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Mondragon – One of a Kind

INTRODUCTORY OVERVIEW

Co-operatism is not an ideology at Mondragon. It is a business strategy. *Mondragon Corporacion Cooperativa, 1995*

The enlightened goodwill of men acting in an individual capacity is the only possible principle of social progress. *Simone Weil, 1977*

From 1976 to 1986 we have been able to create 4,200 jobs when in Euskadi [the Basque Country] more than 150,000 jobs were *lost* [emphasis added] in the same period ... As you see it is not a brilliant result, but only a process of adjustment carefully calculated, reflecting the spirit of solidarity and audacity, has made it possible to avoid having any co-operative member unemployed. *José Maria Ormaechea, former chief executive of Caja Laboral (formerly the Caja Laboral Popular), 1986*

Late in 1995 the leadership of the Mondragon Co-operatives was summoned to a ceremony in New York to receive one of fifty awards worldwide which were handed out for an outstanding contribution, awards issued to celebrate the fiftieth anniversary of the United Nations. And indeed, the Mondragon Group is one of a kind among these case studies of employee-owned businesses. During forty years well over 100 co-operative enterprises were created, providing more than 30,000 jobs by the mid-1990s. It is true that the Mondragon Group is still smaller than either Britain's John Lewis Partnership (JLP), for example, or the group of German businesses associated with Germany's Carl-Zeiss-Stiftung. But it had grown from a standing and employee-owned start. By contrast, John Lewis and Zeiss have 60 and 100 years respectively of employee ownership behind them and each was the offspring of previously successful and long-established capitalist undertakings dating back to the mid-nineteenth century. If average annual rates of growth are the best measure of socio-economic business success,

then the Mondragon Group is probably the star performer of all those studied in this book. By the mid-1990s the Mondragon cooperatives affiliated to Mondragon Corporacion Co-operativa (MCC) – the umbrella organisation for most of them – were in aggregate the ninth largest business in Spain by turnover, generating profits of pesetas 30–40bn.

As for Mondragon, which is pronounced with the stress on the final syllable, it is the Spanish name of a small town in Guipuzcoa, one of the country's three Basque provinces. The town's Basque name is Arrasate. Even in the mid-1990s a large minority of the group's total activity was still concentrated in Mondragon itself or in its immediate neighbourhood.

Apart from geography, the other cornerstone of the group – almost from its inception – has been the co-operative membership arrangements. These were based on three main principles: first, employees have to buy their way into a job by making a down-payment before they start employment; second, employees must be members of the co-operative where they work (and thus indirectly of bodies like MCC); and third, each employee has an equal vote. These arrangements are discussed in the last section of this study.

The group includes a wider range of activities than any other of the businesses or groups of businesses among these case studies. For it extends from manufacturing to banking and from farming to retail distribution. It also includes schools and housing co-ops and an array of specialised institutions ranging from a research centre to its own social insurance and welfare agency. However, despite this astonishing diversity, it is the group's manufacturing co-operatives which have been historically at its heart. Until the last decade they accounted for easily the largest share of both employment and value added. The service sector became mainly responsible for the continued growth of the group from the later 1980s; but even in the late 1990s the industrial co-operatives still accounted for well over half of group employment.

Moreover, within the industrial or manufacturing sector there is a wide span of activity. Domestic appliances, or so called 'white' goods and their components, were traditionally the most important product lines, but there are others, including car components, machine tools, building materials, castings and dies.

Apart from membership of the group and a set of common co-operative arrangements and rules, most of these ventures share a common geography and a Basque national identity. This comes from their location in one of the three provinces of Spain which are officially Basque – Alava, Vizcaya and Guipuzcoa – or in neighbouring Navarra.

However, changes started to happen from the mid-1980s onwards. Geographically there were the beginnings of an expansion in Spain outside the Basque heartland and even abroad, especially in retailing (Eroski) and banking (Caja Laboral, formerly Caja Laboral Popular), but also increasingly in manufacturing too. Second, new business structures began to be permitted diluting the co-operative 'purity' of the earlier years. Whether this dilution indicates a failure of the co-operative model in the face of growing competitive pressures – or whether it is a case of peripheral adaptation which ensures survival and future success is one of the debates surrounding Mondragon as it looks to the future.

Mondragon was conceived with the arrival in the town in 1941 of a Basque catholic priest, Fr José Maria Arizmendiarrieta. Under his leadership a modest apprentice school was opened for local boys. It was five of the original graduates from that apprentice school – who later studied part time to achieve engineering degrees at Zaragoza University – who were the founders of the first co-operative, ULGOR. At the apprentice school and other youth clubs and associations organised by Arizmendiarrieta, they had listened to lectures by Fr Arizmendiarrieta on Catholic social teaching. He was later their adviser when it came to the starting of ULGOR and the establishment of the first co-operative structure; and he remained the key adviser and inspiration for the rapidly expanding group down to his death in 1976.

ULGOR's five founders were not only professionally qualified engineers. They had gained management experience by working in Mondragon's largest business of the conventional capitalist kind – the Union Cerrajera, which was mainly engaged in steel fabrication. Very rarely in the history of the last 150 years have the founding fathers of a new start-up co-operative had this combination of professional qualifications and managerial experience – otherwise the typical life story of those ventures would have been notably more successful.

After making full allowance for the drive of Fr Arizmendiarrieta, it is clear that ULGOR's founders, or at least the four of them that

remained in the group, were entrepreneurially talented. ULGOR started in 1956 with a workforce of just over twenty people, and a modest oil stove as its only product. Particularly after the founding of the group's bank, the Caja Laboral Popular (CLP) in 1959, growth was explosive:

	Number of Co-ops	Number of Members
1956	1	23
1960	4	395
1964	32	2,620
1968	49	5,981
1972	57	10,436
1976	69	15,417
1980	92	18,733

*Note: numbers include the bank, the group's retail network and its agricultural co-ops, but not educational establishments and housing co-ops.
Source: Wiener(1987)

Growth was qualitative as well as quantitative. This earlier period was marked by an almost uninterrupted increase in the output of 'white goods' and in the size of ULGOR, the business in which this production was concentrated. At its largest, in 1979, employment in ULGOR reached close to 4,000 people.

As implied in the third epigraph, it is arguable that the golden years of growth ended in the mid-1970s. When he wrote the article from which the epigraph was taken, José Maria Ormaechea, one of ULGOR's founders and later chief executive of the CLP, was contrasting the ten years' experience down to 1986 – when the group had to struggle to avoid the consequences of recession – with the easier conditions which had prevailed before. In an earlier period, he noted, employment in the group had been growing 'at the rate of about 15% annually, in a national market that was growing at the rate of 6 to 7% of gross national product'.

There may be differences of opinion about exactly when the slowdown of growth should be dated. But the main point is not in doubt. It is that the the group outperformed Spain's conventional capitalist competition both in the long expansionary phase of the economy's business cycle; and in the subsequent years of recession. It grew faster in the former period; and it withstood the recession much more effectively, even managing a significant amount of real growth during those difficult years. One of the most interesting success stories in the group's whole history is how the effects of that recession on group employment were contained – a story which repeated itself in the early 1990s.

What then of the period since Mr Ormaechea wrote his article in 1986?

Among the manufacturing businesses these years have been marked by an almost continuous process of restructuring which indeed started earlier. Symbolic of this restructuring is what has happened to ULGOR. Numbers employed there fell dramatically from their earlier peak. They did so as the output of 'white goods' was restructured and as the earlier mass production systems were largely replaced by more flexible ones. By the early 1990s employment in what used to be ULGOR, but was renamed Fagor Electricodomesticos in 1989, was not much more than half the peak level of 1979, though by 1997 it had jumped back to 3,500..

On the other hand, as a partial offset to the employment consequences of the continuous restructuring of its 'white goods ' production, the group succeeded in the second half of the 1980s and mid-1990s in establishing itself in a major new market – for motor industry components. By the early 1990s, car components accounted for as much as 20% of group manufacturing sales. In the industrial sector the successful penetration of this new market has been a most notable achievement of the group's later years. Furthermore the quality of the group's motor car components has been widely praised – for example in 1992 it received from General Motors Europe its 'Best Supplier of the Year' award.

These successes notwithstanding, most of the growth since the mid-1980s has come either in the service sector or from acquisitions and joint ventures. Two early notable acquisitions were of Fabrelec and Luzuriaga. Each employing over 1,000 people, these were simply acquired by purchase after a change of group policy in the late 1980s. Fabrelec makes 'white goods' in the neighbourhood of Bilbao; and Luzuriaga is a foundry operation spread over a number of sites which produces castings mainly for the motor industry. In both cases their acquisition was designed to strengthen the position in their respective markets of important existing group businesses. On the other hand those working in these two undertakings, Luzuriaga and Fabrelec, chose to settle for different corporate identities over the long term. The former is to remain a conventional wholly-owned subsidiary of the group as a whole. At Fabrelec, by contrast, the workforce voted in 1997 to become a cooperative and for a name change to EDESA. What's more that is not the only example of workers in a newly acquired business voting themselves into a cooperative future. MAPSA when acquired was a bankrupt capitalist undertaking which made components for the motor industry. Like their counterparts at Fabrelec a majority of its workforce voted to adopt a cooperative structure with the associated capital contributions by its members.

But to refer to the question of growth: if the effect of these acquisitions is excluded, then the numbers employed in the group's manufacturing businesses fell. Again, if acquisitions are excluded, employment growth in the group as a whole has mainly been attributable to expansion by the group's retail network, Eroski, its bank, the Caja Laboral Popular, and other smaller service activities.

About the present (late 1990s) and future levels of employment in the group's manufacturing businesses two rather different points seem worth making. The first is that over the middle years of the 1990s manufacturing employment, measured as a percentage of the total, appeared at about 55% to hold up rather well. But second and over the long term the proportion of total group employment engaged in manufacture seems bound to decline, a trend common to all the developed countries of the West. It is also almost a necessary consequence of the continuing success of the group's manufacturing businesses at improving the productivity of their labour. To highlight just one statistic: in the four years down to 1989/90 labour productivity in the consumer durables businesses within the group's manufacturing activity – that is in its mainly 'white goods' undertakings – increased by an annual average of 8.5%. With one qualification, it seems out of the question that the group could manage to increase its market share of these essentially 'mature' goods at the same pace. So, subject to that qualification, employment in those businesses seems bound to decline.

The qualification is, of course, about exports, which fluctuated around 25% of total industrial sales during the 1980s and early 1990s. But they had rocketed up to 46% by 1997 and it looked as if they might well be on target to achieve the goal of 50% which had been set for the year 2000.

It is a plausible hypothesis that the removal of Spain's tariff barriers associated with its EU membership was, to begin with, more a source of new problems than of new opportunities for the group. On the other hand the huge increase in the export percentage in the middle and later 1990s suggest that the balance of advantage from Spain's EU membership later moved in the group's favour. It had needed to become more market-orientated and that was clearly a key factor behind the decision to expand, in joint ventures and otherwise, outside the geographical limits of the Basque country and indeed of Spain itself. But what the export figures of the later 1990s seem to show is that the group had by then substantially achieved a shift to greater market orientation.

With the benefit of hindsight, the need for greater market orientation may turn out to be a key shift of emphasis. The first two major acquisitions were driven by a market rather than a co-operative group logic and others have followed. Joint ventures have been established which are not structured as co-operatives. And the whole relationship of the co-operatives with each other has been formalised and centralised around the Mondragon Corporacion Co-operativa (MCC), founded in two stages in 1990 and 1992.

Like much else in Mondragon, the structure of the group started evolving rapidly from the mid-1980s onwards. In effect, from the early 1960s to the mid-1980s what bound these businesses together was their set of formal ties, embodied in a contract of association with the bank (the CLP). During that period the CLP, quite apart from its banking and banking-related functions, performed a leadership role. But at the end of 1984 that was all changed. An elected Co-operative Congress was established and held its first meeting on 19 December of that year. Subsequent to that, the CLP dropped much of its 'special' relationship with the Mondragon co-operatives and its management consultancy role was spun off into a separate co-operative or into MCC headquarters control department. Now, for most of the co-operatives, MCC performs a federal government role, particularly in strategic planning – although a few refuse to participate in these new arrangements.

Finally, a point of history. With one exception, the founders of ULGOR had all gone into retirement by the end of the 1980s. In effect the group's leadership was passed to a new generation. Inescapably the prestige of the new leaders is less than that of the founders. What is perhaps striking is that the group has managed to weather this once-and-for-all transition without any marked conflict or instability.

THE BUSINESS RECORD

Early History down to 1959 In 1956 five young engineers set up a small new manufacturing business, in a factory built for the purpose, in their home town of Mondragon in Spain's Basque province of Guipuzcoa. Their family names were Usatorre, Larrañaga, Gorroñogoitia, Ormaechea and Ortubay: which they rolled into the acronym ULGOR, to supply the new venture with its name. At the start there was just one product line, unsophisticated oil stoves for cooking, and a workforce which is reported to have numbered twenty-three. In its early days the business was incorporated as a conventional private company limited by shares.

Earlier, in 1955, these same five young engineers had tried to establish their own new business in a less direct way: by the purchase of a bankrupt one in nearby Vitoria. That attempt was not a marked success. But Mondragon had the great advantage of being their home town and one in which they were already quite well known as 'local boys who had made good'. Above all they had the support in Mondragon of the local Catholic priest, Fr Arizmendiarrieta, a man who had already shown outstanding ability as a catalyst of local community initiatives. A convivial institution in the life of young men in the Basque country of those days was the so-called *chiquiteo* – a kind of peer group drinking club and entity for mutual support. It seems that the five relied partly on the friends and contemporaries in their *chiquiteo*, and very much on the support of Fr Arizemediarreta, when it came to raising the capital of ptas 11m needed for the company to open for business.

ULGOR evidently got off to flying start. An early observer, Desroches, reports that it was already employing a workforce of 143 by end-1958, less than three years from start-up. The potential of the business was greatly strengthened when, in the same year, butane gas having reached Mondragon for the first time, the production of gas cookers was added to that of the original oil stoves.

For a British reader Mondragon may perhaps usefully be compared with one of the small towns in the valleys of South Wales. Even if the mountains of South Wales are scarcely a match in height or cragginess for their Basque country counterparts, in the early postwar years the economic and social landscape was not dissimilar. The characteristic settlements of both regions at that time were small industrial towns and/or large industrial villages.

Within the category of small Basque industrial towns, Mondragon might have claimed, before it became world famous for its co-operative group, several special features. One was the antiquity of its metal-working tradition. According to *Encyclopaedia Britannica*, the swords of Mondragon became famous well before those of Toledo. In the early 1940s, when the five engineers who started ULGOR were in their early teens, that metal-working tradition was chiefly represented in Mondragon by a steel-fabricating business of a substantial size and a conventional capitalist character: the Union Cerrajera.

A second feature which distinguished Mondragon from other small Basque industrial towns was the radicalism of its political tradition: a radicalism which embraced both the politics of labour versus capital and the politics of Basque nationalism. Evidence of the former includes an apparently ferocious strike mounted by its labour against the managers and owners at the Union Cerrajera in 1916. The stoppage is reported to have lasted several months before the strike eventually folded. Other evidence comes from the Asturias rebellion in 1934: when the Asturias miners raised the flag of workers' revolution at Oviedo in 1934, the only armed contingent which marched to their support from outside the region came from Mondragon. Then again, in the Spanish Civil War three Mondragon battalions fought on the side of the Republic against the forces of General Franco: one socialist, one nationalist and one made up of less directly affiliated volunteers.

It seems too that Mondragon's Basque nationalism was strengthened by its geographical position. It was never of course the region's capital and it did not have the singular associations with Basque history enjoyed by Guernica. But it was in a central position roughly equidistant from the three main centres of Basque population – Bilbao, San Sebastian and Vitoria.

The Basques, and not just the citizens of Mondragon, were solidly against General Franco in the Civil War. And that was true almost as much of the region's Catholic priests and hierarchy as of its Catholic laity. In February 1941 Arizmendiarrieta arrived in Mondragon with a special mission enjoined upon him by his bishop: to pay special attention to the needs of youth. In 1941 he had behind him

not only his years of study at the seminary in Vitoria. He had also been in uniform, on the Republican side, in the Civil War. In fact, he had quite narrowly avoided execution after being captured by Franco's soldiers. His rather unusual army job was editing a trade union newspaper for his fellows in the Republican army to read.

When Fr Arizmendiarrieta arrived in Mondragon, the Civil War had ended less than two years before. Franco's soldiers and police were quartered in the town and evidently behaved like an army of occupation. It was forbidden to speak the Basque language in public. It goes without saying that there was a complete interdiction on political or trade union activity, except within the Government's Fascist framework.

In his mission to the youth, Fr Arizmendiarrieta's first initiative, in these rather unpromising conditions, was an approach to the top management of the Union Cerrajera. The company operated a small apprentice school for boys, the only facility of its kind in the town and neighbourhood of Mondragon. Fr Arizmendiarrieta's request to its top management was that the size of their apprentice school should be modestly increased. The request was coupled with an offer that, with the help of the local church and local parents, he would find the necessary extra cash. The company refused. What happened next was described in my earlier book as follows:

> Fr Arizmendiarrieta then set about achieving his ends in a different way: he would promote a new and separate technical school. Support from the community was mobilised by techniques which were both ingenious and daring. Ballot-box type objects, 'urns', were placed at street corners; members of the local community were invited to drop pieces of paper inside, indicating whether they would support a new technical school with cash or in kind. It is said that 600 positive responses were found when the 'urns' were emptied. Since Mondragon's population was then about 8,000, the response represented support from roughly 25% of the town's families.

In any case, though both the local authority and the Union Cerrajera chose not to contribute, the support promised in the 'urns' was judged sufficient to go ahead. A small new school, with an initial enrolment of twenty students, was opened in October 1943. Equally important, the involvement of the local community was strongly maintained. Those who contributed elected the school's management committee. Moreover, because of recurrent costs fund raising continued. The students themselves, we are told, played a large part in organising the activities which brought in the money. Their link with the local community was thus put on a more or less permanent basis – and they had gained some first experience of organising themselves and others to get things done.

There are no prizes for guessing that the first intake into the new school included those five young men who later became the founders of ULGOR. There are no prizes either for guessing that the school's curriculum included, as well as technical subjects, lectures by Fr Arizmendiarrieta on Catholic social teaching.

