in the last few generations, as capital has become increasingly concentrated, I think some of the dynamism of this country has been lost. Very few individuals today have the sort of resources necessary to start a business. Employee ownership will enable those people with limited capital to enter the market and start their own businesses.

My second point concerns this question of control. Sherman asked whether workers really feel like owners if they don't have control. We conducted a four year study of 2800 employees in thirty-seven companies, with all kinds of companies and all kinds of employee ownership situations. And the answer we got to that question was yes. Control is not very important to most workers in most employee ownership companies. What they cared about was primarily the financial benefits that ownership provided. That's not surprising. That's what unions have been fighting for for decades. Control has never been a very key issue for unions or other people working for labor.

If this is the case, then does it make any sense to fight a company when it tries to set up an employee ownership plan because the plan doesn't give the workers control, when the only alternative is for the company to be sold to someone else with the employees not getting any of the benefits of ownership?

RICK SURPIN: Okay. I'd like to take a few questions from the audience now.

AUDIENCE COMMENT: My name is Angel Roman and I'm with the Manhattan Borough President's office. How have the conventional lending institutions

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reacted to the employee-owned businesses, especially when there may be potential buyers out there with more centralized management schemes?

**SHERMAN KREINER:** I'd say they've reacted favorably. Banks do require that employee-owned businesses meet the same criteria as any other small business or manufacturing concern seeking a loan, so that's how it's got to be presented to them. Does the business have a solid market? Competent management? The ability to repay? These questions will be asked and must be satisfactorily answered before a lender will fund any sort of business. We've tried to keep questions about the structure of the company out of the debate. Where employee-owned companies have met the business standards, banks have usually made the loans. We know this is true both with big city banks and banks in small towns where the employee-owned business is a major employer.

In Philadelphia, some of the banks we've been working with actually helped finance a feasibility study on worker ownership because they know how important this option could be to the future of their community. We've also been building a successful track record for placing loans with some of the major private lending institutions in the city. These factors, along with the proper loan packaging, has made other commercial lenders more willing to make loans to employee-owned businesses in our area.

**PETER PITEGOFF:** We recently completed a survey of banks on this very question, and the results were very interesting. It seems that many banks, including big banks like Chemical and Chase Manhattan, actually prefer to make loans to companies in which the employees own a majority of the stock and vote it. They prefer this type of structure over one that gives management control of employee-owned stock. Of course, most of the consultants who set up these deals told us that banks do not prefer to deal with employee-owned and controlled businesses. We concluded that it's really the consultants who don't prefer it, so they either never present the idea to the lenders, or they present it to them in the most negative light possible.

**DEBORAH GROBAN OLSEN:** My experience has been similar to Sherman's. For example, when we put together one worker co-op in an industrial plant in north Michigan, we first had to organize a consortium of seven lenders, including some very small local banks, to finance the deal. These banks were willing to go along with the idea, as Sherman said, as long as we came in with the entire package, including the support of the management we'd recruited.

Another example, that frankly was rather amazing to me, was when we put together the Republic Container deal in Nitro, West Virginia. There we were able to put together a one vote per person cooperative ESOP with 100% leverage financing by the local bank at 90% of prime rate, with some involvement of the West Virginia Economic Development Authority. One hundred percent leveraging is rather unusual, but the union, in particular, played a very strong role in developing that deal.

More recently, one of the three largest bank corporations in Michigan

requested MEOC's assistance in conducting a training program for their loan officers on what employee ownership is and how it works. This gives us the opportunity to define employee ownership for the lender according to what we think is the norm. It helps the banks look at worker ownership as another perfectly acceptable, reasonable way to package a deal.

**AUDIENCE COMMENT:** My name is Buzz Taylor. I'm a law student here at NYU. I would like to know whether the panelists think that the tax incentives for creating ESOPs should be extended to cooperatives, and whether Congress is seeking any possible changes in that area.

