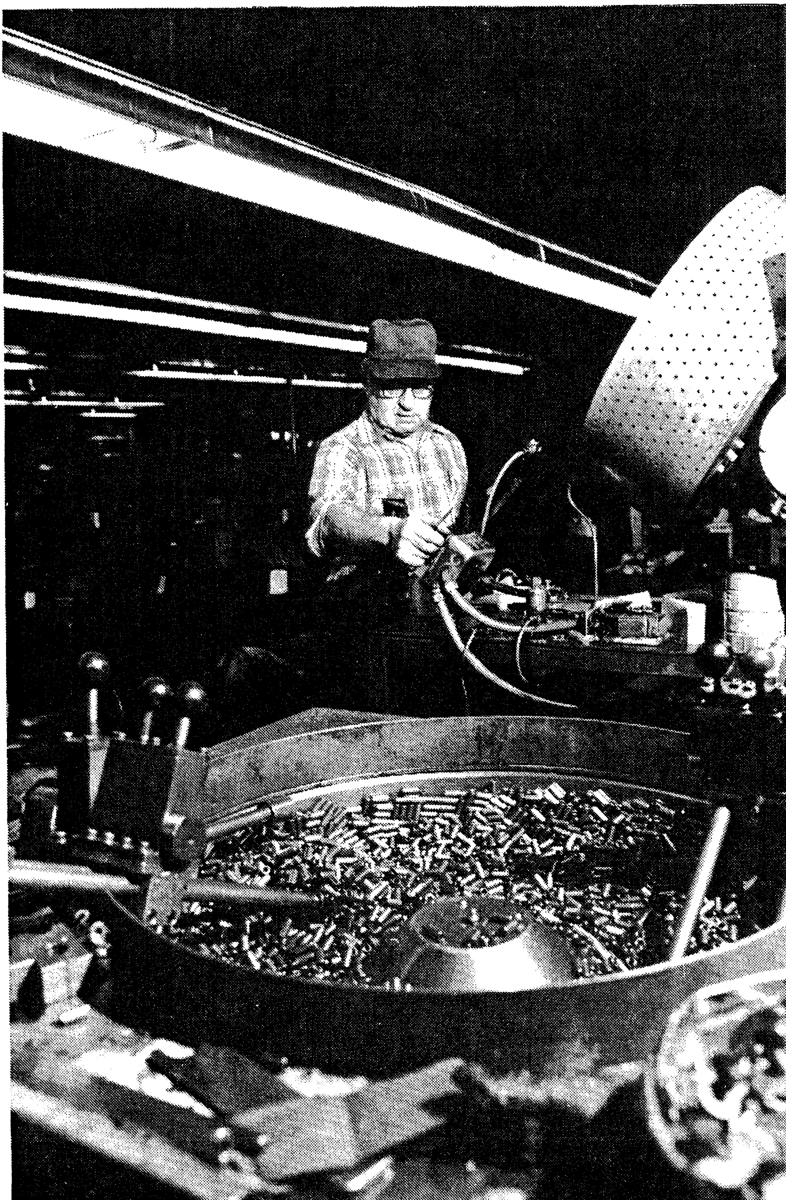

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ESOPs & CO-OPs: Worker Capitalism & Worker Democracy

■ *David P. Ellerman*

The broad purpose of the labor movement has always been to further the economic self-determination of workers, to maximize working people's control over their economic destiny. Self-determination is the goal, but what are the means?

In the past and present state of capitalist society, the only real opportunity for most people to earn a living is by selling their labor as an employee to some employer. In that historical situation, workers can best promote their self-determination through unionized collective bargaining with their employer. Collective bargaining is the best means at hand, but it is only a means, not an end in itself.

As the economic situation changes, new opportunities arise. In some cases, workers can break out of the employees' role and achieve the status of worker-owners of their business. Labor can hire capital (instead of the reverse). In this newfound role, the workers can have much greater powers to control their own economic destiny, to promote their own self-determination. But worker ownership also presents a whole new set of problems and challenges.

The purpose of this paper is to analyze the two major forms of worker ownership in view of the overall goal of the labor movement, to promote democratic self-determination in the

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workplace.

