

WORKER OWNERSHIP AS THE BASIS FOR AN INTEGRATED, PROACTIVE DEVELOPMENT MODEL

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INTRODUCTION

The Philadelphia Association for Cooperative Enterprises ("PACE"), is a non-profit, tax-exempt organization that provides technical assistance on a regional level to employee-owned enterprises.¹ Incorporated in 1976, PACE is the oldest organization of its kind in the United States.² Like many other such organizations,³ PACE began by reacting to the need for effective conversions in the face of plant shutdowns. The benefits of PACE included both the positive publicity given to employee ownership when jobs were being saved and the opportunity to cultivate union interest in developing worker-owned companies. As major collaborators, unions have contributed their ability to organize workers, their access to financial resources, and their expertise in developing political and economic support. With union support,⁴ PACE can provide the necessary legal, business, organizational and educational capability to make worker-owned businesses successful.

PACE's technical assistance is no longer provided solely in response to a specific situation such as a threatened plant shutdown. Instead, PACE initiates employee-owned businesses according to a defined set of criteria.⁵ PACE has assisted in establishing five worker-owned supermarkets in Philadelphia,

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1. The PACE staff, composed of business developers, attorneys, operations and organizational design specialists, and community/workplace educators, provides a full range of professional services. These services include: feasibility studies, economic development planning services, organizational structure analyses, comprehensive legal counsel, business planning, deal structuring, loan packaging, worker and management education, entrepreneurial development, workplace participation and productivity training, organizational design and development, and policy formulation concerning community economic development. *See* PACE of Philadelphia, Inc., Memorandum to Review of Law and Social Change 8 (Sept. 1986)(on file with New York University Review of Law & Social Change).

2. *Id.* at 2.

3. Community Center for Self Help (North Carolina); Community Service Society (New York); Industrial Cooperative Association (Massachusetts); Michigan Employee Ownership Center; Midwest Center for Labor Research and others.

4. Working with the unions is also important to assure that we are creating quality jobs in terms of wages, benefits, and working conditions, and that we are not undermining the interests of workers generally in the industry.

5. *See generally* Panel Discussion at 275-79.

and is actively seeking opportunities to expand the network.⁶ This proactive strategy has evolved from creation of individual enterprises to development of a network of integrated cooperatives. I hope the development model discussed in this article will be replicated elsewhere in other industries. The ultimate goal for the supermarket network is to attain control over a large section of the food retailing market in order to promote community economic development and working conditions sensitive to the needs of the poor, working people, women and minorities.⁷

I

DEVELOPMENTAL ISSUES AND DECISIONS

A. *Defining Worker Ownership*

PACE's organizational evolution included the consideration of several possible organizational directions and foci. The first issues to be resolved were the definition of worker ownership that PACE would support and the type of technical assistance that PACE would offer.⁸ PACE has defined worker-ownership in terms of four basic criteria.⁹ First, the majority of workers in the company must be owners. Second, each worker-owner has one, and only one, vote. Third, profits are distributed on the basis of labor, not on the basis of the size of one's financial investment. Finally, workers must have control of the board of directors. This last criterion is essential because it gives workers control over the organization, not just a financial interest in it. Research has shown that ownership without control may result in frustration and resistance, rather than increased motivation and productivity.¹⁰

Effective worker participation and job satisfaction requires both ownership and control. Employee ownership guarantees that workers will have the necessary incentive to participate in company affairs. The benefits of participation without ownership are limited to those defined by the owners or managers. Workers also may limit their participation since they know that owners or managers can end such programs at their whim. In addition, ownership allows workers to express their views freely without fear of losing their jobs; it assures worker access to information, and enables them to determine what

6. *Id.*

7. *Id.* at 5; see Memorandum, *supra* note 1, at 6.

8. See Memorandum, *supra* note 1.

9. "The two major legal forms for employee ownership are the Worker Cooperative (as defined in Subchapter T of the Internal Revenue Code and several state statutes) and the Employee Stock Ownership Plan (as defined in the Employment Retirement Income Security Act). Both of these forms permit wide latitude in the description of many significant categories, including the designation of governance rights and responsibilities, the allocation and distribution of surplus, and the specification of criteria for ownership and equity participation (including the percentage of employee ownership)." Memorandum, *supra* note 1, at 11.