The upper limit of the technical teaching at the new school was quite modest. It could equip people for junior technician posts and even to be foremen. But it was in no position to offer courses leading to professional degrees. To overcome that limitation Fr Arizmendiarrieta performed another invaluable service. He persuaded the authorities of the engineering institute in Zaragoza to accept eleven of the new Mondragon apprentice school's graduates as part-time students. The arrangement was that these young men would combine working for their living with part-time study. And so it came about that these same eleven successfully passed the professional engineering examinations at Zaragoza in 1952. There are no prizes for guessing that ULGOR's five founders were among this group as well.

Before leaving what were in effect a series of educational initiatives which predate the setting up of the first Mondragon business, one further development must be chronicled. As early as 1948 Fr Arizmendiarrieta was instrumental in the creation of an umbrella organisation to have responsibility for education and training development in the town. It was called the League for Education and Culture. Its most famous subsequent offspring was Mondragon's exceptional polytechnic-type institution, the Escuela Profesional Politecnica.

The remaining parts of the intervening story can be quickly told. Before launching out on their own – first, as we have seen, in Vitoria with limited success, and then in Mondragon itself – four of these five young qualified engineers took junior management posts with the Union Cerrajera. There they apparently sought to persuade its top management to reform the structures of the business in ways suggested by Fr Arizmendiarrieta's lectures. It was only

when this effort at persuasion ended predictably in failure that they decided to try to start a business of their own.

The successful start-up of a new business from scratch is often, and rightly, presented as one of the most challenging tasks of the twentieth century. What is striking about this case of ULGOR is how quickly its founders seem to have had the time to devote to additional activity of an entrepreneurial character. As early as the second year after start-up, in 1958, ULGOR took over two previously capitalist foundries in the neighbouring village of Escoriaza; thereby, among other things, securing a supply of one of its main needed materials.

In the case of those foundries the entrepreneurship of ULGOR's promoters was directly involved. But their example also seems to have been of great importance in these early years. For by the end of the 1950s five other 'confederate' manufacturing businesses had been started, either in Mondragon itself or nearby. They can be described as confederate because in 1959, following ULGOR's example, they transformed themselves from share companies into co-operatives; and because, when the group was later formed, they joined it.

The 'Confederate' Five

Name	Where	Main Product
Arrasate	Mondragon	Machine tools
Construcciones San José	Hernani	Grinding machines
Funcor	Elorrio	Foundry products
Talleres Ochandiano	Ochandiano	Food-handling equipment
Tolsan	Amorebieta	Forgings

The establishment of the first consumer co-operative, also in Mondragon itself, dates from this same period. From the small beginning of a single store can be traced the development of today's rapidly expanding retail network: Eroski. Eroski is notable not only for its size and its rapid expansion in the late 1980s and 1990s. What is perhaps most striking about it is the sophisticated ownership and control structure which it developed in its early days: in which the interests of the consumers and of those who work in the retail network are finely balanced.

The real key to future development in these early days was the legal registration of a credit co-operative in 1959, a step formally acknowledged by a notice in Spain's official gazette in July of that year. Before the end of 1959 two branches were in business: one in Mondragon and one in Elorrio, across the provincial boundary in neighbouring Vizcaya. The rightly famous Mondragon Bank, the Caja Laboral Popular (CLP), was under way. This was the brainchild not of ULGOR's founders but of Fr Arizmendiarrieta. It is not too much to claim that the subsequent development of the group would have been impossible without the local savings which the bank mobilised and then invested in co-operative ventures. From the early 1960s to the mid-1980s it was the set of links between the bank and the individual co-ops which constituted the Mondragon group structure. Those links took the form of a set of contracts of association. The two top posts in the CLP were held for many years by two of ULGOR's founders: the chief executive was José Maria Ormaechea and the chairman Alfonso Gorroñogoitia.

The change in corporate status from companies to co-operatives was effected both by ULGOR and by the other new start-up businesses in 1959. Again, the head and the hand of Fr Arizmendiarrieta was behind them.

Some will divine the hand of providence behind the growth of the co-operatives in Mondragon after Fr Arizmendiarrieta first arrived. But two other ways of looking at what happened seem worth suggesting. One is to point to a kind of dialectic: between the interdiction by the Franco regime of any genuinely free political or trade union activity; and the channelling of creative energy into rather different fields – technical education and Catholic social teaching. We may then pose the question: could the second, and today's quite exceptional co-operative grouping which is its fruit, have happened without the first?

But perhaps the whole story is best presented as yet another example of the importance of the contingent in human affairs. If we look at what happened in this way, we will be inclined to emphasise the absence of any necessity in the sequence of developments. There was nothing necessary about Fr Arizmendiarrieta's arrival in Mondragon in 1941; nothing necessary about his bishop's injunction that he should specially concern himself with the problems of the youth; nothing necessary about the community's response to the initiative he proposed after having been rebuffed by the Union Cerrajera. And this line could clearly be extended indefinitely. In

other words, what we have here may be no more, but also no less, than a case of one good thing happening to lead on to another.

From the Early 1960s to 1980s: The Golden Years of Rapid Growth

In the article from which I quoted in the epigraph, José Maria Ormaechea suggested that the Group passed over something like a watershed in the mid-1970s, after which economic conditions were never really the same again. (In fact the statistics seem to suggest that the discontinuity occurred rather later.)

If we include the Caja Laboral Popular (CLP) and the retail store, eight of these Mondragon businesses – by then all co-ops – were trading in 1960. Total numbers employed at that date seem to have been just short of 400.

For the twenty years down to 1979 the numbers of co-ops and the numbers employed are set out in the table.

Year	Numbers Employed	Numbers of Co-ops
1960	395	8
1961	520	12
1962	801	18
1963	1,780	29
1964	2,620	32
1965	3,441	36
1966	4,202	39
1967	5,082	48
1968	5,981	49
1969	7,945	47
1970	8,543	52
1971	9,416	55
1972	10,436	57
1973	11,417	58
1974	12,915	63
1975	13,808	65
1976	15,417	69
1977	16,504	73
1978	17,022	78
1979	18,295	87

The striking feature of these figures is the consistency of the speed of expansion, at least after the slower build-up of numbers employed in the earlier years. Between the start of 1961 and the end of 1969 a total of 39 extra co-operative businesses were added. Between the start of 1970 and the end of 1979 the corresponding figure was a total of 40 new businesses. Over the 20-year period the group was growing by an average of just less than 4 new co-ops each year: 79 new ones over 20 years.

Two further points are worth underlining. First, very nearly all the additional businesses added to the group during these years – over 70 out of the 79 – were brand new undertakings started from scratch. Very few were the result of the conversion into co-ops of businesses which had previously existed as conventional capitalist companies. The extra numbers due to the splitting off as separate entities of parts of an earlier integrated business were also very few. And so were the numbers of previously independent co-ops which successfully applied to join the group. In fact I know of only one in this category: a leading manufacturer of machine tools, Danobat. Thus far the greatest part of this expansion consisted of the 'organic' growth of new co-operative ventures. So far as I know there has been nothing to compare with it in previous co-operative history.

Second, in this twenty years of new business start-ups there were almost no failures. Once again there is nothing to compare with this in the history of co-operative business. And the proportion of survivors is far higher than would be expected by, for example, a successful venture capitalist.

The rate of employment expansion was also remarkably steady. That emerges particularly clearly if we divide the twenty years into five sequential periods of four years.

Growth of Numbers Employed: 4-Year Periods 1960–1979

Years	Extra Numbers
1960–63	1,385
1964–67	3,300
1968–71	4,334
1972–75	4,397
1976–79	4,487

This steadiness is partly explained by the fact that over this period the responsibilities of a particular division of the bank, the

Caja Laboral Popular (CLP), covered the promotion of new jobs in existing co-operatives as well as in new ventures started from scratch.

A final set of statistics traces the growth of group sales:

Group Sales: (Billions of Pesetas) 1965–85
Constant 1985 prices

1965	17.2	1972	65.1	1979	114.2
1966	25.1	1973	72.6	1980	119.5
1967	29.3	1974	83.9	1981	126.0
1968	32.3	1975	80.1	1982	124.8
1969	48.4	1976	85.6	1983	128.9
1970	50.8	1977	94.5	1984	131.0
1971	54.1	1978	101.3	1985	141.0

Any explanation of this phenomenal growth should take full account of the propitious features of the Spanish economy during the 1960s and early 1970s. These were very much, to use the cliché of the time, the years of Spain's economic miracle. There was a strong and sustained growth in domestic demand and it took place within a heavily protected market. It was not only the group of Mondragon co-operatives which achieved high levels of growth of manufacturing output and manufacturing employment during this period.

And yet, as we saw earlier, during this whole period the employment growth of the Mondragon co-ops easily outperformed that of the Spanish economy as a whole. So it looks as if there *is* something extra to be explained. During the 1960s that extra is probably best accounted for by the example of ULGOR and its early associates; and by the fact that from its very beginnings the CLP was in principle prepared to make loans to help new co-operative ventures to get off the ground.

But from 1969 onwards there is a more specific extra factor which helps us to explain this extraordinary phenomenon of successful new business start-ups and subsequent growth. In that year a decision was taken to set up, within the bank, a new and specialised agency. The agency was to have special responsibilities for the future growth of the group and for overseeing the quality of business performance. It was given the Basque name of Lankide Sustaketa (LKS) which is how it has been known since it was spun off from the CLP in 1991. But during the years which it spent inside the CLP it was most generally known by its Spanish name, the 'Empresarial' Division. The best English translation would be the 'Entrepreneurial Division'. For some reason most of those who have written about it in English have favoured a more insipid translation and called it the Management Services Division. In what follows I shall use the Spanish word 'Empresarial'.

From its inception, the most specific responsibilities of the Empresarial Division concerned the provision of specialist assistance to the existing co-ops and help with the process of getting new ones started. An equal priority seems to have been assigned to each of these tasks. Specialists in the division's professional staff, which was built up quite rapidly until it numbered just over 100, worked with the existing co-ops or with prospective new ones, depending on the balance of need at any particular time. The work with the potential new start-up businesses was no doubt more eye-catching and original, and commentators have understandably devoted more attention to it. But it seems probable that more of the time of the division's professional staff was in fact spent working with the existing businesses: whether helping them to expand or simply to stay out of trouble. There is no need to describe that work. Its character is obvious enough. Evidence of its success is the almost complete absence of business failure in the group over many years. In effect this branch of the division's work can perhaps best be seen as a kind of 'hands on' version of the superintendence exercised by German and Japanese banks over the businesses in which they are important shareholders.

On the other hand, if only because of its originality, there is a case for offering a brief account of the work of the Empresarial Division in relation to new start ups. What perhaps can best be called a selective and stage-by-stage midwifing process was invented by the division and is described at some length in my earlier book. I summarise it here.

The midwifing process evidently came into existence in response to local demand. We may imagine would-be co-operative entrepreneurs approaching the new division and asking for help in the task of going forward to the establishment of a successful new business. At the stage of this first approach, the business would already have had a specific product and market focus. The would-be co-operative entrepreneur might be an individual alone or a

group. The division was a natural choice as an appropriate body to approach with such a request. For it was part of a co-operative bank which was already in the business of making loans to co-operative ventures. The bank could thus be expected to offer similar borrowing facilities to such newly starting businesses – provided that its own lending conditions could be satisfied.

It needs to be stressed that in all cases the first approach, and the associated product and market ideas, came from the would-be co-operative entrepreneur. From its inception, the staff of the Empresarial Division insisted on that as a matter of rule. Any other policy would have called into question the ultimate responsibility for the success or failure of the potential project. It was essential, in the Division's view, that this responsibility should rest from the outset with the would-be entrepreneur; or rather with the would-be entrepreneur and his or her associates. The qualification is necessary because the division further insisted from the start that it would not offer its services to would-be co-operative entrepreneurs on their own. The potential other members, or at least some of them, the potential employees of the prospective co-operative business, had also to be involved from the start of the midwifing process.

The 'high summer' of this co-operative midwifing activity by the CLP's Empresarial Division was the 1970s and early 1980s. Thereafter policy changed and new ventures were promoted, if at all, marsupially – inside existing co-operatives – and only later split off as separate entities. During the high summer period an average of three of four new ventures were successfully midwifed annually. It is this record which has frequently been presented as the single most remarkable business achievement in the Mondragon group's whole history.

As compared with this annual average of three or four new start ups, it seems that the division was typically approached by perhaps ten would-be co-operative entrepreneurs each year. The rest evidently failed to satisfy the sequential conditions which the division imposed during the midwifing process. Only those who satisfied all the earlier conditions were permitted to go forward to the final stage. This was an approach to the CLP's banking division to provide, in the form of loans, whatever finance was judged to be necessary for the venture and which could not be raised by the co-op's prospective members. Typically, a capital contribution per prospective co-operative member equivalent to around one year's salary was required under CLP rules.

What conditions were required for success and how did the midwifing process work? In a fair proportion of cases the product around which they were centred was judged inappropriate within the framework of the group's existing businesses and objectives. Products, and therefore approaches, were turned down because their capital needs per member of the prospective co-op were judged to be beyond the resources of a combination of those members and the bank. As frequently, they were turned down for something like the opposite reason: because the product was judged to fall below a minimum level of technology and sophistication which the division insisted upon. The logic of that was a clear policy objective that the group should seek to raise the quality of the goods and services produced in the Basque country.

Given the satisfaction of this first pair of conditions, a lengthy process, lasting in many cases for well over twelve months, got under way. The key first step was the requirement to choose a prospective manager. If the first approach had been made by an individual would-be entrepreneur, then that person might be chosen as prospective manager. That was not compulsory, however, and a prospective manager could even be chosen from outside. The important point was the suitability and commitment of the potential manager to do the job not his or her provenance.

What happened after that was perhaps the most original feature of the whole process: the prospective manager was taken into the division, and given a salary and an office to work on the project. That happened under a set of arrangements which continued, anyway in principle, until either the new venture got under way or it failed to satisfy one of the subsequent conditions in the series. Meanwhile, a senior member of the division's professional staff was assigned to work jointly with the prospective manager on the project, and to assume a role of 'godfather' to it. Where the project went forward to actual implementation, this 'godfather' was required to stay with it for at least the first twelve months after the start of trading.

With the help of the 'godfather', and with access to the whole range of the division's specialist departments, the prospective manager was essentially required to produce successive drafts of an ever more detailed feasibility study and business plan for the proposed venture. Throughout this pre-investment period, he or she was also required to keep in regular contact with the other members of the prospective co-op and to keep them fully informed. In relation to the prospective membership, he or she had the further task of offering them a full account of what their obligations and rights would be in the event of actual start up: and in particular their obligations to make significant capital contributions to it.

In other words, the process was designed around two main objectives. First it had the objective of making sure that when the bank itself eventually came to decide whether or not it should lend the money necessary to allow the business to get under way, that decision would be reached with the benefit of the best possible information. The second objective of the process was to maximise the commitment to it, and indeed to the group as a whole, of its prospective members, including its prospective manager.

Since it was largely discontinued in the mid-1980s, this exceptional business midwifing process has been the subject of some criticism inside the group. It has been suggested that the process itself was not sufficiently entrepreneurial; too 'bookish' perhaps, and not sufficiently market-orientated. It is also pointed out that the claim of a nearly 100% success rate, through strictly correct, is subject to an important qualification. The qualification is that the success of a fair number of the businesses started by this process, at least in its later years, was achieved only at a high cost in financial support by the bank, over significantly longer periods than was originally foreseen.

No doubt the fact that it has been largely discontinued – or retained only in highly modified form – may be taken as evidence that this method of new business midwifing will not always work. Indeed in a really competitive business environment, like those which have prevailed in Spain since it was discontinued, it may work only rarely if at all. All the same it seems to me quite wrong, as well as churlish, not to concede that it had real success in the times for which it was invented. It also seems to me probable that in similar conditions a similar method would also have been likely to produce good results. Indeed I would be inclined to go further and agree with those who have argued that this method and the results achieved by it were the single greatest achievement of the group during the years of its golden growth. The charge that the costs were excessive, in the sense of imposing an unacceptable drain on the financial resources of the bank, will scarcely stand up in the light of the actual record of the CLP.

So far we have discussed mainly the statistics and the processes of the group's growth in the 1960s and 1970s. In the final part of this section we look at the range of activities spanned by the co-operative businesses which made up the group during this period, and at a small number of particular co-ops.

We begin by excluding – for separate and later discussion – those of the group's businesses which produced services and not actual goods: most notably the bank itself, the social welfare organisation (Lagun-Aro) and the retail stores. We are concerned here only with its manufacturing businesses.

In 1963 ULGOR added to its range of cookers a further product line in the same general category of domestic appliances – refrigerators. By the mid-1970s ULGOR produced a full range of domestic appliances: gas and electric cookers, refrigerators, washing machines and dishwashers. In the 1980s this family of products came to be widely described as 'white goods'. For the country's suppliers of these 'white goods' the Spanish Government proposed a restructuring programme in the mid-1980s, that they should be slimmed down to just three groups. Two of these were to be foreign-owned: by Philips and Electrolux. The third was ULGOR.

The Spanish Government restructuring programme tells us that in the case of ULGOR we are dealing with a business which managed to develop from small beginnings to compete with the top multinationals in Europe-wide markets. It also highlights the supreme importance of ULGOR in the history and results of the group as a whole.

By coincidence, ULGOR's employment and membership numbers peaked in 1979 at a figure of 3,855. That was just over 20% of total group employment and membership at that date. But it was closer to 25% of the employment and membership in the group's manufacturing co-ops. Moreover, if we add in the numbers of those employed by co-ops mainly engaged in supplying components or capital equipment to ULGOR, or in making the castings and forgings which it bought in for incorporation into its domestic appliances, then its weight in the economy of the whole group throughout this period would be shown as that much greater: up to 40% and quite possibly more. A Mondragon resident of some years

standing cites what he claims used to be a frequent comment: 'If ULGOR sneezes the whole group will catch a cold.'