In the United States today, there are two principal forms of worker ownership, the Employee Stock Ownership Plan (ESOP) and the worker cooperative. Advocates of worker ownership can usually be classified as either "ESOP advocates" or "Co-op advocates." The current debate over the most appropriate structure for worker ownership is often conducted in terms of such matters as reducing taxes or gaining access to conventional capital markets. But this distorts and trivializes the basic issues. There is more involved than narrow technical considerations.

Means reflect ends; structures embody principles. What is the goal? Our starting point here is the assumption that the goal is to extend democratic self-determination to the workplace. What is the best structure for the purpose of workplace democracy—not the purpose of minimizing taxes, not the purpose of obtaining conventional financing for management-dominated "employee-owned" firms, not the purpose of undermining unions with "worker capitalism," and not the purpose of "saving jobs" by dumping dying plants and unfunded pension liabilities onto desperate workers? The purpose is workplace democracy in healthy, secure, and unionized firms.

The United States has had two hundred years of experience with political democracy at the federal, state, and municipal level. How can democracy be extended from the communities where people live to the communities where people work? Political democracy embodies certain principles, and those principles are the starting point in drafting a blueprint for workplace democracy. Democracy is based on the one person/one vote principle. Any design for workplace democracy should embody that fundamental rule.

Democracy is a method for people to govern themselves, not a method for property-owners to govern their property. Democracy must be people-based, not property-based or capital-based. Hence in a democratic workplace, the people hire the capital, not vice-versa. And if labor hires capital, then the residual net income after all costs (including interest on capital) is a return to labor, not a return to capital.

The voting and other citizenship rights in a democratic polity are personal or human rights, not property rights which may be bought or sold. Property rights are marketable so they can become highly concentrated in huge accumulations of wealth and power. Personal or human rights cannot be "bought" or "sold"; they are automatically distributed on a one-per-person basis. Hence if any democracy, political or industrial, is to endure, the basic citizenship or membership rights should be assigned as personal or human rights, not as marketable property rights.

In sum, there are at least three design criteria in the blueprint for a democratic firm:

(1) one member/one vote (not one share/one vote),

(2) the residual net income is a return to labor (not to capital), and

(3) the membership rights are personal rights (not property rights).

We shall argue that the worker cooperative legal structure satisfies these criteria. Indeed, the design criteria essentially define a worker cooperative in abstract terms. We shall also argue that the typical ESOP design does not satisfy these criteria. ESOP voting, in cases where employees have voting rights, is ordinarily on a one share/one vote basis; capital hires labor so the net return is proportional to capital, and the voting and other rights acquired through an ESOP are property rights, not human rights.

What is an ESOP?

The legal structure of any form of worker ownership can be analyzed according to how it reallocates and restructures the traditional bundle of ownership rights attached to the common voting shares of a conventional investor-owned corporation.

The Conventional Ownership Bundle includes:

1. The voting rights,
2. The rights to the profits or net income, and
3. The rights to the net book value of the corporate assets.

In a traditional investor-owned corporation, these ownership rights are transferable property rights (as opposed to inalienable personal or human rights).

In an employee-owned corporation, there is no restructuring of the conventional ownership bundle; the traditional ownership rights are simply owned as property rights by the employees of the corporation. Since the voting rights are treated as property rights in employee-owned firms, these firms usually violate the one person-one vote rule characteristic of cooperative firms and political democratic communities where the voting rights are personal rights. Moreover, since the profit rights are attached to the capital shares, the profits are allocated in accordance with the invested capital of the employees, not their labor as in a worker cooperative.

Employee-owned corporations come in two basic varieties:

- *direct* employee ownership, and
- *indirect* employee ownership through a trust arrangement such as an ESOP

There are no tax advantages associated particularly with direct (non-ESOP) employee ownership. The better-paid employees will usually purchase the most shares in these companies, so the power and profits gravitate quickly to the managerial ranks. Hence the directly employee-owned firms tend to rapidly degenerate into management-owned companies (e.g., the Vermont Asbestos Group or the Mohawk Valley Community Corporation).