10. C. Coker, Relationships Between Participation, Personality and Work Attitudes (October 1984) (unpublished paper on file with the New York University Review of Law and Social Change); Long, *The Relative Effects of Share Ownership vs. Control on Job Attitudes in an Employee-Owned Company*, 31 HUM. REL. 753-63 (1978).

issues will be addressed through their participation. In sum, with ownership, "control is real and total, not bequeathed by someone else who can take it back."¹¹

B. Creating Meaningful Worker Participation

Worker ownership, as defined above, delineates a basic structure for worker control. However, structures permitting worker participation do not ensure that meaningful participation will take place; they only create the potential for that participation. Based on this realization, PACE made a commitment to include a worker education program as a major component of the technical assistance it would provide to worker-owned businesses. Such programs may enable workers to utilize effectively structures for worker control.

The PACE worker education program has three main components: expository, process, and developmental. The expository component teaches employee-owners applicable laws and regulations, and the basics of employee-owned structures. It also provides fundamental business and financial skills. The process component familiarizes employee-owners with participation systems, group decision-making styles, and problem-solving techniques. The developmental component facilitates utilization of the firm's democratic governance and production systems to stimulate the dynamic growth and development of the individual, the firm and the community.¹²

C. Geographic Focus

Another issue to be resolved was how to define the organization's geographic focus. One model, for example, was a national model.¹³ According to this model, a technical assistance organization would provide services to worker-owned businesses around the country. The PACE staff, however, believed that the only model that was working successfully was the Mondragon model.¹⁴ This model, started in the Basque region of Spain in the 1950's, consists of close to 100 worker cooperatives with 20,000 employees.¹⁵ In the

11. V. Vanderslice, R. Leventhal, *Making Employee Participation Work: PACE Combines Training and Economic Incentives to Insure Organizational Success* 2,3 (1986)(unpublished paper on file with New York University Review of Law & Social Change).

12. See Memorandum, *supra* note 1, at 18. For an outline and critical discussion of PACE's educational program, see *Design of a Worker Cooperative Worker Education Program: The O&O Project as a Case Study* (paper prepared by the PACE research staff and on file with New York University Review of Law & Social Change).

13. The Industrial Cooperative Association ("ICA") of Massachusetts used this model initially. Now, instead of creating its own national network of cooperatives, ICA provides technical assistance to regional organizations nationwide. See Kuttner, *Blue-Collar Boardrooms*, THE NEW REPUBLIC, June 17, 1985, at 19.

14. See Johnson & Whyte, *The Mondragon System of Worker Production Cooperatives*, 31 INDUS. & LAB. REL. REV. 19 (1977); Kuttner, *supra* note 13. "The Mondragon system is exceedingly dynamic, both economically and technologically. Not only has it become the largest producer of refrigerators and stoves in Spain, but it has also been selling approximately 20 percent of its output in international markets." Johnson & Whyte, *supra*, at 24.

15. Johnson & Whyte, *supra* note 14.

Mondragon model, worker cooperatives are geographically proximate and thus can provide a wide range of support to each other. Following this model, PACE chose to limit itself to providing technical assistance to local worker ownership groups.

By maintaining a regional focus, PACE is able to provide more thorough and competent technical assistance. Organizational development and worker education, for example, can be provided on a more consistent basis and with a better sense of the worker-owned organization's history, development, and current needs. Furthermore, because geographic proximity allows collaboration between businesses and the development of support institutions, organizational concerns may be addressed in a preventive, rather than in a crisis, mode. Finally, joint efforts can be made at the local level to build a political network of local financial institutions, public officials, and government organizations that can provide resources to facilitate the creation and maintenance of worker-owned businesses.

II

A HISTORY OF THE O&O (EMPLOYEE-OWNED AND OPERATED) SUPERMARKETS: THE MONDRAGON MODEL AT WORK

Adoption of the geographically proximate Mondragon model resulted in PACE involvement in a number of different industries in the mid-Atlantic region. In 1982, PACE became involved in the union-initiated employee-owned and operated ("O&O") project.¹⁶ When the Atlantic & Pacific Tea Co. ("A&P") began shutting down stores in Philadelphia, the United Food and Commercial Workers Union local 1357 saw the concept of worker ownership as a possible option for saving the jobs of its members.¹⁷ PACE was contacted to do initial feasibility studies to determine which of the defunct A&P stores would be suitable for setting up a prototype worker-owned store in anticipation of a shut down of the entire chain during the next year.