Though there have been subsequent changes of classification, the original breakdown by the CLP of the group's manufacturing businesses was into five categories. For the mid-1970s, when the number of manufacturing co-ops was between 50 and 60 and when they employed together between 13,000 and 14,000 people, the approximate distribution of employment between the CLP's five sectors was:

Manufacturing Employment/Mid-1970s Percentages

Foundries & forges	13%
Capital goods (including machine tools)	20%
Building materials & construction	9%
Consumer durables & furniture	32%
Intermediate goods & components	26%

What about the other product lines? Furniture-making has been an important activity in the group since quite early days. At least six furniture-making co-ops were started before the end of the 1960s. In his 1987 study Dr Hans Wiener noted that one of them, the co-operative Citamare in Bilbao, had been in the process of closure in 1986. Export markets are perhaps especially difficult to penetrate if your product is furniture. It seems likely that these businesses found it exceptionally difficult to survive the recession of the 1980s.

Much the same general comments may be applied to the co-ops in the building materials and construction sector. In this case too we are dealing with businesses which have been a feature of the group since the early days. The 1960s saw the start up of five co-ops in this sector. All five were still in business in the early 1990s. Yet it must be imagined that they had a hard struggle to survive.

If export performance is a good measure of quality then we find metal-working is pre-eminent. In Dr Wiener's study the sectors are ranked by the percentage of their total sales accounted for by export sales in 1984: foundries and forges head the table by a significant margin. The capital goods sector is broken into two subsectors: industrial plant and machine tools.

Export Sales as a % of Total Sales by Sector 1984

Foundries and forges	42.4
Components	36.9
Industrial plant	31.3
Machine tools	26.1
Consumer goods	25.3
Building materials etc	11.5

Group exports had climbed to 23% of overall production by 1984

The manufacture of machine tools and industrial plant has figured in the group from early days. There were as many as ten machine-tool co-ops in the group in the middle 1980s. The largest at that time was Danobat. According to Dr Wiener: 'The main product lines have always been grinding machines and lathes, which now appear in their modern guise as numerically controlled machines. Later automatic handling equipment was added to the range and quite recently robots.'

The 1991 accounts of the group's bank, the CLP, identify for the first time a new category of manufactured products: components for the motor industry. The motor components sector is spread over three provinces. One of its oldest, Dr Wiener tells us, was 'making moulds and dies, primarily the dies used in pressing steel sheets into motor car body sections'.

The name of this co-operative, which has since left the group, was Matrici. Dr Wiener, writing in 1987, supplies a thumbnail history:

> [It] started in 1963 with twenty-nine members and is still expanding; it is one of the world's leaders in the development of the technology, and it already has the full computer-aided design and manufacturing capability, though most car makers do not yet supply the design in numerical form. Its customers already include General Motors, Mercedes and Volvo, and it is currently attempting to enter both the British and the Japanese market.

Thus, notwithstanding the weight of 'white goods' and their components in the group's manufacturing, there were also other important product lines – especially, perhaps, castings and forgings, machine tools and motor industry components. Given the maturity

of Europe's markets for 'white goods' it may well be that these other products will make the greater contribution to employment and value added in the future.

The fundamental fact is that there is no similar co-operative manufacturing group anywhere in the world. There is certainly none with this combination of product range, typically small-scale production units, and export success. There are, of course, clusters of highly successful and relatively small manufacturing businesses in Italy; and they are frequently major exporters. But these small Italian manufacturing businesses cannot match the product range of the Mondragon group. Typically their manufacturing activities are confined to textiles, clothing, footwear and building materials.

Restructuring and Continued Growth in the 1980s and 1990s. With the odd exception, for example 1982, the 1980s and early 1990s were years of continuing output growth in the Mondragon Group, despite the steep recession of 1992/93. Though the growth rate was lower than it had been in the earlier golden years, it was still positive and significant after taking rising prices into account. For the first half of the 1980s Dr Wiener has supplied a series in 1985 prices. For the years 1986 to 1991 I have used the annual reports of the CLP to calculate a similar series, expressed in 1991 prices. In each case we are talking about the turnover of the group's service operations, of the bank and the retail network, as well as of its manufacturing businesses.

Turnover at Mondragon

Ptas bn, 1985 prices until 1986, thereafter in 1991 prices

1980	119.5	1986	211.6
1981	126.0	1987	230.0
1982	124.8	1988	251.5
1983	128.9	1989	285.8
1984	131.0	1990	306.6
1985	141.0	1991	315.2

Following the establishment of MCC in 1990, not all co-operatives remained members of the group. Four healthy manufacturing co-ops chose to leave MCC in 1992. There is at least one earlier precedent for such withdrawals. But so far as I know, they have not happened before in such numbers in a single year. The four, with their main products are: RPK, springs; Gaiko, valves; Ampo, foundry products; Guizpar, reproduction sporting guns and farm spraying equipment.

They were followed by others (notably ULMA in 1993). The later numbers in the statistical series are therefore no longer continuous. From 1991 to 1995, the statistics recorded by MCC for co-ops which are members of the group are as follows:

Manufacturing Co-ops

Year	Sales (bn. psetas, current prices)	Employment nos.
1991	204	16,907
1992	204	16,193
1993	198	15,101
1994	227	14,793
1995	252	15,826

Distribution and Other Service Co-ops

Year	Sales (bn. psetas, current prices)	Employment nos.
1991	152	6,878
1992	193	7,408
1993	226	8,229
1994	269	9,111
1995	307	10,500

Source: MCC Annual Reports

The overall group numbers give us an indication of the rather differing fortunes over these dozen years of the group's service as against its manufacturing activities. For the decade from the mid-1980s it is only by including acquisitions that the manufacturing sector can be represented as growing. For example, the acquisition of Luzuriaga in 1990 brought in just over 1,300 manufacturing jobs, though growth began again in the middle and late 1990s.. Both in sales and numbers employed, the non-manufacturing sectors – chiefly the activities of the bank (the CLP) and the retail network (Eroski, 'distribution' in the table above) – enjoyed much faster organic growth. For example sales by Eroski accounted for just 22.7% of total group sales in 1985. Its corresponding percentage in 1991 was 29.3. Put differently, but again in constant prices, manufacturing sales increased by just under 48.5% between 1985 and 1991. The corresponding increase in the output of the group's main service activities was just under 62%. By 1997 over half of the MCC sales were accounted for by the retail distribution group (excluding the financial group).

Given the economic conditions, to have managed a nearly 50% increase in manufacturing output over the period 1985 to end-1991 is no modest achievement. On the other hand, competitive pressures forced onto the group's manufacturing co-ops a relentless pursuit of productivity improvement through more or less continuous processes of restructuring. 1989 was also marked by an event in the group's history which has occurred only rarely: a medium sized co-operative called Zertan, which made switches and had a 1989 workforce of nearly 400 people, left the group.

The 1989 accounts of the CLP are notable for the disapearance of the proud name of ULGOR. That did not mean that the 'white goods' production of the group was suddenly discontinued. Essentially, some parts of ULGOR were put into a large white goods specialist manufacturing operation: Fagor Electrodomesticos. And other parts were put into a second white goods specialist which concentrated on smaller objects like microwave ovens and toasters: Fagor Minidomesticos.

The experience of ULGOR may be taken as an example of the intensive restructuring which was experienced during the 1980s by many of the group's manufacturing businesses. After peaking at 3,855 in 1979, ULGOR's workforce fell to 2,256 in 1985. When ULGOR finally disappeared in 1989, and its workforce re-emerged in Fagor Electrodomesticos and Fagor Minidomesticos, the total had come down below 2,000. But then again, by 1997 the total had bounced back to over 3,000.

The continuous restructuring of ULGOR went well beyond any de-manning exercise. There was a general switch to more flexible from mass production systems. With the collaboration of Hitachi from Japan there was investment in new technology. For the mid-1980s Dr Wiener (1987) recorded that the annual production capacities for each of the four main 'white goods' lines which resulted from this restructuring were as follows:

Cookers and ovens	500,000
Refrigerators	400,000
Washing machines	350,000
Washing up machines	150,000

The de-mannning exercise was achieved in two main ways. A minority of the workforce was persuaded to become self-employed: '. . . the workforce was brought down by . . . 466 by persuading the after-sales service people to exchange their membership of the co-operative for contracts as self-employed operators, with the option to rejoin within a stipulated period if this did not work' (Wiener, 1987).

But most of those who were de-manned found jobs elsewhere in the group under a scheme which was used to ease the effects of the recession throughout the group as a whole. For the restructuring was achieved with virtually no compulsory redundancies. Indeed, as José Maria Ormaechea reminded his readers in the article quoted in the third epigraph, the group managed to go on increasing its employment all through these more difficult years. I suggested earlier that the successful midwifing of new start-up co-operative ventures was perhaps the single most important business achievement of the years of golden growth. The success of not only avoiding redundancy but of actually managing to add to total employment during times of recession and restructuring was perhaps the most important business achievement of the 1980s.

The measures taken to avoid redundancy are another original 'social invention' of the group. They are centred on the activities of Lagun-Aro, the Mondragon group's social welfare institution. This was first developed early in the group's history as part of the CLP; and later split off as a separate entity.

The formal need for the group to establish its own social welfare operation arose after 1958 when, by order of the Ministry of Labour, members of co-operatives were excluded from the State social security system. For certain purposes Spanish law treats worker members of production co-ops as if they were self-employed. Early in the 1980s, when the severity of the recession was becoming increasingly intense, Lagun-Aro devised and introduced a scheme whose central aim was to prevent redundancies. By this time the whole group was divided into sub-groups partly sectoral and partly geographical in character. And it was already standard practice for transfers to be made from one co-op to another within these sub-groups, following changes in the demand for labour. At the heart of the 'anti-redundancy' scheme introduced by Lagun-Aro in the early 1980s was a set of measures to facilitate transfers between sub-groups:

For transfers to a co-operative in a different sub-group Lagun-Aro provides quite handsome relocation benefits such as travel expenses in the case of temporary transfers, cheap loans to help with housing if the transfer is permanent, and contributions towards the maintenance of earnings if the transfer is to a lower grade job. For people whose old co-operative has lost some or all of their capital Lagun-Aro makes up what is needed for the capital stake in the new co-operative – often the most important benefit. *But the conditions that have to be met to qualify for these benefits are very stiff* [emphasis added] [Wiener, 1987].

Basically, the co-operative wishing to transfer people out

. . . has to prove that it needs to cut back at least forty people or a fifth of its workforce; it must stop distributing profits, if any, to its members and paying out the interest on their individual shareholdings; and it must cut its members wages to bring them down, grade for grade, to 85% of those on the Caja Laboral's scale [Wiener, 1987].

In other words if a co-operative wants to 'de-man' part of its workforce by transferring them to work in a different sub-group, then those who are going to remain employed by it are required to make considerable sacrifices.

Between 1982 and 1985 these transfers aggregated nearly 2,000 people. More than 10% of the group's workforce was thus covered by these arrangements. It is scarcely too much to claim that, given a willingness to accept the sacrifices which such a scheme requires, then it should be possible for a group in which activities are as diverse as those of the Mondragon co-operatives to come through a recessionary downturn in the business cycle without significant numbers of compulsory redundancies or early retirements.

Assisted Transfers between Co-operatives 1982–1985

Year	Permanent	Temporary	Total
1982	109	314	423
1983	62	428	490
1984	99	322	421
1985	109	416	525

Over the first half of the 1980s the group's main achievement was therefore restructuring without significant numbers of forced redundancies and *with* some continuing growth in real turnover. The key to this success was a combination of acceptance by some co-op members of real financial sacrifices and a readiness to move to different jobs within the group: whether on a temporary or a permanent basis.

José Maria Ormaechea has contrasted a loss of 150,000 jobs in the Basque region of Spain between 1976 and 1986 with an increase of 4,200 in the number of jobs in the co-operative group. He conceded that that was not a brilliant result. But he observed that it had not come about automatically. On the contrary, he wrote that . . . only a process of adjustment carefully calculated, reflecting the spirit of solidarity and audacity has made it possible to avoid having any co-op member unemployed.'

Dr Wiener reports that the policy of seeking to prevent the recession from causing significant unemployment was not universally welcomed by the co-operative membership. Critics pointed out that the distribution of financial sacrifice was not always fair and reasonable. Some argued less equivocally: that 'the sacrifices needed to avoid redundancies are stretching solidarity a bit far'.

This may be one factor behind the greater flexibility in employment practices which became characteristic of the Mondragon group in the subsequent decade.

It is not altogether clear how far the arrangements designed to contain redundancy pressures in the 1980s continued to be used in the 1990s. The 1991 annual report of the CLP, for example, records a 'loss' of 650 industrial jobs; it has nothing to say about transfers to alternative employment within the group. Certainly, arrangements for coping with recession by transferring co-op members to other jobs were still kept formally in place. In the summer of 1993, a senior official of MCC insisted in a conversation with me that, in some sense, the employment guarantee implicit in Lagun-Aro's job transfer system still stood. But whether because of an unwillingness by individuals to accept conditions of transfer or for other reasons, it seems that from the early 1990s the system became less effective in its delivery of that employment guarantee.

At any rate from the early 1990s, it is clear that some co-op members began to be made redundant. The change was said to have been allowed with great reluctance. Generous redundancy

terms included the possibility of eventual reinstatement. Through Lagun-Aro, the redundant worker was guaranteed 80% of full pay: half coming from Lagun-Aro and half from the member's co-op, and thus his or her former colleagues. In cases where whole co-ops had to be closed, any of its members who could not be relocated within the group were paid the whole of the 80% by Lagun-Aro. It was hoped that re-employment could be achieved before the system became unaffordable. And by the mid-1990s this hope seemed to be justified. The trend of employment aid paid out by Lagun-Aro, which had continued to increase in 1993, turned in 1994 and fell sharply in 1995. In 1994, Employment Aid accounted for 43% of total unfunded payments, but was down to 27% in 1995.

However, the extent of any change from an earlier solidarity should not be over-estimated. In *MCC: an Investor Profile*, which was prepared in connection with the possible sale of non-voting equity stakes in a proposed new investment company, MCC comments that 'In the dark days of the 1993 Spanish recession, the worker-owners of some co-operatives within MCC's industrial division reduced their wages in order to restore competitiveness. The event is noteworthy as much for its rarity in labour relations as it is for the strength of co-operation as a business strategy'.

The other way in which the co-ops sought to cope with the ups and downs of the economic cycle was to make a higher proportion of their employees 'temporary', and for longer periods. In the mid-1990s this was a delicate issue in Mondragon. It was one thing to set up joint ventures which were not co-operatives, especially outside Spain; but quite another to break the link between employment and co-operative membership in the heartland of the group in the long-established co-ops in Mondragon itself. Individual cases were 'monitored', and it seems that guidelines on the limits of 'acceptable' temporary employment arrangements were drawn up. As this book went to press, it emerged that a new form of 'temporary' co-op membership was being introduced, offering similar rights to temporary employees as to permanent employees with the one exception of job security.

At bottom, these changes reflect the greater exposure of the Mondragon group to market pressures, especially as a result of Spain's membership of the EEC/EU. Before EU membership, and especially before the Single Market, many of Mondragon's products had enjoyed higher tariff barriers protecting their markets in Spain than they had encountered in selling abroad. The removal of this protection was a serious threat, which could have been fatal. Thus in the late 1980s and early 1990s the group moved somewhat away from the high solidarity of its earlier years and in the direction of more market-orientated policies.

Another example of this greater market-orientation was a further shift in the rules governing maximum pay differentials. The original rules set a 3:1 maximum ratio between the remuneration of top management and that of the lowest paid. The limit was raised to 4.5:1 in the 1970s and then to 5:1 in the early 1980s. Thereafter a number of exceptions were permitted, essentially where these were necessary either to secure or to retain the services of needed managers and other professionals. In 1992 the rules were changed again. From 1993 onwards top management could be paid up to 70% of the market rate for their jobs. That is apparently expected to coincide with a maximum payment differential limit of around 8:1.

The executives on Mondragon offer a plausible defence of these changes. First, the original 3:1 ratio was put in place when the co-ops were much smaller and easier to manage. Now that some individual co-ops are much larger and the group as a whole employs some 34,000 people, there is a great deal more managing to be done. It is also true that Spanish income tax has changed dramatically since the 1950s when there was none: now it rises to a maximum of 50%. So after tax the apparent increase in maximum differentials is lessened.

The policy shift of the late 1980s which allowed corporate acquisitions for the first time, can also be seen as a move away from the original co-operative principles. The acquisitions have been driven by a market rather than a co-operative logic. Moreover the group has not sought to impose on those employed in these recently acquired businesses the same terms and conditions as apply to those in the co-operatives. Indeed the corporate character of these businesses remains unchanged. But the emphasis here should be on the absence of any policy which sought to impose a co-operative struture on newly acquired businesses. As noted much earlier there have been a number of cases where the employees in an acquired undertaking have voted by comfortable majorities to adopt the legal form of a co-operative and have agreed to make capital contributions into these new ventures

accordingly. The two businesses mentioned earlier, Fabrelec and the previously bankrupt firm which took the name of MAPSA when it became a co-operative, are both in the manufacturing sector. But there have also been examples in the retail sector where those working in new ventures developed by EROSKI in the 1990s have chosen to take the co-operative road.

The other big change in the last decade of the twentieth century is the group's move abroad, both by the retail organisation and by various of the industrial co-ops. Orona, for example, which manufactures lifts, has subsidiary companies in Toulouse, Paris, Milan, Oporto, Lisbon and Andorra.

In 1995 it looked as though the strategy for further expansion would rest partly on bringing in capital via what Sr Ormaechaea called the new 'Holding Company'. The mission of the group, agreed by a group-wide Congress in the mid-1990s, had been summarised as follows:

> The scenario has changed because the market is larger, competitiveness is sharper and the size of the companies has taken on other proportions, precisely to tackle the effects of a new situation. We need action, based on the hypothesis of a financial grouping, corporation or holding company, which will result in a reduction in unit costs, an increase in competitiveness, access to greater market share, capacity for investment in new technology, in an audacious effort to increase profitability, keeping external threats at bay and consolidating the future. [MCC, 1995.]

According to Sr Ormaechea this was to be achieved by creating a new holding company:

> The plan is to create a holding company which will carry out these initiatives, constituting an appropriate tool to back the financial investment necessary to launch or control companies in accordance with the strategic decisions of the group.
>
> The purpose of the Group in the future is to respect the basic principles which inspired its creation, and to search for the best way to adapt to changing circumstance.