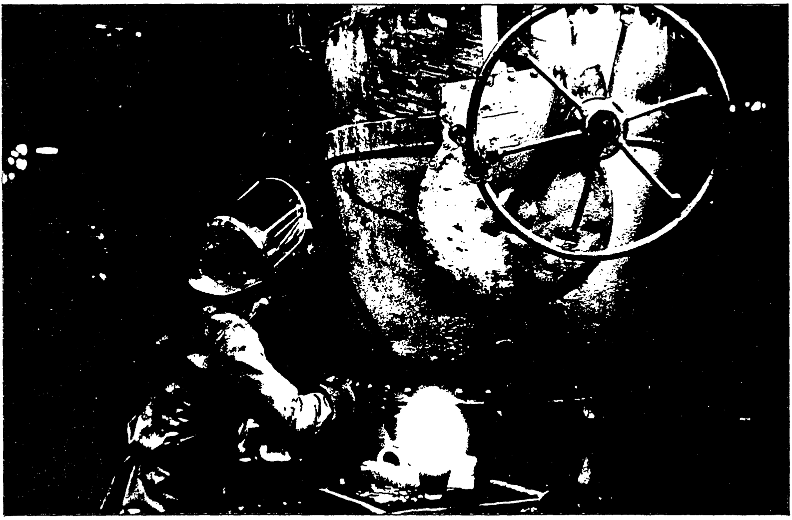
Most examples of employee-owned corporations are ESOPs where the ownership is indirect through an employee stock ownership trust or ESOT. The present form of the ESOP was established by the Employee Retirement Income Security Act (ERISA) of 1974. As in a pension plan, the corporate contributions to an ESOP are exempt from the corporate income tax. But, unlike an ordinary pension plan, an ESOP invests in the employer's stock—which makes an ESOP into a new vehicle for employee ownership (but a risky substitute for a pension plan).

The principal novelty lies in the "leveraged" ESOP arrangement wherein the ESOP gets a bank loan that is guaranteed by the corporation. The ESOP uses the money to buy stock from the corporation and then the stock serves as collateral for the loan. The company's periodic cash contributions to the ESOP are funneled through to pay off the bank loan. A tax break is captured because the company contributions count as deferred labor compensation, so the company pays back both the principal and interest on the loan with earnings that are deductible from taxable corporate income. Under conventional ownership, only the interest can be deducted as an expense. As the loan is paid off, the ESOP shares are allocated to the employees' accounts. The employees do not acquire direct ownership of their shares until they terminate their employment with the company or retire. The employees' shares end up being paid for by the dilution of the existing shareholders and by the foregone taxes.

The main tax advantage to the company is the ability to deduct the value of shares issued to an ESOP from the taxable corporate income. The recent *Tax Reform Act of 1984* has increased the tax-favored status of ESOPs for companies, owners, and banks. The taxable income to a bank is the interest paid on a bank loan. On a loan to the leveraged ESOP, 50% of the interest is now tax-free to the bank. Dividends paid out on stock held in an ESOP are deductible from corporate income whereas dividends on other shares come out of after-tax corporate income. If an owner sells a business to an ESOP and reinvests the proceeds in the securities of another business within a year, then the "rollover" is tax-free. These tax-breaks have made the ESOP into a highly favored financial instrument. But an instrument for whom? And for what purpose?

The original architect of the ESOP was a corporate and investment banking lawyer, Louis Kelso, who has co-authored books entitled *The Capitalist Manifesto* and *How to Turn Eighty Million Workers Into Capitalists on Borrowed Money*. The conservative but populist aspects of the Kelso plan appealed to Senator Russell Long, who pushed the original ESOP legislation through Congress and who has continued to spearhead the ESOP legislation.

ESOPs are usually established by corporate managers or owners who are interested in the tax benefits and who are not particularly interested in transferring any power or control to the employees. The vast majority of ESOPs are in companies where they represent only a small percentage of the ownership. In almost all ESOPs, majority or minority, the shares are distributed in proportion to pay so the distribution of votes and profits is as skewed as the



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wage and salary differentials within the company. An employee usually does not receive the vote on a share until the share is "paid for" by paying off the loan through the ESOP, and even then only if the vote is "passed through" to the employees. In the meantime, the votes are exercised by the trust committee often selected by the financiers and management.