**PETER PITEGOFF:** Yes, I think that co-ops should get the same benefits. In fact, cooperatives already have some substantial tax breaks. The provisions of sub-chapter T of the Internal Revenue Code that gave tax advantages to agricultural co-ops years ago, have since been extended through case law to apply to worker co-ops. It's not as extensive a tax benefit as those available to ESOPs, but it is available. In addition, the 1984 tax act included a provision that created an incentive for owners who are retiring or selling small businesses to sell their companies to their employees. That can be done either through an ESOP or through what's now defined in the Code as an eligible worker owner cooperative.

**BOB BAUGH:** There's also an innovative piece of federal legislation utilizing unemployment insurance that's been introduced by Congressman Ron Widen from the Third District in Oregon. He proposes that, in states that have been particularly hard hit by unemployment, when a plant closes down the employees would receive their entire benefit in a lump sum. This would provide the employees with a substantial pool of capital to buy out the company, and it doesn't involve an ESOP or lender financing because the money has already been banked by the corporation to pay unemployment benefits. The idea is actually based on one of Margaret Thatcher's programs, and although I'm not certain right now how the AFL-CIO stands on it, it is an intriguing possibility.

Another issue I'd like to discuss concerns pension funds and ESOPs. In the majority of companies, ESOPs are instituted in addition to pensions, but there are cases where ESOPs are used as a financing tool to take the place of pensions and that concerns me. For example, in my father's company, they just instituted an ESOP and sent him a check for what had been his pension fund — his ESOP is now his pension. Now, this is great if the company is doing well when he retires, and Corey has plenty of statistics to back that up. But if business is bad, he could walk away with little or nothing. ESOPs, unlike pension funds, are not insured by the government, so you have to realize that there is a gamble involved in these situations.

**AUDIENCE COMMENT:** My name is John Siegal. I'm a member of the Review of Law and Social Change and I also work at the New York State Urban Development Corporation. I guess my question is for Corey and Peter. I'd like to hear what they think about the future of employee ownership as a

political issue, and what support it has in Congress. With the impending retirement of Senator Russel Long, who's been the prime advocate of ESOP tax breaks, are these tax advantages threatened in the tax reform debate? Also, has the work that all of you folks have done over the last ten years begun to build a political constituency for ESOPs and worker co-ops that we'll see playing a greater role in Congressional politics and in national politics generally?

**COREY ROSEN:** My guess is that Senator Long's retirement will mean that there won't be any new incentives for ESOPs. Nevertheless, the House Ways and Means Committee, which was the group most opposed to ESOPs in the last session of Congress, has indicated that although tax breaks in general are probably going to be cut, the ESOP tax breaks are not going to be hurt too badly. Four of the five senior Democrats on the House Ways and Means Committee, one of whom will be the next Chairman, spoke in favor of ESOPs, and a comfortable majority of the Senate favors them. In terms of there being a real constituency for active promotion of ESOPs in the future, I think that's a long way off. It really was Senator Long's personal campaign that achieved the accomplishments so far. The rest of the people in Congress think it's a good idea generally, but it's not a high priority yet.

**PETER PITEGOFF:** I'd like to answer the question from a perspective outside of Washington, D.C. I think that too often employee ownership and some of the benefits of employee ownership are pegged solely to the tax advantages. It's true that the tax advantages are important incentives and certainly help give a competitive advantage to some of the more successful companies. However, in a lot of local, community-based economic development, tax incentives aren't very relevant. Tax deductions don't mean much if you don't have any profit and taxable income to deduct from.

I don't know what the future will bring in terms of federal tax legislation. I do know that in the last eight to ten years, one substantial political change has been the emergence of community-based and regional groups promoting local development of democratic corporations. At least fifteen regional development groups that I know of now exist around the country and in Puerto Rico. To the extent that these continue to operate as stable locally-based organizations, I think that there will be some increased activity in the future.

**SHERMAN KREINER:** I also think that the existence of the tax breaks makes it very difficult to build a political constituency because it greatly broadens the definition of what is considered employee ownership. The fact that minority ESOPs with no employee control are defined as employee ownership, along with the democratic organizations that we work with, is a real detriment in the long run to building any kind of political constituency around the goals that we think are important. While I'm certainly not going to argue to do away with those tax benefits, in a lot of the contexts in which we operate, they aren't terribly relevant, and they tend to fundamentally hamper political coalition building.