By 1996 this proposal seemed to have been put on hold. But the decision in principle by the Mondragon Group to sell equity in its heartland enterprises to financial investors (including foreign investors) raises two related issues. First, how can it sell equity without giving up employee ownership? Second, if the biggest star in the employee-owned firmament worldwide cannot find resources, except by giving up its employee ownership status, does this not indicate that employee ownership has distinct limits as a system for ownership of a business?

The basic answer given by MCC to the first question is that employee ownership would not be surrendered. Investors in the holding company would have no more than a financial interest – the privilege of sharing in the annual profits and capital growth of one of the most successful businesses in the Western world but no votes and no control of management. This would be underpinned by two other aspects of the arrangements. First, investments by the holding company would be mainly and unconditionally in new ventures; any investments in existing co-ops would be subject to their approval. Second, they would be restricted to a small minority: not more than 20%.

The answer to the second question is best seen as a balance. On the one side is the imperative: 'adapt or die'. On the other, there is no intention of risking the central tenets of the co-operative system. As for more directly business objectives, the conclusion of a booklet issued by MCC in 1996, to celebrate the fortieth anniversary of the foundation of the Mondragon co-operative system, sets an aim of doubling both overall sales to ptas 1,000bn and the volume of international business by the turn of the century, and quadrupling the number of production plants outside Spain. More qualitatively, it describes the future as follows:

> We do not mean to say that we have fully achieved our aims, nor that our experimental co-operative cycle is complete. What we wish to convey is that we are in a constant process of development and adaptation of our social aims and our capacity to compete in ever more demanding international markets where nobody, as the purists would say, is going to look at our 'social credentials', but at the efficiency and performance of our co-operatives.

However, the same document re-enunciates the ten basic principles approved at the first co-operative congress in 1987:

- Open membership – equal employment opportunities for all

- Democratic organisation – one member, one vote
- Worker sovereignty
- Instrumental and subordinate nature of capital
- Management participation by members
- Wage solidarity
- Co-operation between co-operatives
- Social transformation via majority reinvestment of profits
- 'Universal sharing' objectives: of peace, justice and development
- A commitment to education

THE MONDRAGON SYSTEM

Ownership The Mondragon Group differs in a number of ways from the other businesses and groups of businesses which we are reviewing in this book. Of these one of the most eye-catching is the size of the capital stake which new recruits are required to contribute as one condition of permanent employment and co-op membership. The figures in pesetas have been constantly adjusted for inflation. For those who joined existing co-operatives, the typical sum from the early 1960s to the early 1990s was the equivalent of six months' salary. By the mid-1990s, it was roughly equivalent to one year's salary in the lowest rung of employment. For those involved in the start-up of new ventures from scratch – something which admittedly more or less ceased to happen from the mid-1980s onwards – the capital sum required has typically been twice as much.

Moreover, the financial commitment required of new recruits is, in a sense, even more substantial than these figures imply. Of the capital sum contributed by the new recruit, 25% is immediately deflected to collectively-owned reserve funds. Whatever the fortunes of the co-operative business over the period during which the new recruit works for it, he or she will never see that 25% again.

On the other hand, if we leave on one side those working in businesses which have been acquired by the group as wholly-owned subsidiaries from the late 1980s onwards, these arrangements seem to have been accepted by new recruits as entirely reasonable ever since they were first instituted. Indeed there has typically been an over-supply of potential new recruits, ready to accept these conditions of permanent employment, compared with the number of places on offer. There is little or no evidence that the capital contribution requirement has acted as a deterrent to those whose cash resources are limited. New recruits have been required to find a part of what they must contribute in a cash down payment. But they have normally been permitted to subscribe the balance out of their earnings over a period of up to three years.

The capital contribution of the new recruit, reduced by what is deflected to collective reserve funds, then becomes the starting balance of his or her individual capital account, as it has come to be called. This balance is adjusted annually in line with the economic performance of the business and the strength of the balance sheet – upwards if there has been a profit and downwards if there has been a loss. The share of profits or losses so allocated is proportionate to the sum of the individual member's earnings during the year in question, plus the interest due on the balance of his or her capital account. In the early years 70% of annual profits and losses were normally allocated to individual capital accounts in this way, with the remainder being passed into collective reserves. However in the more difficult economic conditions of the 1980s this proportion was lowered to 45%.

It is important to be clear that profit shares allocated to the individual capital accounts of co-operative members in this way remain locked in. They cannot be turned into cash until the member in question stops working for the business, either through retirement or on some other grounds. Then, and only then, does his or her final capital account balance become payable. On the way it will have been subject to an annual valuation adjustment in line with changes in the cost of living. Those retiring from the co-operatives in the early years of the 1990s, after thirty years of service, have turned capital accounts into cash which amount to the equivalent of about two years of their final salary. Because profits were harder to achieve after 1980 than in the earlier years, those retiring at the same time with shorter periods of service behind them have taken out rather less.

All those working in the Mondragon co-operatives are bound by these ownership arrangements. Moreover the rules do not allow ownership by outsiders. So the arrangements may be said to include an identity rule: that there must be an identity between those who work in a co-operative business and those who own it.

At least from the viewpoint of the group these arrangements seem to have worked well. The capital contributions of new recruits have contributed significantly to the accumulation of

capital. The lock-in rules have worked to increase the ability of the co-operatives to invest. It seems, too, that the requirement of having to make a significant capital contribution has had an effect on the prevailing culture. Visitors have often been struck by evidence of 'peer group monitoring'.

On the other hand, in any particular co-operative the deflections to collectively-owned reserves involve some sacrifice by present to future co-op members. Whether that will seem reasonable to particular individuals will no doubt much depend on their family situations; and especially on whether there is a son or daughter who is hoping to find work in the group.

This began to become a significant issue in the 1990s as an increasing proportion of the original co-operative members reached retirement age. The larger numbers of retirements threatened the capital resources of the co-operatives. One solution – whether officially or unofficially – has apparently been for relatives of retiring co-operative members to be offered a job in return for allowing the money to stay invested in the co-operative.

Control Just as ownership is governed by an identity rule in the Mondragon group, so is control. Only those who work in the group can have a voice in its top policy-making bodies; and all those who are so working must have one. As is normal in almost all corporate bodies, top policy-making power is vested in a general assembly of all members. It is the character of the members that is unusual. They are workers and holders of capital accounts – worker shareholders, if I may simplify a little. In the early years, when income differentials were limited to a maximum of 3:1, voting in these general assemblies was proportionate to rates of pay. But since the early 1960s the voting rules have been democratic: one worker one vote.

The General Assemblies elect the boards of directors and the latter appoint top management: usually just the chief executive who may then choose his or her top team. The elected directors cannot be part of the top management team. To that extent the position is perhaps closer to that in Germany – with its two-tier management and supervisory board system – than to the unified boards of the US and the UK. On the other hand the powers of Mondragon's elected boards are significantly greater than those of supervisory boards in the Federal Republic of Germany. They frequently include a significant proportion of middle managers and professionals. The prediction that blue-collar majorities tend to elect blue-collar boards of directors is confounded by this Mondragon experience, as indeed it is elsewhere.

Those who wish to may see these control arrangements as reflecting a sensible separation between the powers of business *government* and those of business *management*. Within reasonable limits, the managers are left free to do the professional job of managers. Three further points of detail are worth noting. The first is that the chief executive normally attends and may speak at board meetings, but has no vote. Second, his or her position will normally be to some extent protected by a service contract against the consequences of sudden dismissal. Third, in all or most of the co-operatives the top management and the board of directors have regular joint meetings. Apart from anything else these are designed to prevent the two bodies from going their separate ways.

Such are the ownership and control arrangements of the individual co-operative businesses of the Mondragon group; or rather they are what applies in the case of so-called first degree co-operatives: that is, of all the manufacturing businesses and all those others which do not – as for example does the bank and the social welfare organisation Lagun-Aro – supply group-wide services. The latter are essentially owned and controlled by the co-operatives of first degree. Those who work in them are required to make capital contributions to them and are allowed a voice, albeit a minority one, in their governing councils.

The ownership and control arrangements of the first degree co-operatives have been subject to various modifications of detail as a result of their having been brought together in a successive series of sub-groups starting from the late 1960s. For example, the sub-groups have normally involved a degree of profit and loss-sharing. And much the same applies in relation to the umbrella group, Mondragon Corporacion Co-operativa. However, such modifications did not fundamentally alter the basic arrangements.

A description of the formal position may not describe what actually happens in practice. A plausible characterisation of these arrangements is that they amount to passive democracy. That does not mean that votes by the membership of the co-operatives are not taken, or that they can be ignored when they have been. But it does mean that in normal circumstances regular managerial decision-

making is not significantly affected by the democratic arrangements. It is also true, as we shall see later, that managerial control at the centre began to be sharply strengthened in the early 1990s.

Industrial Relations Neither the group nor the individual co-ops recognise any trade unions for wage bargaining, or any other collective purpose. The origin of this state of affairs is historical: independent trade unions were outlawed by the Franco regime and remained so down to the mid-1970s. But it is also true that there has been no move by the co-operatives to recognise the trade unions since then. Moreover, though individual co-op members are entirely free to join any trade union of their choice, it appears that only a small minority have done so. Nor, so far as I know, has there ever been any substantial movement of opinion in favour of official recognition.

Given that neither the blue-collar workforce nor the management has favoured recognition, it is scarcely surprising that that has not happened. The existing arrangements have stood the test of time, and to change them would be to take an unnecessary risk. But there is also some specific evidence of more positive attitudes to the existing arrangements. In the early 1980s a survey found that only 25% of those working in the group favoured a change in the arrangements in order to give a strong role to trade unions. For comparison with the sample of those working in the co-operatives, the survey authors also questioned a second group working in conventional capitalist firms. One of the questions put to the latter asked them to express a 'preference between co-operative structure [*sic*] and trade unionism as vehicles for the advancement of labour'. More than half (52%) gave their preference as the former (Bradley and Gelb, 1983).

Special institutions in the industrial relations of the co-ops were introduced at an early stage and survived into the 1990s, having acquired greater prestige and authority on the way. These are the social councils which are a feature of every co-operative. Their basic logic is threefold. First, the need for a channel of communication between top management and the rank-and-file membership. Second, the need for a forum in which non-top-management opinions can be aired. And third, the need for a body to process complaints, grievances and questions of discipline at the lower levels of the rank and file. Neither the meetings of the general assembly of all members nor the meetings of boards of elected directors could, it was felt, properly fulfil these important and necessary functions. Hence the need for social councils, which became essentially elected non-management bodies from about the mid-1980s.

On the other hand, during the earlier years these social councils were at least partially controlled by top management, which enjoyed the right to appoint one of their nominees to take the chair, William Foote Whyte and his wife Kathleen King Whyte describe an extended process which ended when the right to take the chair at social council meetings passed from a management nominee to one of their elected members. At least since that change took place, the social councils can partly be seen as 'in house' unions; and thus as exhibiting some similarities with 'company unions' in Japan.

It need scarcely be said that no system of institutions, cultures, and worker *mentalité* can deliver entirely trouble-free industrial relations. We need to remind ourselves too of the strike at ULGOR in the early 1970s. On the other hand, it would be a complete mistake not to acknowledge that the whole 'Mondragon system' confers on the co-operatives a significant and substantial industrial relations advantage. On successive visits, I have almost invariably had the reply from management that the industrial relations in the group are for the most part quite unproblematic.

Social Welfare At least for certain key purposes – like absence from work through sickness, and unemployment – worker members of co-operatives are treated by Spanish law as if they were self-employed. There are semi-Government institutions which co-operatives are free to use and which can provide the necessary cover. There are also some cases in which co-operatives are required to make use of these semi-Government institutions, at least to some specified extent, for example for pensions.

Early in the 1960s a decision was taken that, so far as the law allowed, the group would provide a full range of social services for those co-operatives which chose to take advantage of them. Until the early 1970s these functions were carried out by a specialist division of the CLP. Later they were were spun off and came under what was essentially a free-standing and not-for-profit provider of a range of welfare benefits called Lagun-Aro. The English phrase 'social welfare' may give an inadequate view of the range of

functions and services supplied by it. In a sense it is better seen as a mini, non-Government, provider of many of the services which in Britain, for example, are supplied by the welfare state. The services it provides are wide-ranging and efficient:

– It was substantially as a result of an ingenious and tough scheme introduced by Lagun-Aro that the group was able to negotiate the 1980s recession with virtually no redundancies at all.

– It seems to have been notably successful at keeping down the overhead costs of its services. Both on pensions and sickness benefits Lagun-Aro appears to provide better value for money than the state competition.

– Lagun-Aro has devised an original system of rewards and punishments for discouraging extravagant use of non-essential medical services. Those covered by it are divided into groups and the groups are set target annual budgets. Subject to a non-penalised overshoot of 10% compared with these budgets, any further overspending results in a surcharge on members of the group in the following year. Conversely there are rewards, in the shape of discounted charges, for members of groups which underspend.

– On the evidence of Lagun-Aro, small may well be cost effective when it comes to the provision of these 'welfare state' type services. However it seems improbable, in the short and medium term, that political conditions will be such that this example will be widely followed. (For further details of Lagun-Aro, see *Job Ownership*, 1982.)

The Bank Of all the employee ownership success stories in today's world, that of the Mondragon bank, the Caja Laboral Popular, is in some ways the most appealing. There is a wonderful contrast between the genesis of the project and what has become of it. Who would have thought that in little more than a third of a century a new start-up credit co-operative, initiated by a few obscure young engineers on the advice of a priest, would have grown to be one of the largest and most profitable banks in a large Western economy? It is a story to confound the textbooks of the schools of business administration.

For the first twenty-five years, from 1959 until the mid-1980s, the development of the bank was linked so closely to that of the Mondragon Group as a whole that it has seldom been presented as a success story on its own. There was real symbiosis. The bank needed the growing and multiplying co-operative businesses as entities to lend money to; and those businesses in turn needed the bank as a source of loans. The Empresarial Division invented the method of midwifing new co-ops as described earlier. The essence of the bank's achievement was mobilising *local* resources for *local* investment; and this was not necessarily dependent on its own co-operative status.

By the early 1980s the growth of the bank had run well ahead of that of the Group. In 1964, 77% of the bank's total resources were invested in the group. The proportion fell to 49% in 1979, 25% in 1985, less than 10% in the early 1990s, and by 1997 was under 5%.

When the bank started in 1959, there were two branches. One was in Mondragon itself, which is in the province of Guipuzcoa and the other in a small town across the provincial boundary in Alava. The logic behind this was that the provincial authorities in either of the two provinces might move in and frustrate the initiative – but were unlikely to do so simultaneously in both. When the idea was first proposed by Fr Arizmendiarrieta, the initial response of the 'simple engineers' who had founded ULGOR was consternation. But those same engineers frequently remarked later that success comes more easily in banking than in manufacturing. In the first twenty years alone, the bank grew a hundredfold.

Total CLP Resources

Ptas bn, constant 1985 prices

1963	1.3
1968	13.0
1982	129.1
1985	187.0

Source: Wiener(1987)

Ptas bn, constant 1991 prices

1985	277
1988	316
1991	429

Source: CLP Annual Reports

CLP Deposits and Equity

Current prices

	Deposits, Ptas bn	Equity, Ptas m
1991	355	43
1992	408	50
1993	439	56
1994	457	64
1995	586	74

Source: MCC Annual Reports

From the two branches when the project first started in 1959, the bank grew to 201 in 1991, and 230 in 1995. Employment rose, but more slowly.

Numbers Employed

1975	587
1984	1,226
1991	1,279
1995	1,384

In 1991 the former Empresarial Division became a free-standing consultancy. With the launch of two new financial services companies, one specialising in insurance and the other in leasing, the bank moved to offer the same range of services as those available from other major banks. It has also divided its functions between wholesale (business) customers and retail (individual) customers, and moved out beyond the Basque heartland.

The Retail Network The group's retail network was set up as 'Comerco' in 1969. In the next year it adopted the Basque name EROSKI. It was based on the merger of five local consumer co-ops. Until the 1980s it received little attention from the admirers of the Mondragon phenomenon. This is partly because consumer co-ops are common in many countries. Moreover, the growth of EROSKI was slow by comparison with the more glamorous manufacturing co-ops. It is also probable that many observers failed to notice the most interesting feature of Modragon's retail co-ops: their hybrid ownership and control arrangements in which the interests of the stores' workforce is finely balanced with those of its customers. Dr Wiener called this balance 'a beautiful compromise'.

Dr Wiener argues that given the character of the Mondragon Group as a whole, the natural structure for a Mondragon retail business should have been as a workers' rather than a consumers' co-operative. He then goes on:

> But it would have been too much of a break with tradition simply to abandon the consumer interest. For this reason there are also (as well as worker members) consumer members and for them there are centrally organised activities and events. To ensure a proper balance between the two interests, the board of directors (of Eroski) consists of six members elected by the employees, and six elected by the consumers. The chairman is always from the consumer side.

The 1990s witnessed an important new development. Eroski merged with the Valencian co-operative Consum to form the Eroski Group. These two companies also operate a number of subsidiary companies, including Erosmer, a holding company created in 1992 to promote large hypermarkets in Spain. Numbers employed at Eroski grew from 744 in 1979 to over 1,000 in 1981, and nearly 2,000 in 1989. In 1990, Eroski abandoned its old self-imposed geographical restriction of confining its activities to its home Basque territory. In these new shopping developments, Eroski also dropped the co-operative form and promoted what were at least to begin with straight capitalist ventures. Eroski the co-operative became owner or part-owner of developments which were not structured either as classic consumer co-ops, or in its own image of mixed consumer and employee co-operative ownership. On the other hand, and as noted much earlier, employees in those new ventures were later enabled and indeed encouraged to become part owners.

Already, by the early 1980s, the relative growth rates of the manufacturing and consumer co-ops in Mondragon had switched places. By 1992 Eroski's sales accounted for more than half the group's total.

Eroski: Sales and Numbers Employed 1991-95

Current prices

	Sales Ptas bn	Workforce
1991	153	6,878
1992	193	7,408
1993	226	8,229
1994	270	9,111
1995	307	10,500

Source: MCC Annual Reports

The Group and the Subgroups From its earliest beginnings the leaders and thinkers in the Mondragon Group have emphasised its experimental character. It is true that the Spanish phrase most commonly used to describe the whole project has been the Experiencia Co-operativa. But the Spanish word *experiencia* seems to have more of an 'experimental flavour' than the English word 'experience'. When they use the phrase *Experiencia Co-operativa* spokesmen for the group seem to want to tell us that it has been, and will go on being, a continuously evolving experience.