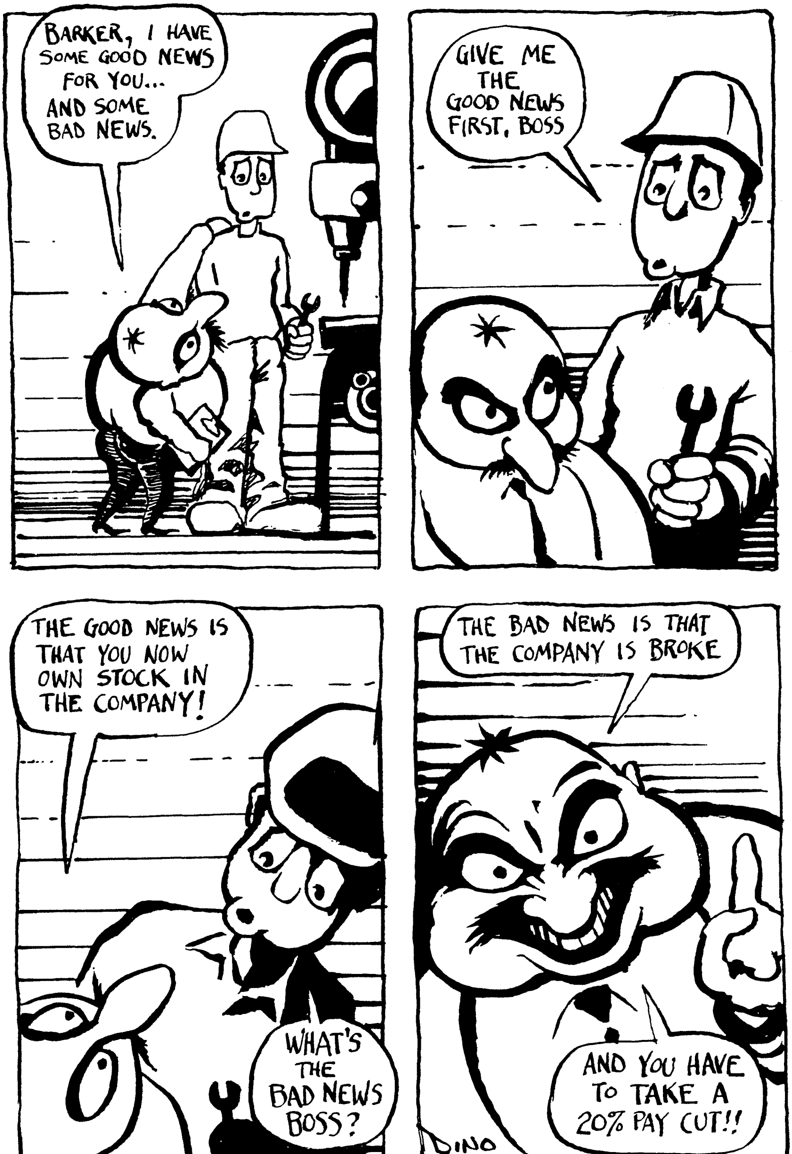
What is a Worker Cooperative?

A worker cooperative restructures the conventional bundle of ownership rights listed above. The first two rights—the voting rights and the profit rights—constitute what are called *membership rights*. A corporation is a *worker cooperative* if those membership rights are personal rights attached to the functional role of working in the company. Each worker-member gets one and only one vote. The net income is assigned to the worker-members on the basis of their labor (measured by hours or by pay). In a worker cooperative, the third ownership right to the net book value remains a property right held by the worker-members of the cooperative through some appropriate legal mechanism.

In a worker cooperative, labor hires capital so the structure is labor-based or "labor-ist." In a conventional corporation, employee-owned or absentee-owned, capital hires labor so the structure is capital-based or "capital-ist." Since labor is the hiring factor in a worker cooperative, the voting and profit rights are assigned to the people who work in the firm, not to capital, even though the members will supply capital to the firm by their membership fees and through retained earnings. This member-supplied capital is recorded by a system of internal capital accounts or by other means, and it receives a fixed interest-like return. The positive or negative economic net income, after normal expenses and after the interest-like return on member capital, is assigned to the members on the basis of their labor (called "patronage"). Since the membership rights are not proportional to this member-supplied capital, the members could, depending on their seniority, have quite different amounts of capital in their internal accounts and yet have the same voting rights and the same rights to patronage returns based on current labor.