When A&P shut the Philadelphia area chain down in March, 1982,¹⁸ much sooner than expected, the union decided to block bid on 21 of the supermarkets on behalf of the entire group of local A&P workers. As a result of the bid, A&P decided not to shut the stores down, and instead created a new A&P subsidiary called Super Fresh Food Centers. The Super Fresh contract is a unique and unprecedented labor agreement because it establishes the groundwork for the stores to become worker-owned. The contract gives employees in each of the Super Fresh stores a right of first refusal on the physical plant in the event that A&P decides to sell, franchise, or otherwise dispose of that physical plant.¹⁹ If the employees as a group choose not to purchase it, it

16. See generally *Worker Owned and Operated Supermarket Yields Financial Success, Personal Rewards*, The Wall St. J., Aug. 18, 1983, at 25, col.4; Kuttner, *supra* note 13, at 22.

17. *Id.*

18. Kuttner, *supra* note 13, at 22.

19. *Id.* at 23.

must be offered to the umbrella corporation of the worker cooperatives through PACE for purchase before it can be put up for public bid.

Another groundbreaking element of the collective bargaining agreement was that, as long as labor rates did not exceed a ceiling defined as a percentage of sales, the company would make a contribution into a union-controlled fund at the rate of one percent of gross revenues.²⁰ That fund would be used for productivity bonuses and as a capital loan fund to help finance the buyout in the event that the workers exercise their right of first refusal.

The most important outcome of these negotiations was that PACE, on behalf of a group of A&P workers interested in worker ownership, obtained options on two sites that became the first two O&O supermarkets.²¹ Those stores opened in the fall of 1982, and have succeeded at sites where A&P had been experiencing substantial losses. A description of one of the stores noted that: "Sales are up 100 percent to \$170,000 a week. Labor costs are running at nine percent of gross sales, compared to about fifteen percent when the store was operated by A&P. Another index, sales-per-person-hour, is about twenty percent above the industry average."²² Each store was separately incorporated. Adhering to the PACE criteria, they were both structured as worker cooperatives: all shares were held by employees; voting was on a one worker/one vote basis; profit distribution was based on labor participation; and workers held the majority of seats on the Board of Directors. Finally, an extensive worker education program was implemented to provide workers with general industry and financial information, legal information relevant to worker-owned businesses, and training in democratic decision-making processes.

III

AN INDUSTRY-SPECIFIC FOCUS

With the successful opening of the first two O&O supermarkets, PACE began a re-examination of its development strategy with an eye toward an even more focused plan than the multi-industry, but geographically proximate, plan suggested by the Mondragon experience.

First, the PACE staff recognized that it had developed an expertise in the supermarket industry. The staff had considerable confidence in its ability to estimate accurately start-up costs, to prepare financial analyses, to develop staffing models, and to address miscellaneous operational issues. In addition, PACE had developed working relationships with important actors in the industry: marketing consultants, wholesalers, engineers, equipment and refrigeration technicians, and the union. The time anticipated to evaluate a new site, prepare a business plan, deal structure and loan package, prepare necessary legal documents, assemble an equipment package, and recruit and train workers and managers would be considerably less for a third supermarket than for

20. See *Worker Owned and Operated Supermarket*, *supra* note 16.

21. See Kuttner, *supra* note 13, at 22.

22. *Id.* at 23.

the original two. In all likelihood, it would also take considerably less time than to complete similar tasks for a product in another industry. In addition, the skills necessary to provide ongoing assistance of all types were also much more readily available, through expertise which had developed on the PACE staff and through already established relationships with outside consultants.

Second, the initial supermarket experience underscored the benefit of joint activities by business enterprises with common interests. For example, by virtue of the combined volume of their purchases, each of two supermarkets pays less to their wholesaler for groceries than either would pay alone. Economies of scale in the purchase of many other goods and services (for example, auditing) were also readily apparent. In addition, the existence of several stores provided a forum for discussion of common problems and the opportunity for one experience to inform the other.