In the later 1980s and the early 1990s that was especially true of the arrangements covering not the individual co-operative businesses but those of the group as a whole; and those of the continuously evolving subgroups which occupy the space in between.

From the mid-1980s these arrangements were in almost continuous change and flux. The group as a whole was initially embodied in links between the individual co-operative businesses and the group's bank, the Caja Laboral Popular, and *not* in a group structure properly so called. Those links, as we saw earlier, took the form of more or less identical contracts of association between the individual businesses and the bank. In effect the contracts imposed on the businesses the common set of arrangements – about ownership, control, industrial relations and so on. At least by implication, these contracts also conferred on the bank the role of group leader.

In the mid-1980s, while the old contracts of association remained in place, the bank gave up its leadership role. There were a number of reasons for that major change. Perhaps the single most important one had to do with the quite outstanding growth performance achieved on its own account by the bank. As a result the co-operative businesses accounted for an ever smaller proportion of its loan book. Its obligations to its clients outside the co-operative group were judged to be incompatible with a continuing group leadership role.

The group-wide arrangements which have come into existence since the bank gave up its leadership role have various distinguishable elements. The first and largest which confers legitimacy is a democratically elected body called a 'Co-operative Congress' which meets formally about every two years and informally in between and may be thought of as a group-wide general assembly. The central task of the congress is to debate and set general policy for the corporation as a whole. The second element of the new arrangements is the so-called Standing Congress Committee (SCC). The designation is perhaps best taken to be a form of shorthand. The committee is perhaps best understood as a co-operative of third degree, for its members are one or more of the elected directors from each of the sectoral subgroups. Given that these subgroups are best understood as second degree co-operatives – with their directors in turn elected by and from the boards of the co-operatives of first degree, the characterisation of the SCC as a third degree co-operative is logical even if a little cumbersome. Its (the SCC's) members elect from their number a president who presides over meetings of both the SCC and the congress. The SCC president and its members serve for four-year terms and may be re-elected.

At the apex of the new arrangements is a new corporate entity: the Mondragon Corporation Co-operative (MCC). The SCC appoints its chief executive and must approve his or her selections for the fifteen senior posts which make up its 'management council'. That council in turn selects the top management staff who form the secretariat of this new apex entity. If it is helpful, the SCC can perhaps be seen as an internal board of directors for the MCC, with the twin main tasks of implementing congressional policy and monitoring the performance of senior MCC management.

In the mid-1990s these new group-wide institutions were still evolving. They were formally agreed at a meeting of the 'Congress' in early 1991, when they replaced an earlier set of more interim arrangements. It must be more likely than not that they will continue to evolve.

And the same is likely to be true about the set of subgroup

arrangements which were also agreed at the 1991 Congress. Here the main background can be summarised in just three points. The first is that the earliest subgroup dates from as far back as 1964: when ULGOR came together with three of its supplying co-operatives to form ULARCO. Then, second, in the 1970s the entire population of individual co-operatives was formed into subgroups with either a geographical or a sectoral character, or both. The third is that a part of the profits of the individual co-ops was normally pooled as also, in some cases, were various management, sales and financial functions. And labour could also be pooled, in the sense of being temporarily transferred from one co-operative business to another, in response to fluctuations in demand.

The main feature of the new subgroup arrangements agreed at the 1991 Congress was to replace mixed – regional and sectoral – subgroupings with exclusively sectoral ones. And the main reason behind the change was that sectoral subgroupings were seen to be more market-orientated than regional ones.

What all this amounts to is a substantial strengthening of the central co-ordination among the Mondragon co-ops. This is embodied in a huge new central office building which would not disgrace a big multinational. The formula for the continuing reality of 'co-operation' is two-way communication between MCC at the Centre and the lowest-paid employee, in the smallest individual co-op, at the periphery. On the one hand, the corporate government of MCC gives control of it to representatives of the co-ops. On the other, major new developments for the group as a whole – for example the proposal to set up a holding company – have to be discussed at general assemblies of the members of individual co-ops. In this way the group seeks to retain the best of co-operation whilst meeting the challenges of the global markets of the 1990s.

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The ESOP Phenomenon in the United States

Today 1,000 public corporations that are traded on stock exchanges – the Employee Ownership 1,000 – have significant employee stock ownership. The average holding is over 12%, while employees are the top shareholder in almost half of these companies. Significant employee ownership now encompasses a third of the *Fortune* 500 industrials and a fifth of the *Fortune* 500 Service Corporations. By the year 2000, a quarter of *all* public corporations will be more than 15% owned by their employees and a quarter of private sector employees will be in such companies. *From the blurb on the dust jacket. 'The New Owners: The Mass Emergence of Employee Ownership in Public Companies and What It Means to American Busines', by Joseph Blasi and Douglas Kruse, 1991*

Table 4 shows . . . how the Employee Ownership 1,000 compares to the employee-ownership sector in the US economy, which has about 10,000 firms with more than 4% employee ownership. Only 10%, or 1,000, of these firms, are publicly traded corporations, but they account for about 40% of employee holders, while 9,000, or 90% of these companies are closely held . . . .

The startling news is that 12.5% of the private-sector workforce, or 10.8m American workers, own stock in companies in which employee ownership exceeds 4% of total company market value. *Ibid.*

Perhaps because of a combination of the relative youth of their country and the relative influence of marketing men in it, American academics, more so than their UK counterparts, have an engaging fondness for hyperbole. I suspect that most readers of what follows will take away a more qualified picture of employee ownership in today's America than that conveyed by the two epigraphs above. Nevertheless, they do have the great merit of conveying a real and valid impression of the scale of the broadly-based employee ownership that spread across the USA in the period of rather more than twenty years from the passing by

the Congress in 1974 of the country's first legislation on employee stock ownership plans (ESOPs) down to the time of writing. Its scale dwarfs that of all other phenomena of this kind at any time and in any other country. True, there was a fashion for employee stock purchase plans in the corporate America of the 1920s, and the number of US employee-stockholders is reported to have been proportionately much higher then than seventy years later. But this earlier movement was not strong enough to survive the sequence of the Wall Street Crash and the Great Depression. In any case, that stock purchase movement happened without legal or fiscal support. By contrast, what we started to have in 1974 was something rooted and underpinned in laws and tax reliefs. What is more, it is the American ESOP legislation that has put broadly-based employee ownership on the international business map. Without this American experience – both the ESOP legislation and its take-up – what has happened elsewhere could at most have attracted the interest of a small band of specialists and enthusiasts.

There is no real doubt about the drivers behind this broadly-based employee ownership. In research at Baltimore University, Michael Conte and Helen Lawrence argued convincingly in the early 1990s that 'the significant growth of ESOPs during the 1980s may have been caused by two factors: a philosophy that workers are more productive when they own employer stock, and special tax benefits accorded to employers to establish these plans'.

To US readers the story of how these special tax benefits were first introduced is no doubt well-known. For readers outside the USA, however, it is important to emphasise that the origins of the ESOP are in right-of-centre American populism rather than left-of-centre social liberalism. The driving political value has been about the importance of spreading wealth rather than about shifting power at the place of work from the agents of capital to the shop floor. There is apparently also some evidence from the record of votes in the Congress that the issue has been somewhat more popular with Republicans than Democrats, although the ESOP movement's original and outstanding political champion was a southern Democrat, Russell Long, a Louisiana senator from 1948 until 1986. Russell Long's father, Huey Long, was elected to the Senate, also as a southern Democrat, in 1932 – and assassinated three years later. Before his election, during several terms as

Governor of Louisiana he had been responsible for various public works and similar measures which in some important respects prefigured the New Deal.

Huey was widely criticised by his contemporaries for his propensity to behave like an elected dictator and that may well explain his assassination. But for our purposes, what is chiefly of interest is his strong advocacy, during the last years of his life in Washington, of government measures to transfer property from richer to poorer citizens. His central idea seems to have been simple – to confiscate the 'excess' wealth of the rich and pass it to the poor. For example, had Huey Long's 'Share Our Wealth' project ever been implemented, those with two houses or two motor cars would have been liable to have one of them confiscated.

His son Russell Long later elegantly distinguished between his father's policies on wealth spreading and his own. He called his own ESOP measures an example of 'populism without Robin Hood'. And he tirelessly pointed to a key distinction: between a set of measures designed to spread *existing* wealth, which could scarcely avoid compulsory transfer; and another set designed to rearrange the ownership of *future* wealth so that its distribution would be different. He saw the latter, as is of course the case with the whole body of America's ESOP legislation, as being entirely voluntary. The intellectual foundations for this approach had been laid by Louis Kelso, who also invented the ESOP concept.

Judged by its take-up at least down to the middle 1980s, the American ESOP legislation was a first-class success. As we have seen, it has been taken up in special situations and it has been taken up more widely, if also more on the margin, across great swathes of corporate America. Have the hoped-for effects on business performance been realised?

There is growing evidence that, if linked up with appropriate schemes and policies of non-financial employee involvement, significant employee ownership can be followed by measurable improvements in performance. The word 'significant' is used here in two senses:

– for the individual employee his or her ownership stake needs to be significant: worth a good deal more than the value of a few days' wages;

– for the workforce as a whole the aggregate of employee ownership needs to be significant: such as to make their voice an

important and even perhaps the dominant one in setting the long-term policies and objectives of the business.

For America, the most authoritative evidence for these benefits is probably that collected in a sample study undertaken by the American Government's General Accounting Office in the late 1980s. Its findings have been widely confirmed by academic sample studies in the USA. (British evidence has so far been confined to monograph studies of individual firms. But it points in precisely the same direction.)

The National Center for Employee Ownership (NCEO) summarises the US evidence as follows:

> ESOPs and Corporate Growth: a 1987 NCEO study of 45 ESOP and 225 non-ESOP companies found that companies that combine employee ownership with participative management style grow 8% to 11% per year faster than they would otherwise have been expected to grow based on how they had performed before these plans. Subsequent studies by the General Accounting Office and by academics in Washington State and New York found the same relationship. Studies in participative management alone find a small positive impact on performance, but not nearly enough to explain the synergy between ownership and participation these other studies have found.
>
> ESOPs and Stock Price Performance: Data compiled between 1992 and 1995 as part of an ongoing study by Joseph Blasi, Douglas Kruse, Michael Conte and, after 1993, American Capital Strategies, found that an investment of equal amounts in a basket of securities in public companies with more than 10% broad employee ownership would see a return of 80.19% compared to 48.69% for the Dow and 44.87% for the S&P 500s. The researchers point out that this does not establish a causal linkage between employee ownership and stock performance because companies that set up these plans may also have certain other consistent features that make them perform better.
>
> ESOPs and Bankruptcy: A 1995 study by Michael Conte at the University of Baltimore found that during the 1980s fewer than one out of 100 ESOPs were terminated because of the bankruptcy of the plan sponsor. (NCEO Web Page, March 1996.)

Before coming on to the vexed question of what actually constitutes employee ownership, readers may need to be reminded of an important distinction: between, as the Americans say, leveraged and unleveraged ESOPs. Both are tax-privileged mechanisms by which shares in the companies they work for can be transferred into the ownership of their employees. In the case of unleveraged ESOPs (which are very similar to what are known as 'stock bonus plans'), the cost of the shares transferred to employees is normally financed directly, with help from significant tax reliefs'. In the leveraged cases, the money is borrowed; and what the company pays for, again normally out of tax-relieved profits, is the subsequent stream of interest on those borrowings, and their repayment. Clearly if the aim is a rapid shift of large chunks of ownership – and, in the limiting case, of the *entire* ownership of a business – then what you need to do the job is an ESOP of the leveraged type. According to the Conte/Lawrence numbers, in the late 1980s about a third of ESOPs were leveraged – slightly more in 1990:

	All Plans	Leveraged	Unleveraged
1988	8,543	2,591	5,952
1989	7,618	2,534	5,084
1990	7,560	2,711	4,849

Conte/Lawrence supply an annual series for the total number of ESOPs going back to 1980 and forward to 1990, though with a gap in 1981. The series shows a peak in 1986:

Esop Numbers: All Plans 1980–90

1980	4,925	1986	10,834
1981	na	1987	9,358
1982	8,405	1988	8,543
1983	8,470	1989	7,618
1984	8,618	1990	7,560
1985	9,878		

A similar trend line, though with a suggestion of some pick-up in 1990 and an earlier peak, is apparent if we take the Conte/Lawrence statistical series not for the number of ESOP plans but for the number of employee participants.

ESOP Participants: 1980 to 1990 in 000s

1980	5,342	1986	10,828
1981	n.a.	1987	10,816
1982	6,906	1988	7,925
1983	9,680	1989	6,672
1984	10,573	1990	7,017
1985	10,944		

Conte later managed to unearth a statistical series for a subset of larger ESOP companies, those which file form 5500 with the US tax authorities. This confirms the trend of the earlier Conte/Lawrence research. It also extends to 1991 and shows that in the final year there was some recovery in the numbers. There were 2,657 'form 5500 companies' at end 1991 compared with 2,404 at end 1990.

So how do we reconcile these statistics with the figures of 10,000 firms and 10.8m employee shareholders cited from *The New Owners* in the epigraphs? The main answer is that Blasi and Kruse have cast their net wider than Conte and Lawrence. The latter focus narrowly on companies with actual ESOP plans. The estimate offered by Blasi and Kruse embraces, in addition to ESOPs, employee ownership which has come about in other ways as well: for example through what they call deferred profit-sharing plans, employee stock-purchase plans and stock-bonus plans.

There are two further points. First Blasi and Kruse fix their threshold of significance at only 4% of the equity capital of a business being held by its employees. The top management team alone could, in many cases, own that percentage of a firm's equity between them. Nothing wrong in that; but it is clearly rather different from what most people understand by 'employee ownership'. Second, at least so far as I can understand, Blasi and Kruse's overall totals are informed *estimates*, no more than that, though equally no less.

We still have to ask both how to understand and how to interpret the declining numbers in the two Conte/Lawrence series after they had peaked in the middle 1980s. The authors themselves offer three suggestions. First they note the elimination by the Congress in 1986 of the earlier tax-credit ESOP provisions. These had produced rather meagre amounts of employee ownership at rather high tax cost. So the Congress was quite easily persuaded to revoke them. The two further explanations arise from changes in the economic rather than the tax climate in the second half of the 1980s. The stock market crash of Black Monday happened in the autumn of 1987; and it is suggested that for some time thereafter companies may have felt reluctant to pass what managers would have seen as undervalued shares to their employees. Moreover, as economic conditions became tougher towards the end of the 1980s, companies may have become less willing to use profits, even pre-tax profits, to reward their employees with shares.

That brings me to a key question: not what caused the declining numbers in the two Conte/Lawrence series but how the reductions were typically effected. According to Dr Conte all, or almost all, plans confer a buy-back right on the business and these buy-back rights have been almost invariably exercised when terminations have taken place. It may well be that in some cases fears of not being able to cope with ever-increasing buy-back liabilities in the future have prompted private companies to go for 'buy-back terminations' of their existing ESOP plans.

I have discussed the overall statistics of employee ownership in the USA at some length partly because of the apparent conflict of evidence between Blasi and Kruse on the one hand and Conte and Lawrence on the other. For the most up-to-date information, perhaps the best source is the NCEO. It estimates that in 1995 there were 9,500 ESOPs and stock bonus plans in the USA with assets of $225bn and covering 10m employees. The NCEO series shows a fall-off in the numbers of ESOPs since 1990, and the organisation regrets in a 1996 newsletter the apparent fall in political support for them in the 1990s.

But the relative stagnation of the ESOP numbers in the years between the late 1980s and when this was written should not obscure the main point: that the phenomenon of the American ESOP dwarfs, to repeat, all experience at other times and in other places. By comparison with the American numbers, Mr Malcolm Hurleston of London's ESOP Centre estimated that in 1994 there were perhaps sixty so-called 'case law' ESOPs in the UK and less than ten of the so-called statutory variety.

So much for the overall scale of America's employee ownership experience. But no introductory discussion to my American case studies would be complete without looking at the rather different purposes to which that most versatile American social invention – the leveraged ESOP – may be applied. For all the American case

studies in this book have involved a leveraged ESOP. The changes of ownership resulting from leveraged ESOPs tend to be both more radical and more interesting.

However, before we move on to the uses of leveraging, a critically important qualitative and analytic distinction must be introduced. It goes without saying that the entire body of ESOP companies are attracted by the tax reliefs that employee ownership can offer. But our understanding of this whole ESOP phenomenon will be greatly sharpened if we separate off a subset from the aggregates. The subset consists of those ESOP companies which are attracted not only by those tax reliefs but by the opportunities of sharing power with their non-management employees – of transforming them from wage labour into real business partners – which employee ownership also offers. Of course, this distinction should be seen in practice as a spectrum. Of course, too, a business may be first attracted to employee ownership by the tax reliefs – or for example by its 'defensive potential' – and then later wake up to what we may call its human opportunities. Nevertheless, much that may otherwise be puzzling when we come to examine actual ESOP experience will be made clearer if we keep this distinction in mind. And it has its complement on the union side: between those that do and do not welcome the 'partnership potential' of employee ownership.

Turning back now to leveraged ESOPs, their general purpose is to buy big blocks of shares, with a view to the gradual allocation of those shares to employees, and in many cases indeed to acquire 100% of the equity capital. One of the three American case studies which follow in these final chapters, Allied Plywood, is in effect a 100% ESOP. A second, United Airlines (UAL)), is majority (55%) employee-owned. In the other case, Polaroid Corporation, a leveraged ESOP was indeed used to acquire no more than a minority shareholding. Like UAL, Polaroid is also unusual in that it was a quoted rather than a private company when its ESOP was introduced, and indeed has remained that way.

That brings me to a more general point. According to the NCEO, about 15% of all ESOPs are in public firms. They are much more frequent among private companies, and, to judge from Conte's data, this is even more true for the narrower category of leveraged ESOPs.