ESOPs and the Labor Movement

Louis Kelso and Senator Russell Long have a vision, a vision of the ESOP as a central instrument to broaden the ownership of corporate capital and to revitalize capitalism by "giving the little guy a piece of the action." It is a vision of "workers' capitalism," a vision of "turning eighty million workers into capitalists on


BARKER, I HAVE SOME GOOD NEWS FOR YOU... AND SOME BAD NEWS.
GIVE ME THE GOOD NEWS FIRST, BOSS
THE GOOD NEWS IS THAT YOU NOW OWN STOCK IN THE COMPANY!
WHAT'S THE BAD NEWS BOSS?
THE BAD NEWS IS THAT THE COMPANY IS BROKE
AND YOU HAVE TO TAKE A 20% PAY CUT!!
DINO

borrowed money."

Any fundamentally pro-labor transformation of American industry must take place with the active support of the American labor movement. Labor is understandably skeptical of a program delivered to it by an investment banking attorney and a Southern Democrat. As the following quotation indicates, Kelso envisions the role of the union under "Universal Capitalism" as an emasculated ESOP booster club.

> Under Capitalism, the labor union will obviously not be needed as an instrument of power to effect a laboristic distribution of wealth. This was the function it performed in the transition from primitive to mixed capitalism, and is still performing. But to say that the labor union will not be needed to perform this function in a justly organized economy, with diffused ownership of capital and a capitalistic distribution of wealth, is not to say that there will then be no socially useful service for it to undertake. Voluntary associations of capitalist workers, operating through democratic processes of self-government, may serve their own members and the whole society by functioning as agencies for the economic education of the newly-made capitalists, and as instruments for the protection of their property rights. [*The Capitalist Manifesto*, 1958, p. 157.]

If unions are to give up their traditional role of protecting the workers and influencing management through collective bargaining, then does Kelso expect the workers to use their new-found "ownership rights" to democratically self-govern their work? Apparently not.

> Manager-employees should manage, and non-manager employees should be beneficial owners, but should not interfere with management. Amateur management is the last thing such a concern needs. [*Testimony before House Committee on Small Business*, 1979, p. 136.]

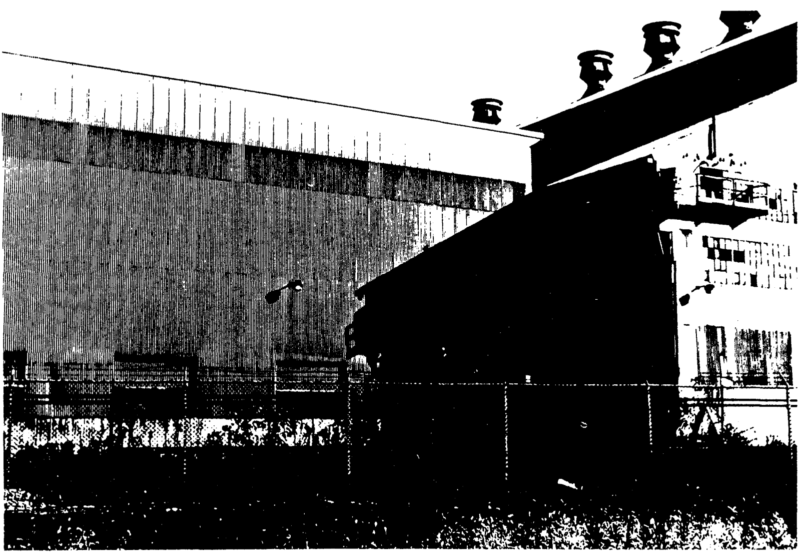
Thus, workers are to forfeit traditional collective bargaining and then turn over their fate to a professional caste of managers. According to Kelso, the employees should not "amateurishly" interfere with the managers who are "professionally" telling the workers what to do. It is easy to see why workers and unions are not more enthusiastic about this vision of industrial relations in the brave new world of Universal Capitalism.

ESOP Ownership as Second-Class Ownership Without Control

Progressive ESOP advocates would like to dismiss these views of Kelso and others as individual idiosyncrasies—which just coincidentally are shared by all but a handful of ESOP boosters. But these ideas about the "proper" role for labor are unfortunately built into the typical ESOP design. Trusts are usually set up when someone is not "trusted" with direct ownership. The trust mechanism interposes a layer of trustees between the indirect "beneficial owners" and the exercise of ownership rights.