The PACE staff's observations suggested that the geographic focus of development activities should be complemented by an industry specific focus. The business staff then undertook a year long project²³ to define criteria for identification of target industries. These criteria included: market opportunity (growth, restructuring, protected market or niche); potential for clustering and vertical integration;²⁴ appropriate capitalization per job; size and economies of scale; available trained workers; interested unions; comparative advantage in the local or regional market; replicability; and special worker ownership advantages. A number of industries were identified,²⁵ and preliminary development steps were then undertaken in several industry areas. In application of these criteria, and because of the success of the O&O network, food-related businesses with food retailing at the core of the system is currently the primary focus of PACE's efforts. The remainder of this paper will discuss the development of the food strategy.

IV

A JOINT VENTURE MODEL FOR COMMUNITY ECONOMIC DEVELOPMENT

A. The Role of the Community

Planning for this integrated, industry specific strategy progressed in several areas simultaneously. One major concern was the role of the community. PACE planners realized that since food retailing enterprises were neighborhood-based businesses and many would be located in areas with strong com-

23. Confidential report by Francis Brody, intern from the Yale School of Organization and Management (Summer 1983).

24. PACE's first step consisted of horizontal integration, *i.e.*, opening up more supermarkets. Vertical integration is established by creating enterprises related to the supermarket industry: food processing, production, and distribution. The success of these enterprises is strengthened by the protected market of the O&O network.

25. The industries identified in addition to the food industry included health care, nursing homes, computer repairs, and energy saving products. While some projects in these non-food areas were evaluated, no projects are currently active.

munity groups, the cooperation of these groups would be essential. However, previous experience with businesses developed by community development corporations ("CDC") suggested a strong likelihood of failure when community organizations were involved in day to day management and other key areas of business decision-making.²⁶ Generally, the problem with CDC involvement is the lack of managerial capability. Moreover, substantial community ownership or control is inconsistent with PACE's plan of worker ownership and control, and with the anticipated positive impacts on productivity and job satisfaction associated with that structure.

Nevertheless, the community did have certain legitimate interests in the business. PACE identified several key interests that the community might have in a worker-owned venture. These interests included: site control in the event of a business failure; a reasonable percentage of jobs for people from the local community; an income stream, if possible, generated by the repayment of debt service by the business enterprise; and some formal input in business decisions. These interests were incorporated in the model for the business enterprise without compromising worker ownership and control, and without permitting the inherent conflicts between community and worker interests to be played out in forums where permanent resolution was unlikely.

The community interests suggested a model in which a local community development corporation served as a developer or co-developer of the real estate and supermarket building, so that in the event of business failure, site control would revert to the developer. A second element of the development model would involve a community group as a conduit for debt financing to the worker-owned and controlled supermarket operator. Loans from public and alternative sources would be lent to the community group, which would, in turn, re-lend the money at a small premium to the worker-owned and controlled business. Through this development plan, as many jobs as possible could be provided for local community residents, being careful not to compromise the viability of the business as a consequence of there being too many unskilled workers. Finally, the development plan would permit community input in business-related decisions by reserving a seat on the board of directors for a representative of the community group elected by the worker-owners. Thus, the community group would have a minority role in making policy decisions for the worker-owned and controlled business.

With this joint venture model in mind, PACE proceeded to identify communities with strong community development corporations, and where there was also strong potential for a successful worker-owned and controlled supermarket. A market consultant was hired and asked to do a market analysis to determine the potential for newly constructed supermarkets or conversions of

26. For example, the ICA set up a market in the Boston area that funneled finances through a CDC. The CDC never turned the ownership over to the workers as planned. The business venture failed due to undercapitalization, lack of managerial capability, and inadequate market analysis.

existing and abandoned supermarket sites in those communities. A number of neighborhoods in Philadelphia were identified where there was a need for a supermarket, a potential site, and a strong community development corporation. Those communities became the targets for PACE development activities.