Leveraged ESOPs
Breakdown between Public & Private Companies

	Total Leveraged	Public	Private
1988	2,591	346	2,245
1989	2,534	377	2,157
1990	2,711	446	2,265

The imbalance in the use of leveraged ESOPs as between private and publicly quoted companies is even more marked among small businesses than large ones. Leveraged ESOPs are roughly *twenty* times more likely to be used by small private companies than by their publicly quoted counterparts:

Leveraged ESOPs
Breakdown among Smaller Companies: 1988-90

	Total Leveraged	Public	Private
1988	1,530	70	1,460
1989	1,368	62	1,306
1990	1,490	66	1,424

It is often argued that the most important and frequent purpose for which American private companies use leveraged ESOPs is as a mechanism for buying out the shares of a main shareholder or shareholders – especially in the case of family businesses. The case study of Allied Plywood is an example of precisely that. There is a fair expectation that this will also turn out to be the principal use of the much more recent statutory ESOPs in the UK. Ownership succession in private companies and especially in family businesses is a growing problem to which ESOPs offer an attractive solution, and that is one reason why the Allied Plywood case study is included at the end of this book among others which look forward to the future of employee ownership. The other reason is that – exceptionally for a US ESOP-owned company – Allied Plywood has so structured its arrangements that its employee ownership may perhaps be sustained almost indefinitely.

As we saw in the steel industry case studies, more rare but also more dramatic use of the leveraged ESOP in today's America is as a mechanism which can save businesses, or parts of businesses, and thus jobs and incomes, which would otherwise almost certainly be

lost. There can be no certainty that if the ESOP mechanism *is* used for this more dramatic purpose, the result will be success. It is also true that these dramatic and potentially job-saving ESOPs are no more than a small minority in the whole population of America's ESOPs. In the highly competitive national and international markets for steel and other manufactured goods, there are situations where it is almost impossible to save these jobs in Western countries unless the workers concerned either accept a pay cut or notch up significant and rapid improvements in productivity, or both. A cut in wages will almost always deliver an improvement of competitive edge more rapidly than any scheme of productivity improvement. On the other hand, if workers are to accept restraint in relation to wages they will clearly prefer to do so when they will themselves be the main beneficiaries of any resulting improvements in profits. That as we have seen, was the logic behind each of the two dramatic employee buy-outs – at Weirton and at Republic Engineered Steels Inc – included among my case studies. We should not hesitate about insisting to politicians that the jobs saved are real jobs and that the source of saving them was ESOP legislation.

The reasons for the establishment of ESOPs in American steel companies were, to repeat, especially to save jobs. At Polaroid Corporation, the world famous manufacturer of instant cameras, instant film and all kinds of instant images. the logic of the ESOP was essentially defensive: the ESOP was established by Polaroid's directors and then used to acquire a big block of shares as a key move in defending the business against a hostile takeover bid. On the other hand, the high court in Delaware later ruled that there was nothing illegal about what Polaroid had done, basing its judgment on the argument that, as well as being a defence against the takeover bid, the ESOP was also in line with Polaroid's long-established policies of enlightened employee relations.

We noticed earlier that relative to their use in private companies the use of leveraged ESOPs in American businesses which are publicly traded was quite modest. But the numbers are not negligible – between 400 and 500, or perhaps between 2% and 3% of all quoted US businesses. One hypothesis is that where they have been used by quoted American companies, a motive has been as a preventive defence against precisely the kind of hostile takeover bid with which Polaroid was confronted. As an extension of that preventive use, leveraged ESOPs have been used to take public companies private – and so remove them beyond the reach of hostile takeovers. Probably the most famous example of this was at the car hire company, Avis, in 1988. And the Avis experience remains important notwithsdtanding the fact that the company was the subject of a conventional capitalist offer in 1997, and gave up its employee ownership when the offer was accepted.

This discussion has concentrated mainly on leveraged ESOPs. As I have said, they tend to be more interesting. But there is also a more general reason for this focus: the subject matter of this book is not employee ownership on the margin but total or at least substantial employee ownership. More precisely, the book is about employee ownership which is so substantial as to demand a new status for a business's employee shareholders and new systems of involvement such that they can make their influence properly felt.

By fixing their cut-off point at 4% ownership by employees, the authors of *The New Owners* that I quoted in the epigraph are effectively telling their readers that they are interested in employee ownership of *all* kinds. That is fine, but readers of that book should probably be advised to keep the distinction clearly and continuously in mind. The differences between employee ownership of 4% and 100% are so great that it is improbable that they share any significant non-formal characteristics. Of course, there is a whole spectrum of incremental ownership percentages stretching from 4% to 100%. It may be arguable that (a) in most of the cases of minority employee ownership, the employee-owned percentage is growing year by year; and (b) many of the companies which end up being substantially or wholly employee-owned have started with a lower percentage. But this still leaves a very large and potentially growing number of US businesses in which the employee ownership is maintained at a steady but quite small percentage – whether at the 4% base level taken by the authors of *The New Owners*, or at their 12% average, or even somewhat higher. Although employees own shares in these companies, both the current and prospective level of ownership is so low that it can surely add little if anything to employees' sense of involvement or influence in the business.

At the heart of my interest are those American companies which are majority employee-owned. I know of no very reliable estimate of their total number but it probably falls somewhere around 1,000. It is the quality of these businesses and the effect of their ownership

arrangements on those who work in them which seems to me to be at least as interesting and important as their number.

For the future, perhaps the most critical question to emerge from these case studies is whether majority employee ownership is likely to be sustainable without changes in the present US law. The earlier evidence of the two big steel companies tells forcefully against sustainability. And in the absence of some quite exceptional developments, the same is projected to be true of United Airlines.

And that brings me back to the contrast between the American and British employee ownership experience. In terms of relative size in the middle 1990s, there is no comparison. But there is one respect in which employee ownership in Britain may be said to be ahead of that in the USA. It is that the leading British businesses which are majority or wholly employee-owned have structured their employee ownership in such a way that it should even be possible for it to be sustained indefinitely. That is surely important though the numbers involved are only tiny. What is surprising is that the issue of sustainability seems to have been largely ignored, as one of only minor importance, in the USA. It may indeed seem odd, to readers as well as to the writer, to spend huge amounts of time and effort adapting the corporate culture of a business so as to be in line with employee ownership – only to be forced to abandon that ownership after what is unlikely to be much more than a decade.

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Polaroid: Using an ESOP as a Takeover Defence

INTRODUCTORY OVERVIEW

Excellence ... We employ excellent people and we expect excellent performance.

Ownership ... Each of us is responsible for knowing what our business goals are and each of us is responsible for doing all we can to achieve them. Each of us expects to be informed on matters that affect our business and to have an opportunity to influence the decision making process. Each of us expects to share in the Company's fortunes – both good and bad.

Respect ... We believe in the dignity of every individual in the Company. *From a statement of Polaroid's Company Values, February 1987*

Employee Owners ... have a longer perspective. While they also have an interest in quarterly results, they have an even greater concern about the very long-term success of their company and the stability of their jobs. Far from abating, the *current* move toward employee ownership of company stock is likely to increase, perhaps dramatically. Like institutional investors they will demand – and deserve – to be heard.

Employee ownership is not a fad ... not an anti-takeover ploy. It's a global phenomenon ... it's important ... and I'm all for it. *Taken from 'Some Thoughts on Corporate Ownership in the 1990s'. Remarks by I. M. Booth, then President and CEO of Polaroid Corporation, delivered before the Cornell Club of Boston. 4 April 1990*

In the fashionable industrial relations language of the late 1980s and early 1990s, the use of the words 'own' and 'ownership' have been extended beyond their older conventional limits. For example, it has become normal to talk about 'owning' and 'ownership' not only in relation to pieces of property but also in relation, say, to a problem. In this extended usage 'owning a problem' means taking responsibility for finding a solution to it. As can be seen in the first of the two epigraphs, Polaroid was using the word 'ownership' in

this extended sense in a statement of its company values as early as February 1987, eighteen months before the employees started to become 'real' employee owners in July 1988.

Whatever judgement may be made about the 'real' employee ownership, at least from July 1988 to the completion of the repayment in December 1997 of the company's original ESOP loan, employees certainly had to 'own' their share of the problems of Polaroid. For in 1995, for the second time in less than ten years, Polaroid embarked on a big restructuring operation with job losses on a large scale. The redundancies were virtually all voluntary – indeed some argue that redundancy was made very attractive. Nonetheless, in this second instance the restructuring, when completed, will have reduced Polaroid's workforce in the mainland USA by 20%.

The 1995 restructuring came two years before the maturity, in December 1997, of the company's ESOP, which was set up in connection with the earlier restructuring exercise in 1988. Alongside that earlier restructuring, just under 10 million of newly issued shares, amounting to 14% of its common stock, were bought on behalf of Polaroid's employees. The buyer was an ESOP trust set up earlier in the same month.

In fact, as the management is understandably keen to emphasise, discussions about a possible ESOP had begun inside Polaroid at least as early as 1985. The necessary authority had been given at a board of directors' meeting in May 1988, that is two months before it was formally used for establishing the ESOP in July.

Some months later, in March 1989, the company bought in and cancelled 16 million of its common stock shares. Following these two transactions (July 1988 and March 1989), Polaroid's employees were, through the mechanism of the ESOP trust, the owners of just under 20% of its common stock, a figure which later reached a high of 22%. Collectively, they had in fact become the largest single stockholder on the morrow of the ESOP trust purchase of July 1988.

But it was not so much any corporate philosophy about the metaphysical importance of ownership which precipitated the ESOP share purchase. Rather it was self-defence – more precisely it was anticipatory or preventative self-defence in what became a hard fought takeover battle. Through an informal telephone call, management apparently became aware of a take-over threat in late

June 1988. In the form of an unsolicited letter written by a California-based financial conglomerate, Shamrock Holdings, and dated 19 July, the threat rapidly materialised. A formal bid followed in September 1988.

After an intense battle and a crucial court judgment, the bid was formally withdrawn in April 1989, when Shamrock also undertook to refrain from any further takeover attempt for at least ten years. In this case, the ESOP turned out to be the decisive factor in the takeover defence. That alone gives this case history a particular interest.

For readers whose interest extends beyond the study of takeover battles within the framework of conventional Anglo-Saxon capitalism, the Polaroid ESOP, its largest even if still minority shareholder for more than nine years from 1988, raises a number of other questions:

– What effect did it have on industrial relations?

– What effect did it have on business performance?

– To what extent did its employee owners start to behave like real owners?

– Given a choice, would Polaroid's employee owners seek to sustain that ownership when the ESOP came to an end in 1997?

As we shall see, the answer to the fourth question, when it came up in 1997, was apparently more 'yes' than 'no'. But that is to anticipate.

The Company and Its Record in Outline Because of its instant cameras, Polaroid is a household name all over the world. Its head office is built around Technology Square in Cambridge, Massachusetts, a town with a notable concentration of what President de Gaulle used to call '*la matière grise*'. Its headquarters building is scarcely a stone's throw from the Massachusetts Institute of Technology (MIT) and not much further from Harvard Yard. From this base, Polaroid in 1995

– made sales of $2.2bn, of which just over half were outside the USA;

– employed 11,662 people worldwide, sharply down on 1994, and scheduled to fall further after the latest restructuring ;

– made profits from 'operations' of $89m, down from $200m in 1994.

In 1990 Polaroid was no. 218 in the list of America's largest companies compiled by *Fortune* magazine; but measured by the popular recognition of the Polaroid name its position was much higher: no. 42 in the USA according to Landor Associates' *Image Power Survey* of the world's most powerful brands. It came no. 65 even in Europe according to a Landor measure of 'familiarity and esteem'. (By 1996 Polaroid had slipped out of the *Fortune* 500, but its brand image was still way up on its size.)

Polaroid's founder, Dr Edwin Land, was born in Bridgeport, Connecticut, in 1909, began studying at Harvard in the late 1920s but left to work as an inventor on his own account before completing his undergraduate degree. In 1932, jointly with George Wheelwright III, who had taught him physics at Harvard, he founded the Land-Wheelwright Laboratories. The Polaroid Corporation was founded by him in 1937. In 1947 he made public the most famous of his many inventions, the Polaroid one-step camera.

From the early 1950s to the late 1970s, Polaroid was essentially a single-product business. Employment peaked at just under 21,000 in 1978. At just over $72.50, the 1978 year-end share price was also higher than ever before or since.

The story of Polaroid during the 1980s, if we exclude the Shamrock bid and the company's response to it, is mainly one of consolidation and diversification. In a foreword to a booklet which summarises the statistical record of the business between 1980 and 1990, Ian MacAllister Booth, Polaroid's chairman, president and CEO until 1995 – from whose remarks to the Boston Cornell Club I quoted in the second epigraph – wrote of the 1980s as being a decade of transition: 'During the past decade, Polaroid Corporation managed a significant transition from a pioneering company which invented and developed instant photography to a broad-based imaging company offering instant, conventional and electronic imaging products.'

It was towards the end of this process of restructuring that the company became exposed to the bid from the financial conglomerate Shamrock Holdings, which had little or no experience of photography or of what Polaroid likes to call the 'instant imaging' business.

The conditions which prompted the bid were typical enough. The Polaroid share price had been steadily falling from its peak in 1978. There had been progress in achieving Mr MacAllister Booth's 'significant transition' – away from being a one-product company.

Workforce numbers were sharply down and profits, after actually turning negative in 1985 (following a notably high tax charge) had shown a respectable recovery in 1986 and 1987.

The aftermath of the Shamrock bid and the restructuring was a sharp improvement in profits. Indeed, the highest operating profit ever achieved was in 1989, and the results for each of the subsequent five years were also good.

Profits from Operations: 1985-1995, $m

	Operating Profits	Special Costs*	Profit from Operations
1985	33.6	nil	33.6
1986	135.7	nil	135.7
1987	153.8	nil	153.8
1988	173.8	151.9	21.9
1989	304.2	40.5	263.7
1990	284.3	nil	284.3
1991	246.6	nil	246.6
1992	213.8	nil	213.8
1993	185.4	44.0	141.4
1994	200.3	nil	200.3
1995	89.2	247.0	-157.8

*Mainly restructuring costs

Up to the end of 1997 there were no further attempts to take over the company – indeed, so long as the original ESOP continued, it was probably takeover-proof. The consensus, in relation to the arrangements which followed, was that they would probably provide adequate protection.

I conclude this introductory overview with three rather different points. The first is commercial: the tension between technical and market orientation in relation to the company's profitability. Until 1995, Polaroid essentially remained a technology-driven company. However, new products introduced in the first half of the 1990s did not fare as well, or at any rate did not take off as fast as management had hoped. Moreover, the Polaroid range of products is technically wide, as well as broad-ranging in its target markets. At one end is the simplest modern version of its original 'single-product', one step camera. Sales of this product were

forging ahead in the mid-1990s but the most promising new markets were uncertain – countries like Russia and China. The Captiva (or 'Joshua') line, by contrast, a compact and more sophisticated version of a one-step camera introduced in 1992, 'has not met sales and profit targets, and been restructured to reduce production while still meeting consumer demand', to quote from the 1995 annual report.

At the other end of the spectrum, Polaroid introduced sophisticated medical scanning equipment called Helios. Announced in 1992, this was still making substantial though declining losses in 1995. Finally, there are the graphics imaging products – mainly intended for use in offices – which was still too new to be judged at the time of writing (1997). The commercial skill and new product judgement of Polaroid's ESOP period top management was called into question by the sales record of these new products. The new CEO, Gary T. DiCamillo, who took over in 1995, sharply changed the focus of the company from technological development to market orientation.

But future success will not depend only on whether this change of emphasis proves to be right or wrong. The fact that between the two big restructurings in 1988 and 1995 the employees were the single largest body of shareholders was important not only for defence against possible takeovers but also for the internal functioning of the company. Was employee ownership and motivation significant in the relatively trouble-free achievement of the massive job cuts? And would the commercial effect of mistakes in relation to new products have been compounded without it? In the case study which follows we look carefully at the so-called 'Total Quality Ownership' and 'Ownership Stretch Objective' programmes which were introduced in the early 1990s. Did these programmes 'change the culture' at Polaroid to the point where processes of 'continuous improvement' got under way and can now be sustained? And how do these interrelate in this non-union company with what some have seen as an accident-prone record of labour relations, as symbolised by the benchmark case brought against Polaroid in 1995 by the US National Labor Relations Board?

Finally, it is appropriate to record the death, in 1991, of Polaroid's founder, the inventor of genius, Dr Edwin Land. Dr Land had stepped down from the posts of Polaroid's president and CEO as long ago as 1975. And in 1982 he had given up the chairmanship and resigned his place as a director. Of course it is as an inventor that he will be chiefly remembered. But he may also be credited with responsibility for having created a rather unusual combination of industrial relations policies: non-union, but whether despite or because of that, with a humanistic centre. He was also something of an inspirational leader. In the annual report for 1990 which records his death, his successors quoted the following passage from his letter to shareholders in 1980, ten years before:

> Do not undertake the program unless the goal is manifestly important and its achievement nearly impossible. Do not do anything that anyone else can do readily; industry should be the intersection of science and art; the second great product of industry should be the fully rewarding working life for every person; the most intelligent use of a science requires understanding that comes only from increasing the knowledge in that science; it is relatively easy to organise a company with a homogenous set of good minds; but the ultimate greatness of a company depends on the variety of good minds within it.

Before the Takeover Bid: The First Phase – Down to 1978 The Polaroid story begins with the birth of Edwin Herbert Land in Bridgeport, Connecticut, on 7 May 1909. *Encyclopaedia Britannica* (1974 edition) highlights his invention of a 'one step process for developing and printing photographs [which] culminated in a revolution in photography unparalleled since the advent of roll film' and goes on to sketch in the background to his invention:

> While a student at Harvard ... Land became interested in polarized light, light in which all rays are aligned in the same plane. He took leave of absence, and, after intensive study and experimentation, succeeded (1932) in aligning submicroscopic crystals of iodoquinine sulphate and embedding them in a sheet of plastic. The resulting polarizer, for which he envisioned numerous uses and which he dubbed Polaroid J sheet, was a tremendous advance. It allowed the use of almost any size of polarizer and significantly reduced costs.
>
> He developed and, in 1936, began to use numerous types of Polaroid material in sun-glasses and other optical devices. Polaroid was later used in camera filters and other optical equipment ...
>
> Land began work on an instantaneous developing film after the war. In 1947 he demonstrated a camera (known as the Polaroid Land Camera) that produced a finished print in 60 seconds. The Land photographic process soon found numerous commercial, military and scientific applications. Many innovations were made in the following years, including the development of a colour process.