Trusts are used, for example, when the beneficial owners are children, or are legally incompetent. Trust mechanisms have also been used to separate the control of massive pension funds from the worker-beneficiaries. As a result, the pension funds have been used to finance the export of jobs to union-free environments.

ESOPs use the trust mechanism. When Kelso refers to the employees as just being "beneficial owners," that is not a Kelso eccentricity. This is the language of the Federal ERISA law. The "employee-owners" are insulated from the control of their own worklives by the trustees who exercise the votes in the "best interests" of the worker-owners. For ESOP workers, as for children, the ownership is put in a "trust" because the ultimate



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owners are not trusted.

This insulation of control from the workers underlies the ESOP vision. It is a vision of society split between an elite including top managers, industrialists, bankers, and lawyers on the one side, and the other people such as their employees on the other side. It is a "populist" vision of placating the workers by letting them in on "a piece of the action" in a manner appropriate to their station in life.

In this vision, there are really two classes of ownership:

(1) first-class ownership for the elite, and

(2) second-class or beneficial ownership for the workers.

First-class ownership is ownership with control. Second-class ownership is "ownership" without control.

A striking example of first- and second-class ownership is the allocation of control in leveraged buyouts. There has been a recent spate of non-ESOP leveraged buyouts by management. Even though the stock is purchased with borrowed money, the managers exercise the votes of the shares they have purchased. That is first-class ownership. But in the typical employee leveraged buyout organized through an ESOP, the employees only get to vote "their" shares as the loans are paid off. In the meantime, management and the financiers exercise control over the firm. That ESOP employee-ownership is second-class ownership. In both cases, the shares were purchased with borrowed money. In one case, the owners vote the shares and, in the other case, the owners do not.

A Democratic ESOP?

ESOPs were designed to promote worker capitalism, not worker democracy. Is it possible to restructure an ESOP to make it more democratic, to put some control in the hands of the employee-owners? One basic principle of democracy, fundamental to both political democracy and the union movement, is the one person/one vote rule. There seem to be two ways to rig an ESOP to make it more democratic: (1) the two-tiered scheme; and, (2) the two share classes scheme.

In the two-tiered scheme, the votes are not passed through even on allocated shares, so that all votes are exercised by the trust committee. But then the ESOP agreement also specifies that the trust committee will follow the voting instructions of the employee-owners. The employee-owners vote, on a one person/one vote basis, about how to instruct the trust committee to vote the shares. The few democratic ESOPs, such as the Solar Center in San Francisco, Rath Packing in Iowa, Atlas Chain in

Pennsylvania, and the recent Seymour Specialty Wire in Connecticut, all use variations on the two-tiered voting structure to satisfy the one person/one vote rule.

There is a difference, however, between *using* this two-tiered scheme and having it stand up to legal and governmental scrutiny when challenged. In particular, it is not clear how to reconcile the fiduciary duties of the trustees with the agreement to obey the instructions of the beneficiaries should a case arise where there is a perceived divergence between the two obligations.

In the two share classes scheme, there would be voting and non-voting stock. Each employee-owner would get one share of voting stock and the vote would be passed through. The remaining shares would be non-voting. This scheme seems preferable because the votes are directly exercised by the workers. However, the status of this scheme is unclear under present legislation. Current law requires ESOP shares to have the highest combination of voting and dividend rights, commonly interpreted to exclude non-voting shares. Pending a definitive interpretation of the law or new legislation, a one person/one vote ESOP, using the two share classes, is potentially in conflict with ESOP law.

Both schemes make the ownership more first-class by overcoming the barrier the ESOP trust puts between the workers and their voting rights. The two-tiered scheme does an "end-run" around the trust by having the trustee vote the shares according to a separate vote taken by the employees. The two-class scheme breaks through the wall by having the votes "passed through" to the workers.

Another problem is to keep the ownership in the workers' hands over the course of time. As workers leave, their vested shares are ordinarily issued to them so the shares could be sold to outsiders. Recent legislation allows a company to insure maintenance of the shares in the ESOP trust through a buy-back arrangement. The norm, however, is to permit the gradual leakage of shares beyond the workforce.