B. Foundations for the Development Strategy

The development strategy discussed above was built on foundations laid during the creation of the first O&O supermarkets. PACE had a close working relationship with the United Food and Commercial Workers Union, which would serve as a source of workers for the new ventures, provide facilities for worker training and credit union resources for worker equity loans. In addition, provisions in collective bargaining agreements, negotiated at the time of the initial O&O conversions, provided workers with the right of first refusal on physical plants in the event of a shutdown or sale and with contributions by conventional employers to a capital loan fund controlled by the Union's designees. PACE had also developed working relationships with the city Department of Commerce, quasi-governmental lending institutions, alternative lending institutions interested in the worker ownership concept and community development, (for example, the Local Initiative Support Corporation ("LISC")), and local conventional lending institutions. Existing relationships with grocery wholesalers would provide a broad range of development services, including assistance in site evaluation, review of architectural drawings, preparation of specifications for major systems, preparation of floor plans, identification of equipment packages, and development of relationships with refrigeration engineers and other technicians.

C. Financing

PACE also recognized that this strategy would require a financing source that it controlled to provide gap financing, as well as worker equity loans, to complement the limited resources of the union's credit union. Local church organizations interested in food delivery mechanisms for the inner city assisted PACE in fulfilling this need. The Interfaith Revolving Loan Fund ("IRLF") was initiated by PACE in conjunction with the Nutritional Development Services of the Philadelphia Archdiocese and Episcopal Family Services in Philadelphia.

These two church organizations have been joined by the Presbyterian Church, Methodist Church, Baptist Church, Reformed Church of America, National Cooperative Development Corporation, several small local foundations, and the Ford Foundation. Total commitments to capitalize the loan fund are now in excess of one million dollars. The IRLF successfully operates as the supermarket network's internal financing entity, providing below-market loans, equity, and debt financing.

V

STRAWBERRY MANSION COOPERATIVE: THE JOINT VENTURE
MODEL IN ACTION

Attempts were made to incorporate many elements of the community role, as defined by PACE, into Strawberry Mansion.²⁷ The site is owned by a partnership comprised of a private developer and a non-profit community development corporation. Debt financing for the supermarket was funneled through another local community development corporation, Strawberry Mansion Citizens Participation Council. The city mandated that the Council have a major role in corporate and business operations, including one seat on the nine-member corporate board of directors. A second seat is held by a representative of another local community organization. The remaining seven seats are held by worker-owners. Finally, one-third of the full-time employees and one-half of the part-time employees are community residents, virtually all of whom were recruited by community organizations.

The market opened in July 1985. The first year of operation highlighted both the pitfalls and the potential of this development model. Because there had been no supermarket operating at the site previously, financial projections were based on market surveys. Sales projections were never attained, and key expense items were not adequately controlled. As a result, the store sustained operating losses, and some worker-owners, including worker-owners drawn from the local community, had to be laid off. Factors affecting performance included: a) an improper mix of skilled and unskilled workers; b) serious management capability problems; and c) a tumultuous board process in which political struggles in the community often found their way into the corporate board room, the community representatives dominated the board process, and management initiatives and actions were often overturned.

Nevertheless, the store is continuing to provide low cost, high quality food to a community which, in the past, was used to high prices and low quality. The store has created more than sixty new jobs, including a substantial number held by previously unskilled community residents, and ninety percent of the work force is composed of minorities.

The future status of the market is in question. PACE withdrew as a consultant to the project in September 1986 after its recommendations regarding restructuring went unheeded. In March 1987, the market went into bankruptcy. Various reorganization options are currently being considered.

The Strawberry Mansion experience has underscored the importance of

27. Strawberry Mansion is a neighborhood in North Philadelphia. It is a predominantly low-income and minority community with the highest infant mortality rate in the city. PHILADELPHIA DEP'T OF PUBLIC HEALTH, VITAL STATISTICS REPORT (1984). The Strawberry Mansion supermarket cooperative, financially supported by the city and the federal government, was the first major economic development in the community in 20 years. The opening of the supermarket in 1985 was the culmination of a 15 year effort by the community to obtain a shopping center.

properly balancing concerns for business viability with the other social and political goals of a model incorporating community interests. Unfortunately, some of the requirements imposed on that project, while conceptually consistent with PACE's goals, tipped that balance too far to sustain a viable business operation over the long-term.