I have a dim memory of special dark glasses, called Polaroids, being on sale in British shops in my childhood – during the war and immediately after it. There is a sentence in the *Encyclopaedia Britannica* article about the work of Land and his Polaroid Corporation during that conflict: 'During World War II he applied the polarizing principle to military hardware, including infrared filters, lightweight range finders, sights for anti-aircraft guns and other weapons, and night adaptation goggles.'

It is not clear how far Polaroid continued to work on defence contracts after the war, probably not very much. For the period from the invention of the instant camera in 1947 onwards we have the judgement of Mr MacAllister Booth quoted earlier for the view that down to about 1980, the Corporation was 'a pioneering company which invented and developed instant photography.'

In other words, for over thirty years after 1947, Polaroid was essentially a one-product business. But it needs to be emphasised at once that its chief characteristic was its almost unfaltering sales growth, reflecting rapid growth in the demand for Polaroid cameras, in the United States and worldwide.

Both Polaroid's employment numbers and its share price reached a peak in 1978 of 20,884 and $72.5 respectively. The company's sales and employment growth during the final years of its 'pioneering ... instant photography' phase were as follows:

Sales ($m) & Employment 1973 to 1978

	US	Other	Total	Employees
1973	493.1	192.4	685.5	14,277
1974	487.3	270.0	757.3	13,019
1975	495.6	317.1	812.7	13,387
1976	586.7	363.3	950.0	14,506
1977	645.8	416.1	1,061.9	16,394
1978	817.4	559.2	1,376.6	20,884

The year 1978 was in fact an *annus mirabilis* for Polaroid by a third measure: return on stockholders' equity. That reached a figure of 13.8%, which was not exceeded until 1989.

What seems to have driven the growth of employment during the decade down to 1978 was a combination of two factors: first, the continuous increase in the sales of instant cameras and, second, a policy of bringing inside the business the manufacture of components previously made outside. By the end of 1978 the second process was all but complete. It seems clear too that by then the growth in the sales of instant cameras had started to slow down. In any event, Polaroid's employment began to fall in 1979.

A Transitional Decade: 1979 to the Eve of the Shamrock Bid A way to measure Polaroid's performance between the 'high peak' year of 1978 and the unwelcome receipt of the unsolicited letter from Shamrock holding in July 1988 is to trace the year-by-year evolution in the percentage return on stockholders' equity. After its peak of 13.8% in 1978, and if we exclude a rebound to 9% in 1980, the pattern is one of almost continuous decline to 1985 – when a negative figure of minus 0.3% was registered – followed by a strong recovery in 1986 and 1987.

Return on Stockholders' Equity: % 1978–87

1978	13.8	1983	5.4
1979	4.0	1984	2.8
1980	9.1	1985	(0.3)
1981	3.2	1986	11.7
1982	2.5	1987	12.5

For sales, there is much the same pattern. But because of falls in the numbers employed, output per employee over this same eight-year period was held steady at around $85,000 in constant prices from 1978 to 1985. But that run of six almost flat years was then followed, as in the case of the other measures, by a sharp improvement to $94,000 in 1986 and $104,000 in 1987, nearly 20% above the 1981 figure.

Sales and Employment 1981–87

	Current Price ($m)	Constant (1981) Prices ($m)	Employees
1981	1,420	1,420	16,784
1982	1,294	1,247	14,540
1983	1,255	1,164	13,871
1984	1,272	1,136	13,402
1985	1,295	1,115	12,932
1986	1,629	1,387	14,785
1987	1,764	1,426	13,662

To complete this statistical summary of the period down to 1987, two other series are worth putting on the record :

	R&D	Capital Spending
	$m, constant (1981) prices	
1981	121.4	42.5
1982	114.0	30.3
1983	114.2	46.5
1984	120.5	73.9
1985	102.1	89.9
1986	107.7	70.5
1987	115.1	94.3

Compared with total sales varying between $1.1bn and $1.4bn in constant prices, R&D expenditures were fluctuating between a low of about 8% and a high of just over 10% of turnover. On the other hand the movement of the capital spending figures show a radically different trend. After falling sharply between 1981 and 1982 there was a sustained recovery. Presumably it was this investment which funded the transition from a single-product company to Mr MacAllister Booth's 'broad-based imaging company offering instant, conventional and electronic imaging products'.

On the other hand, given the long decline down to 1985 in the return on stockholders' equity, this was no time to be over-generous with dividends. Between 1981 and 1985 the annual payout to stockholders was held steady at 50 cents in nominal terms – and thus declined in real terms. Stockholders had to wait till 1987 for their reward: an increase to 60 cents on the dividend. Moreover this was payable on each of two new shares into which the old shares had been split.

In fact, between the 'low' of 1985 and the high of 1987 – the stock split year – shareholders saw a more than threefold rise in the value of their shares. The price went from a low of $12.19 in 1985 to $42.63 in 1987. Allowing for the stock split these figures imply a sixfold rise in the value of a retained shareholding. On the other hand, even in 1987 the price of Polaroid's shares exemplified the rule that what goes up may come down: the shares traded down to a 'low' of $16.75 in the fourth quarter.

In summary, this ten-year period from the 'high peak' year of 1978 to July 1988 contains both positive and negative elements. On the positive side, the management had succeeded by 1986 and 1987 in turning round the direction in which profits were moving and propelling them sharply upwards. There was also a big improvement in labour productivity. But on the other hand, when faced with the Shamrock challenge, management showed itself capable of improving the company's profit performance at an altogether faster pace. At least in theory it might surely have been possible to achieve an acceleration in the pace of improvement without the Shamrock challenge.

In any event those behind the bid from Shamrock evidently felt that Polaroid was well positioned to deliver substantial further improvements: more precisely at the price they offered of $34.50 per share, later increased to $42.00, and under their management they reckoned that that there was a fair chance of that happening.

What of the 'culture' of Polaroid during this period? Before his retirement early in 1993, Owen Gaffney was a group vice-president. He had been with Polaroid for thirty years – with responsibility for overseeing manufacturing operations and then for human resources. His view is that in the headlong expansion of the mid-1970s the company somewhat lost its way; and in particular that it partly lost touch with the humanistic values of its founder, Dr Land. On the other hand, and as a result of sustained remedial efforts by management during this period, he also believes that by 1987 both the morale of the workforce and the values of the company were back in fairly good shape. As evidence for this, he cites first the statement of values, promulgated in 1987 (see epigraph). He also cites the fact that already, before there was any

threat of a takeover bid, the management had started discussing an ESOP, and eventually set one up, at least partly because of its apparent congruence with company philosophy.

Whatever the state of workforce morale in late 1987 and early 1988, that was due to be sharply tested by the conditions associated with the purchase of shares by the ESOP in July 1988; and more generally by the conflict with Shamrock and what may be called the costs of victory.

THE ESOP AND THE SHAMROCK BID
JULY 1988 TO APRIL 1989

Polaroid publishes a fortnightly in-house magazine *Polaroid Update*. The front page of the issue dated 3 April 1989 carries a simple headline across two columns: WE WON. What this referred to was the withdrawal of the Shamrock takeover bid coupled with an undertaking that it would make no further attempt to take over Polaroid for at least ten years.

When a substantial company is subjected to a takeover battle, even when it wins and as in this case sees off the challenger, it will normally emerge somewhat changed. At Polaroid, the main changes were two: a massive 'restructuring plan'; and a purchase of company stock by the ESOP Trust which the company had set up in March 1988, but which was only wheeled into action in July. Strictly, the events associated with the ESOP were a part of the restructuring plan – that is how the two were presented by management at the time. However, for clarity, the ESOP and the restructuring exercise are treated separately for the purposes of this study.

Restructuring and Job Cuts Management announced its restructuring plan on 12 July 1988. This was a week before the receipt of the formal letter from Shamrock Holdings, but roughly a month after the first intimation by telephone that a bid was in the offing. There is no reason to doubt the link between the intimation of the bid and the plan to restructure.

Top management set a precise goal for the restructuring plan: to reduce costs by $70m annually – or by just less than 4% compared with total costs in the previous year. Looking back in the light of the 1995 restructuring proposals, the job cuts of 1988 look quite modest. But they were easily the largest and the toughest components of that earlier cost-cutting exercise. There were two parallel programmes of voluntary early retirement and voluntary redundancy. Here too a numerical target was set: that 1,500 jobs should go. In fact the figures show that employment fell by just over 2,000 between 1987 and 1988, from 13,662 to 11,613.

The *Polaroid Update* of 1 September 1988 reported that as many as seven of the company's corporate 'officers' – its top-line managers – would be taking early retirement. These included a senior vice-president for finance and a group vice-president for worldwide marketing. Although redundancies were generally voluntary, one can only imagine that these were painful decisions. Polaroid's CEO, Mr MacAllister Booth, was quoted in the *Polaroid Update* as describing the seven early retiring officers as 'valued, colleagues, dear friends, builders of this Company and, in many cases, personal mentors of mine'.

The total workforce reduction in 1988 was 18%. That was followed by a ballooning of payroll and related costs in the latter year because of special redundancy and early retirement payments. It was not till 1989 that the benefits of the manpower reductions began to show up in Polaroid's cost base. Total payroll and benefit costs in 1989 were $547m – down from $585m two years before.

It would be wrong to imply that this massive restructuring programme consisted exclusively of manpower reductions. Quite apart from the ESOP, it included, as reported by the *Polaroid Update* on 1 August 1988:

– [the] worldwide marketing of conventional films to increase revenues, and

– an internal reorganisation to strengthen the focus on instant imaging and accelerate the development of new products.

The effects of these two other changes cannot be quantified directly. One possible measure of the overall success of the restructuring was the increase in operating profits from $154m in 1987, the last full year before it, to $264m in 1989, the first full year after it.

This improvement suggests two general reflections for a business the size of Polaroid. The first is that even where a striking improvement in performance has been achieved – as was the case at Polaroid between 1986 and 1987 – there is probably always room for substantial further improvement. Second, such is the force of inertia that in some circumstances an outside challenge may be a necessary condition for securing that extra improvement.

However plausible or otherwise those reflections may be, there can be little doubt that the Shamrock challenge had a notable influence on the Polaroid ESOP: namely on the timing and the size of the stock purchase, to which we now turn.

The ESOP and Shareholder Neutrality Like many other American quoted companies, Polaroid introduced a special kind of ESOP called a 'tax credit ESOP' in the early 1980s, soon after the relevant tax credit was voted by the Congress. The company continued to make contributions to it until those credits were withdrawn in 1986. While the relevant credit lasted, the company received a dollar off its tax liability for every dollar – up to a maximum of 1% of payroll – it contributed to the plan. It would have been perverse not to have taken advantage of these provisions. On the other hand, it was surely unrealistic to think that the Congress would allow such 'free benefits' to continue indefinitely.

It was not until March 1988 that Polaroid took steps to set up an approved ESOP, although the management had begun to discuss the possibility at least as early as 1985. The ESOP was conditionally approved by the board of directors in May 1988. The condition was that the plan should be 'shareholder neutral' – in other words, not inimical to their interests. As the ESOP came to an end in 1997, the way Polaroid had handled the issue of maintaining neutrality, *vis-à-vis* non-employee shareholders, was beginning to look like a precedent for all quoted companies which want to channel profits into an ESOP. In this respect Polaroid may reasonably claim that its ESOP was something of a pioneer.

I simply do not know to what extent the possibility was foreseen in March 1988 that the ESOP might come in handy should Polaroid be subject to a takeover challenge. But it is hard to believe that all of the top managers were wholly unaware of the possibility.

In any event, when the company announced its massive restructuring programme on 12 July, the ESOP was swung into action as part of it. A total of 9.7m new Polaroid shares were issued and bought by the ESOP at a price per share of $30.875. The new stockholding gave the ESOP around 14% of the total Polaroid equity.

But what must have struck the employees with the greatest force was the set of management decisions about how the purchase of the ESOP's stockholding was to be financed. It was to happen through reductions in pay and the suspension of some other benefits, for management and non-management alike. There was a 10% cut in total 'compensation expenditures' for all staff. A further cut of 5% was imposed on top managers – the eighteen corporate officers. These reductions, calculated to cover the $300m loan repayments and associated interest over the ten-year life of the ESOP, would not be restored at least until after the conclusion of the loan repayments. In this way, or so the management argued, the ESOP could be judged 'neutral', or 'fair', to Polaroid's existing shareholders.

The 10% reduction in total compensation payments can be broken down into three components: (i) 5% was a straight wage cut; (ii) a further 3% took the form of a reduction in the annual cost of living pay adjustment that would otherwise have become due in full in the month following the restructuring exercise; (iii) the third component, 2%, took the form of a suspension of various non-cash benefits in Polaroid's employment contracts. From then on the management kept track of the resulting savings and claimed throughout that they had matched the principal and interest payments on the ESOP loan. A question-and-answer sequence in *Polaroid Update* (1 August 1988) set out the principle behind this technique for achieving 'stockholder neutrality':

> *Question*. Why can't the company pay for the Stock Equity Plan, instead of the employees doing it?
> *Answer*. The Company *is* [emphasis original] paying for the Stock Equity Plan. As part of the overall restructuring of the Company's compensation and benefits plan, corporate funds that would have been allocated to payroll will instead be used to fund the ESOP.

The logic of the answer, as explained to me by management, has two parts. First, the reduction of 10% in 'compensation' can be seen as amounting to a switch from one form of compensation to another – the prospective ESOP benefits. Second, the company is the provider in both cases. Readers must judge this logic for themselves.

However satisfactory or otherwise this answer, the question and answer taken together suggest that the most sensible way of looking at the ESOP from the employees' point of view is as a scheme of compulsory saving of a rather special kind. It was of a rather special kind because (a) it was a significant gamble, but also (b) because those who were forced to do the saving could have some

influence on the likely outcome of the gamble. For the record we should also note that, since the dividends on the ESOP shares were used to to help pay off the ESOP loan, these were forced savings which were to yield no income for up to ten years.

Allocations of shares into the individual accounts of employees took place every six months. Given the ten-year maturity of the loan taken out to finance the ESOP stock purchase, it was calculated that roughly 5% of 9.7 million shares – or just less than 500,000 – would be allocated out (pro rata with earnings) every six months. Favourable subsequent developments outweighed unfavourable ones. In particular, lower than projected interest rates outweighed the impact of lower than projected payroll savings – which arose because there were fewer staff on the payroll. So the original repayment timetable might have been brought forward. In practice, the company reduced the cost to employees by starting to pay dividends (originally earmarked to help pay off the loan *throughout* its life) about three years before the loan's maturity date.

A useful calculation of 'who gets what' was circulated to employees by the company for the first sixth-month period of 1990. The total number of shares to be allocated was shown to be 483,000. The total relevant payroll aggregate for the six-month period was then shown to be $165.6m. Dividing the latter by the total number of shares to be allocated yielded the calculation that each eligible employee would receive roughly 2.9 shares for each $1,000 of annual earnings. Thus someone earning $20,000 annually would receive a share allocation of 58 shares, and someone on twice that would get 116.

This circular went on to provide estimates of the likely number of shares which would be built up by employees when the loan repayments had been completed in 1997. For someone paid an annual $30,000 in 1990, it was estimated that his or her package of accumulated shares would number 920 at the end of 1997. The circular concluded by showing the value of such a share package, on different assumptions about the share price. At a price of no more than $20 the value of 920 shares would be $18,400; at $30 per share the value would be $27,600; and at $42 per share, the value would be between $38,000 and $39,000. If the price per share at end-1997 was $100 then the value of 920 shares would be $92,000. The figure that the circular does not give is the accumulated value of benefits foregone. However, in May 1996 Ralph Norwood, vice president and treasurer, estimated that the break-even share value for employees would be about $40 per share – after making allowance for interest they might have earned if they had saved this money in a more conventional way. For the record, the final price was comfortably above the break-even figure, approximately $45.

When Mr Norwood gave that estimate, Polaroid (and its employees) were considering whether to continue with an ESOP after the completion in late 1997 of the final interest and loan repayments in the original plan. The decision which was later taken may well surprise critics of Polaroid's whole long-running employee-ownership project, both inside and outside the company. Though there was no actual voting, the management judged that a big majority of the workforce favoured a second infusion of employee ownership, albeit at a reduced level. Moreoever management was sufficiently confident about this to introduce a new set of employee ownership and related employee savings and make them a condition of employment from 1998 onwards and to present them to new recruits as benefit of working at Polaroid. The full details need not concern us. But the essential numbers are a 5% reduction in wages compared with what these would otherwise have been, split between:

– 3% to buy shares for employees;

– 2% as an enhanced pension contribution.

The management is prepared to offer two rather consequential judgements about these developments and they seem worth having on the record:

– The main reason for the strong employee support behind a second infusion of employee ownership was a widespread recognition of the value of the forced savings which had beeen accumulated through the original ESOP.

– Although, following the end of the original ESOP, there will be no chunk of employee-owned equity held as a block, there are likely for at least a number of years to be enough shares in friendly hands to see off a hostile takeover bid.

Legal Challenges Over the first few months of 1989 Polaroid managed to survive a series of Shamrock challenges brought against it in the courts of the State of Delaware where Polaroid is registered. What is mainly of interest here is the ground on which the

Delaware courts rejected Shamrock's challenge to the ESOP. Essentially the court accepted the 'good faith' of the Polaroid ESOP and ruled that that 'good faith' was not seriously undermined by the fact that it had also operated as a valuable defence mechanism in a takeover battle.

In January 1989 the challenger had increased the price it had earlier offered to pay for Polaroid's shares from $42.00 a share in September 1988 to $45.00. However, with hindsight, January 1989 was the month that marked the turning point against Shamrock. For it was on 6 January that the vice-chancellor of the Delaware Chancery Court, Carolyn Berger, gave the thumbs down to its submission that Polaroid's 1988 ESOP was 'invalid'. The vice-chancellor's judgment ran to 53 pages. A few key sentences from it were published by *Polaroid Update* on 18 January:

> 'I am satisfied', she wrote, 'that the Polaroid ESOP is fundamentally fair. I do not find either the timing of its implementation or its possible anti-takeover effect objectionable under the facts of the case.
>
> 'The fact that the ESOP was partly defensive . . . does not make it unfair. This is a defensive device – assuming that it is one – that is designed to and appears likely to add value to the company and all of its stock holders. It does not prevent the stock holders from receiving or considering alternatives. In sum, the plan adopted by the directors is fair and should not be invalidated.'