These schemes work to endow an ESOP with cooperative attributes. For example, ESOPs are designed to base voting on property rights, so more votes accrue to those with more invested capital. By overriding that with a one person/one vote scheme, the property rights basis is partially transformed into a treatment of voting rights as personal rights. Another prominent characteristic of property rights is their marketability. By setting up a mandatory buy-back of the shares, that marketability characteristic is also negated in another move in the direction of treating the membership rights as non-transferable personal rights.

In each concrete case, the appropriate legal structure for worker ownership will depend on a complex set of factors which cannot be considered here. The point is that there is a wide range of legal possibilities. There are worker capitalist schemes designed to undermine union influence with visions of "ownership" while at the same time insuring that it is second-class ownership without control. There are also legal structures designed for democratic worker ownership where there is one person/one vote, where labor hires capital, and where the ownership rights are transformed into labor-based membership rights. The latter can be approximated by using a worker cooperative structure and/or a democratically restructured ESOP.

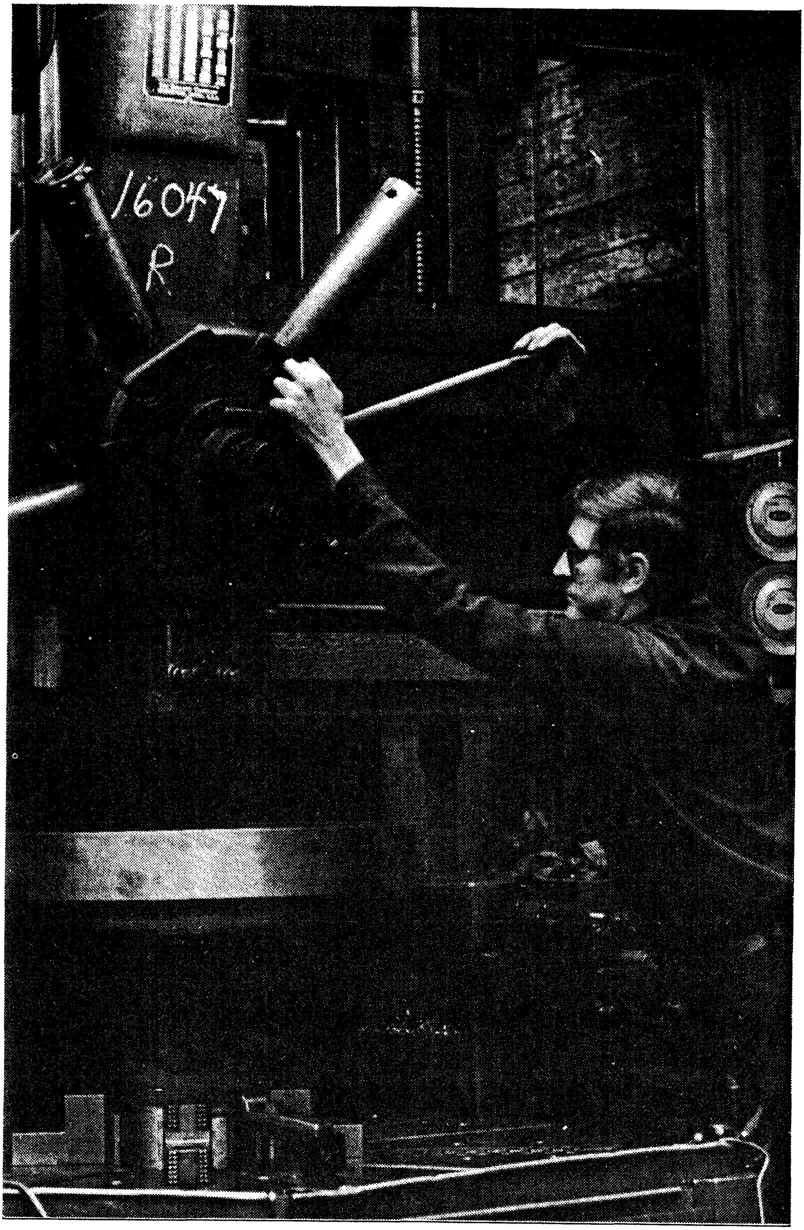
In either case, the union has a vigorous role with some new challenges. In the imposed management-dominated ESOPs, the union can bring a whole new set of issues to the bargaining table, the issues of turning second-class ownership into first-class ownership. In the worker co-ops or restructured ESOPs where the worker-ownership is already first-class, the union faces new challenges and opportunities both inside and outside the firm. Inside the firm, the union has the role of guaranteeing the democratic rights of the members by serving as the "legitimate opposition." Outside the firm, the union can provide the links between the individual worker-owned firm, other worker-owned firms, and the broader labor movement. Labor solidarity can then take on new forms to meet the technical, managerial, marketing, and capital needs of the unionized democratic worker-owned firms.