VI

FURTHER DEVELOPMENT OF THE O&O NETWORK

Despite the Strawberry Mansion experience, PACE is continuing to work with community development corporations in targeted areas to develop new supermarkets. In some instances, PACE is assisting the development corporation to serve as the primary real estate developer, with PACE acting as the primary developer of the worker-owned and controlled supermarket operator. In other instances, PACE is working with the community development corporation to create a joint venture model in which the development corporation and PACE will develop the real estate together. Finally, community development corporations which have already decided to act as sole developer or as a joint venture partner with a private developer have approached PACE to serve as the operations developer for a worker-owned and controlled supermarket. In those cases, the relationship between PACE and the development group resembles a landlord-tenant relationship which a conventional supermarket operator might enter into with a conventional private developer. Presently, there are projects active in Northwest Philadelphia, South Philadelphia, and in several low-income suburban communities. In some of those projects, site control has been obtained and leases have been negotiated.

PACE is also expanding the network of worker-owned and controlled supermarkets through the acquisition of existing markets that are offered for sale. In particularly desirable situations, PACE finds itself bidding against area supermarket chains and major independents. As the O&O network expands, PACE bids have greater credibility. In addition, as the network of PACE industry contacts expands, more and better opportunities are presented. Recently, the largest independent operator supplied by the same grocery wholesaler which supplies the O&O stores had some financial difficulties as a result of problems in one store in his network. As a result, the grocery wholesaler, as the largest creditor, took over operation of several profitable stores. PACE was offered those stores for the O&O network. With financing from the National Cooperative Development Corporation,²⁸ the stores opened as worker-owned and controlled supermarkets on October 21, 1986. These stores are the fourth and fifth stores in the O&O system,²⁹ and they are structured somewhat differently from the initial stores in that a non-

28. The National Cooperative Development Corporation is a subsidiary of the National Cooperative Bank. It was created by the federal government for consumer and worker cooperatives and is now a private bank.

29. These stores are located in Darby and Upper Darby, western suburbs of Philadelphia.

leveraged ESOP mechanism is used. However, PACE's basic worker ownership criteria still apply.

VII

PRESENT OUTLOOK OF EMPLOYEE-OWNED SUPERMARKETS

The creation of development opportunities and prospects for acquisition has been painstaking. Many more sites and many more markets have been rejected than have been accepted. Many opportunities have been lost in competitive bidding processes against much stronger competitors. However, the quality of prospective deals has improved as the concept has become more well-known, the range of contacts in the industry has increased, and the flagship stores have demonstrated that worker ownership can be successful. At this time, the experiment has moved beyond the creation of prototypes to the development of a system with a demonstrable market share. This growth has created new needs.

With an increasing number of operating supermarkets at different stages in development, the network needed quality control standards and an established environment conducive to worker ownership, control, and participation. The legal device that has been used to meet these needs is an agreement licensing the O&O trademark and trade name. That agreement sets minimum standards for quality and worker ownership. The agreement also provides for organizational assistance and management consulting services offered by PACE to the stores on an ongoing basis.

The licensing agreement is administered by the O&O Investment fund and managed by PACE. The fund is structured as a second degree cooperative: a cooperative organized and controlled by cooperative institutions. Its board of directors is composed of union representatives and representatives of each of the established O&O stores. In addition to administering the licensing agreement, the fund serves as a forum for discussion of common problems affecting the worker-owned and controlled supermarkets. Further, it is designed to serve as a vehicle for obtaining economies of scale for the O&O stores in the purchase of goods and services. Already, it has been successful in negotiating rebates to each of the stores from the common grocery wholesaler based on the combined volume of purchases of all of the O&O stores together. Recently, it began to address the question of joint advertising for O&O banner stores.

The O&O stores are designed to serve as the core of a more comprehensive food delivery system. Those supermarkets will provide a protected market for more capital intensive food production or processing enterprises. PACE is now identifying food production and processing industries most conducive to development as worker-owned and controlled enterprises and is also studying the feasibility of a conversion to worker ownership of a shutdown meat-processing facility.

A proactive, industry specific development strategy for worker ownership

is fairly risky. Development time frames are long, and many factors may result in a project being stopped. However, the opportunities for market support, common problem solving, and economies of scale increase the likelihood of long term survival for the individual business enterprises.³⁰ PACE is committed to continuing this development process in the food industry, and to exploring its replication in other targeted industries.

30. In the past six months, PACE has developed joint activities, in addition to the O&O board, in advertising, management, and personnel.