Populism: Broadened Ownership Rights or Broadened Human Rights

What about "broadened ownership"? Isn't it a populist idea? If not, what is the genuinely populist alternative?

Before the political democratic revolutions in the West, political sovereignty over people's lives was based on property rights in land. The monarch was the ultimate owner and ruler of the land. Power was sometimes delegated to lesser nobilities who "owned" or had "tenancy" and thus governed various regions of the country. The ownership of land was equated with political sovereignty over the people on the land. The landlord was the Lord of the Land.

Given such an ownership-based system of political government, one could imagine two strategies for the transition to *political* democracy:



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(1) a broadened ownership rights strategy, or

(2) a broadened human rights strategy.

In the broadened ownership approach, the equation between land ownership and political sovereignty would not be challenged. Instead, the idea would be to "democratize" and broaden the ownership of land, to "give the little guy a piece of the action." By becoming small landholders, some people would then gain a small measure of political control over their lives.

In the broadened human rights approach, the idea would be to sever the connection between land ownership and political control so that the rights to govern the people residing in a community could be transformed into personal rights assigned to the functional role of residing in that community.

While there was some weakening of the grip of traditional landed property by the development of numerous small holders, the political democratic revolutions ultimately took the human rights approach and did not stop short with mere "broadened ownership." There are good theoretical and practical reasons for this. Theoretically, the right to democratic self-determination should be a human right, not a property right which must be "purchased" from its prior "owners." From a practical viewpoint, it is a will-o-wisp to think that political democracy could be approximated by keeping the rights to govern people's lives as property rights.

It is a fundamental fact that property rights can be concentrated into a few hands, while personal rights are automatically decentralized on a "one-per-person" basis. As long as political power was based on property ownership, it would be futile to expect the broadened ownership of small landholders to fundamentally challenge the historical concentrations of property and power. Political democracy was *only* established by removing the question of political sovereignty from the whole arena of property rights through universal suffrage without property qualifications.

The history of social progress is the history of transforming certain property rights into human rights.

Today, the next step in social progress is the democratization of industry, extending democracy to the economic sphere. As one might expect, there are two strategies: (1) the broadened ownership rights strategy, and (2) the broadened human rights strategy. The broadened ownership strategy accepts that the control of people's worklives should be a matter of owning certain property rights, but argues that the ownership of such rights should be "broadened." The human rights strategy argues that the right of democratic self-determination should be a human right in the workplace as it already is in the political sphere.

Each strategy is represented by a legal structure for the organization of a firm, the conventional ESOP structure and the worker cooperative structure (with or without a democratized ESOP). Since conventional ESOPs do not challenge the traditional role of property rights in industry, ESOPs are much more "realistic" to bankers, corporate lawyers, managers, and conservative politicians. The massive historical accumulations of property and economic power are not challenged by creating more microscopic employee-shareholders through broadened ownership and worker's capitalism. At best, the workers will get hooked on a game they cannot win. At the very least, conventional ESOPs will confuse, divide, and undermine the labor movement. Thus, the economic powers-that-be are hardly worried and, indeed, may be quite supportive, when "populist reformers" expend their energies trying to broaden the ownership of corporate capital. Property rights can always be concentrated; personal rights cannot. As long as "populist reformers" stick to the game of property, power will always tend to remain in the same hands.

Genuine populism must change the rules of the game so that the control of industry will be people-based rather than property-based. Progress points in the direction of further democratization of industry by moving the control over people's worklives from the domain of property to the domain of human rights. Towards these ends, the best available means are unionized democratic worker-owned firms structured as worker-owned cooperatives and/or democratized ESOPs. ✦