In making her judgment, Carolyn Berger was apparently influenced by two specific points. The first was the humanistic tradition of industrial relations at Polaroid. And the second was the so-called 'neutrality' of the ESOP *vis-à-vis* the interests of Polaroid's existing shareholders. Commentators were quick to point out that if one or other of those two conditions had not been satisfied, the vice-chancellor's ruling might well have gone the other way.

Shamrock Holdings appealed against this ruling but without success. In a second and later legal move, in March 1989, it launched a court challenge to Polaroid's $50 a share buy-back plan which had been announced in February. But in this case too Shamrock failed. Before the end of March, the Shamrock directors showed the white flag by offering up all its Polaroid shares for buy-back treatment.

The buy-back offer may be seen as having clinched the issue 'game, set and match' against Shamrock Holdings after the latter's challenge had already been decisively weakened by the vice-chancellor's ruling in the Delaware Chancery Court. It effectively secured the loyalty of the majority of Polaroid's existing shareholders. It was made possible by the support of an investment fund called Corporate Partners, headed by two partners, Lester Pollack and Ali Wombold, of Lazard Frères in New York. Given the Delaware Court ruling and the support of Lazard Frères, it was only a question of time before Shamrock caved in.

Finally we turn to litigation between Polaroid and its employees. This arose from the decision taken in February and March 1989 not to offer the ESOP shares for re-purchase when Polaroid launched a $1.25bn stock buy-back plan. The buy-back plan was in fact announced on 21 February 1989 with a price per share of $50 – well above the figure at which the shares were then trading. Not surprisingly, the offer was a success. What then became the subject of a legal challenge was the fact that not all of the ESOP shares were offered back for re-purchase. The result was that at the conclusion of the re-purchase exercise the ESOP's stockholding amounted not to the original 14% of Polaroid's equity, but close on 20%.

The Business Record 1989–96 Measured by operating profits, the performance of Polaroid during 1989–91 was well ahead of anything that had gone before. However, this progress was not sustained and in 1995 the company launched its second massive restructuring plan which involved the loss of a further 2,500 jobs or 20% of the workforce.

What happened? All began well. The results of the 1988 restructuring programme started to work through to the bottom line in 1989. The costs of payroll and related benefits were almost $40m lower in 1989 than they had been in 1987. In round figures average operating profits ran at $265m for the three years to end-1991, compared with no more than $108m for the three years to end-1987.

Moreover, Polaroid, though not its operating profits, benefited from a huge out-of-court settlement with Eastman Kodak. Net of money distributed to employees, that settlement strengthened the balance sheet by the equivalent of more than three years' net profits at the new post-restructuring average annual rate of $265m. The

case arose out of a long-standing claim for patent infringement by Polaroid against Eastman Kodak. After a series of court judgments in 1990 and 1991, an out-of-court agreement was finally announced on 15 July 1991. Under it, Kodak paid Polaroid a total of $924.5m in a combination of cash and what the accountants call 'short-term instruments'. Of this total the management allocated $50m pre-tax to Polaroid employees in the form of cash bonuses while a net figure of $871.6m was brought into the 1991 accounts as a 'litigation settlement'.

It is worth setting out the wide difference in the value of the company implied by the different prices put by different people on the Polaroid shares from 1988 onwards: the price paid for its new shares by the ESOP trust in July 1988 was $30.875; eight months later, in March 1989, $50 a share was paid in the buy-back transaction; in between, in September 1988, Shamrock Holdings made a formal offer at a price of $42.50 a share, having suggested $34.50 per share in the 19 July letter announcing its bid. Looking forward and by way of comparison, the *New York Herald Tribune* of 10 December 1997 showed Polaroid stock trading at $46.03, with a high and low of $60 and $30 over the previous twelve months.

Wall Street was not notably impressed by the 1988–91 turnaround. Indeed almost continually from the end of the Shamrock bid in April 1989 until the end of 1997, the price movement of the company's shares underperformed that of the market average by a significant margin. At $28.50 in mid-January 1989 the price was not much more than half the $50 a share which the company had paid for the 22% of its equity which it had bought back in early 1989. And it was also well below the final price of $42 which had been offered by Shamrock. On the face of it, Polaroid shareholders would have been better off if Shamrock had won in 1989 and they had pocketed the $40 a share which had then been on offer.

No doubt the 'Wall Street Community' was disappointed by the decision, taken by Polaroid's directors early in 1992, not to pass on to the shareholders any of the money received from Kodak in the out-of-court settlement. Instead, the board had decided simply to maintain the dividend at the level of 60 cents a share which had been paid without interruption since 1987.

More fundamentally, Wall Street investors may also have been disappointed by the company's performance. Indeed, already by the end of 1994 the company itself was disappointed by the performance of the key product launched in 1992, the 'Joshua' camera (sold under the name 'Captiva' in the USA).

The story as told by the company in 1996 was that market research, including 15,000 focus interviews, had identified a niche market for a small sleek version of Polaroid's traditional one-step camera; but the investment needed to develop the product was much greater than could be justifed by a small niche market. The company went ahead all the same – and the product did not sell as well as had been hoped. Production was discontinued in 1996.

The new medical imaging equipment called Helios, launched in 1992, also opened up more slowly than expected; but by 1996 prospects were improving – for example a deal had been signed with the Japanese company Konica for it to market Helios in Japan.

One thing which kept Polaroid going was burgeoning sales of its long-standing one-step camera in emerging economies – in 1995, Russia was Polaroid's second largest market, with nearly $200m in sales (a success attributed by some to reluctance on the part of the Russian man-in-the-street to hand over film to third parties to be developed – and perhaps to be inspected by the Russian authorities). In 1993, 54% of sales were in the USA; by 1995, this had fallen to 46%.

Despite the company's marked successes in overseas sales, the commercial story of Polaroid in the first half of the 1990s was stagnation or worse. The decline in profits was set out in the introductory overview. Other key data, taken back to 1986 for ease of comparison, are as follows:

Polaroid 1986–95 (current prices)

	Employees	Net Sales ($bn)	% Return on Stockholders' Equity	Shares Outstanding
1986	14,765	1.63	11.7	61.9m
1987	13,662	1.76	12.5	61.9m
1988	11,613	1.86	(2.2)	71.6m
1989	11,441	1.90	33.5	52.1m
1990	11,768	1.97	63.3	50.1m
1991	12,003	2.07	148.6	48.9m
1992	12,359	2.15	12.7	46.7m
1993	12,048	2.24	9.3	46.8m
1994	12,104	2.31	14.7	46.0m
1995	11,662	2.24	(17.8)	45.5m

Notes: The 149% return on stockholders' equity in 1991 reflects the settlement with Eastman Kodak. The number of shares outstanding for 1986 have been restated to reflect the 1987 two-for-one stock split.
Source: 1995 Annual Report

This was the background to the 1995-6 restructuring programme of which the first wave, launched in the first quarter of 1995, proved inadequate. Further job cuts followed late in the year. As in 1988, seven corporate officers were among those who went. There was also a freeze on pay during 1996 (with some flexibility for 'exceptional' performance-linked rises). The focus of the company was shifted from technical research to marketing, and it launched a new promotional effort to recoup its position in US markets. In 1995, too, Mr MacAllister Booth, the long-serving chairman, president and CEO, reached retirement age. His successor, Gary DiCamillo, formerly the number two at Black and Decker, brought with him a marketing background. The 1995 developments were summarised in Mr DiCamillo's first annual statement, published in the 1995 annual report:

> Combined with the February 1995 severance programme, the December 1995 restructuring will reduce our workforce by about 2,500 positions, or roughly 20 percent, and will reduce our expenses by more than $150m on an annualized basis. We expect to complete the plan by mid-1997 . . .

On the company's shift from technical to market orientation, he commented:

> We curtailed several major research and engineering programs, shifting more research dollars toward those projects with the greatest potential for commercialization. In so doing, we continue to maintain our strong research focus, but are concentrating resources on those projects that are closer to the commercialization stage.
>
> We are refocusing our high-resolution business for medical and graphic arts markets, and also our electronic imaging business so that their infrastructures are aligned more closely with their near-term revenue potential.

Whether all this will cost Polaroid its technical edge in the medium and long term, only time will tell. However, the first fruits of the change of tack were positive: the first quarter figures for 1996 included a 13% sales increase over the first quarter of 1995, including a 10% rise in flagging US retail sales of integral film. This was said to reflect 'the ongoing impact of the company's more aggressive promotional efforts'. International sales rose 9%, with a decline in Russia being offset by growth in other developing markets like China and Latin America. 'Western Europe saw improved sales of integral film both at dealer and retail levels'. Helios was going well, while the company's new graphics imaging business had sales orders 'in line with estimates'. Before allowance for restructuring, which cost $247m in 1995 and a further $110m in the first quarter of 1996, operating profit was $4.5m. This compared with an operating loss of $31.6m in the 1995 first quarter.

Trying to Change the Culture Advocates of employee ownership will weaken their case if they fail to recognise at least three key caveats. The first is almost a point of logic: that employee ownership is only one among an enormous range of variables which influence business performance. It follows that in any particular case its influence – for better performance or otherwise – may well be swamped by the influence of other variables. The results of employee ownership at Polaroid should be at least partly understood in that light. Proof is not possible in cases of this kind. But it is plausible to suppose the effects on the business of the problems associated with its new product development were such over the eight years down to mid-1996 as to swamp any benefits which could have flowed from its employee ownership during this period.

The second caveat surfaces in a number of other case studies in this book but can scarcely be too often reiterated. It is that the benefits of employee ownership do not materialise spontaneously, they have to be intensively worked for. Any expectation that, given a significant level of employee ownership, then continuous improvement will follow automatically, is certain to be confounded. There is a growing accumulated body of empirical evidence to that effect in the USA. The most reliable research study is probably one carried out in the 1980s for the Congress by the American Government's General Accounting Office (1987). This looked at the performance over a five-year period of a matched sample of companies with significant levels of employee ownership (EOBs) on the one hand, and their conventionally owned counterparts on the other. It

showed that by itself the effect of the employee ownership on the relative performance of the companies that had introduced significant amounts of it was zero, but that when associated with effective systems of non-financial participation and involvement by employees then the picture was very different. EOBs which also satisfied that second condition were shown to outperform both their conventionally-owned counterparts and their own pre-employee ownership performance. A combination of profit and employment growth were used to measure performance.

Top management at Polaroid probably became aware of this second caveat only rather gradually. That is not to charge them with having entertained a naive expectation that their ESOP would, of itself and automatically, deliver improvements in performance. But in the early days after the introduction of the ESOP in 1988, their priorities were doubtless somewhat different: with managing the restructuring exercise as smoothly as possible. But there was later a strong and public commitment by top management to the introduction of effective employee involvement systems. The programme around which the desired changes started to be introduced was called Total Quality Ownership (TQO). It was described in a letter to shareholders jointly written by Mr MacAllister Booth and Mr Sheldon Buckler, the board's vice-chairman, and published in the Annual Report of 1991:

> This initiative, involving all 11,000 Polaroid workers worldwide, coaches employees on how to increase the value of our products while reducing significantly the time between product design and delivery in the market place. The central principles of TQO are designed to bring employees closer to customers, to meet, then exceed, customer requirements, and to continually improve, innovate and participate *as owners* [emphasis added].

By mid-1992, according to a pamphlet called *Our Growing Ownership Culture:* 'More than 1,500 Polaroid employees, including most officers ... have gone through what is known as the Participation Workshop.'

Where continuous improvement is achieved at all, it takes place typically in the actual work places and work units where people engage in their productive activities. According to Owen Gaffney, there were some failures as well as some successes in its first couple of years. On a visit to Polaroid in December 1992 I was introduced to one group that had taken over real responsibility for seeing that they all pulled their weight. Measurable benefits had already started to appear. I was given to understand that it was not the only one.

Perhaps, too, the company achieved some improvements in performance from a series of organisational changes, in 1991 and then again in 1992 and 1995. Out of the 1991 reorganisation emerged three separate, semi-autonomous and customer-focused divisions; together with a fourth unit which had more of a support function. The three semi-autonomous divisions were focused on instant imaging products for family, for business, and for technical and scientific markets respectively. The fourth had responsibility across the whole field of electronic instant imaging products and development. Then, at the end of 1992, further changes were superimposed on this earlier re-organisation, with the aim of achieving still faster responses to developments in the market. A third stage came in 1995 when the division of responsibility between electronic products and all others had come to seem unhelpful: in particular those engaged in making film based products had an interest in preventing customers from making a switch to electronic imaging and vice versa. The new organisational breakdown introduced in 1995 was based on three core areas of focus – established business customers, the retail consumer, and new lines of business. According to Mr DiCamillo, each of these three new divisions '... has global operating responsibility for setting strategy, developing products, and marketing those products to its customers. Each will be accountable for its own sales, profits, and asset management.'

Each of this pair of new departures, the TQO programme and the successive changes of organisation, is very similar to what has been tried, since they became employee owned, at, for example, Republic Steel in the USA and the Baxi Partnership in the UK – and also in many conventionally-owned undertakings. The extent of their success is always hard to measure – quite apart from the fact that it may always be swamped by the consequences of more powerful variables. On the other hand it may well be, in the case of both this TQO programme and this series of reorganisations, that they have been successful in the sense and to the extent that performance would have been worse without them.

At the outset of this discussion about cultural change at Polaroid I made the general point that employee ownership advocates should

recognise three caveats. Having now dealt with the first two of these, we now move on to the third.

The third caveat may be put most simply by saying that, in businesses above a microscopic size, employee ownership probably needs a legitimised representative institution of one kind or another. The aspirations and potential of the rank and file employee owners are unlikely to be fully realised if their voice can only find expression through a combination of appeals to management on the one hand and speeches in general assemblies of employee shareholders on the other. The needed representative institution may take the form of a trade union, as it has frequently done in the American steel industry. But it does not have to take that form. Indeed there is one example in this case study series, though admittedly only in a subsidiary undertaking, of a union going into 'voluntary liquidation' following the successful introduction of employee ownership (a Tullis Russell Group subsidiary, Brittains). That experience may or may not tell us something about what is likely to happen when employee ownership is successfully introduced and the union chooses to ignore it. But then a company may have a long-established non-union representative institution: the paradigm example is the John Lewis Partnership.

It is true that the Polaroid board of directors always includes a Director selected from the rank and file of employees – a notable feature of the company even though such a director must by law represent all shareholders. The selection process starts with self-nomination and the finally successful appointee is selected by a committee of the board.

Nonetheless, it is probably not too much to say that problems relating to the need for a legitimised representative institution for rank and file employees have been an important source, possibly by themselves but probably alongside widespread management scepticism, of employee ownership difficulties at Polaroid. It seems probable, though this cannot of course be proved, that they have had an independently negative effect on any performance benefits which may or may not have been delivered for the company by its employee ownership.

A Legal Drama First, the background. To begin with and down to its dissolution by top management in August 1992, there existed at Polaroid – and had existed since anyone then working there could remember – an elected Employees Committee (EC). It was not a union, not even, as in the case of the Independent Steelworkers at Weirton, a single-company union. It was not a union because it was financed not by the rank and file employees who voted to elect its members, but by the company. It was summarily closed down by Polaroid's top management in August 1992 because a case, challenging its legality under America's New Deal trade union laws of the 1930s, was pending in the courts. Presumably management believed, rightly or wrongly, that the challenge might succeed.

The New Deal trade union legislation of the 1930s was embodied in the Wagner Act, named after the sometime mayor of New York. It aimed among other things at inhibiting the establishment by managements of sweetheart unions. The main provisions of the act include the denial of its protection to representative employee bodies which are financed by the company and at the same time have dealings with the management. The provisions of the act may also be breached when, as in the case of Polaroid's former EC, the top officers of the representative institution are elected not directly, by the rank-and-file employees, but by a pre-elected body of committee members.

The 1992 court challenge to the legitimacy of the EC was in fact launched by one of its own recently elected members, Charla Scivally, a secretary. After three years of employment with Polaroid, she had successfully stood for election to the committee in February 1992, on a platform calling for change. Apart from bringing the challenge which led to the EC's dissolution, Ms Scivally later showed notable energy organising a campaign aimed at achieving the recognition by Polaroid of an authentic and legitimate union. For that to happen the law requires a vote by not less than 30% of rank-and-file employees. In this case she needed 2,700 signatures. According to her own count she managed to muster 1,200.

Later Ms Scivally was dismissed by Polaroid. The alleged ground was that she had disclosed a confidential company document to a third party. She apparently had a different story. According to Polaroid, the National Labor Relations Board conducted an investigation but dismissed her 'unfair labor practice charge' against the company.

On the other hand, what seemed *possible*, at the time of writing in late 1997, was that, as it were by proxy, Ms Scivally had at least

an outside chance of winning another, quite different, challenge to Polaroid in the courts. This is a challenge to a new thirty-member body which was set up by the company some time after the dissolution of the EC, and on the basis of fairly extensive research and discussion. It is called the Employee Owners Influence Council (EOIC). Its constitutional arrangements were carefully designed, under the leadership of Ann Leibowitz, the company's in-house labour counsel at the time, to avoid falling foul of the provisions of the Wagner Act. The chances that they would survive the court challenge were presumably strengthened when America's House of Representatives passed new legislation in September 1995 aimed at protecting the right of employers to establish organisations for sounding out employee opinion along the lines of the EOIC. From the company's viewpoint, its key relevant characteristics are that it is a selected cross-sectional group of employees rather than an elected one, and that it will not negotiate with management. Rather, its members simply express their individual opinions and responses to questions.

But there is a danger in the opposite direction: of massaging the character of the new EOIC institution so far that it loses all legitimacy among large numbers of rank and file employees. Doubts about the likely perceived legitimacy of the EOIC were also expressed to me privately in Cambridge in December 1992 by Vin Tognarelli and Nick Pasquarosa, both then with management posts but both previously having held top positions in the EC.

In that same conversation with me in December 1992, Mr Tognarelli and Mr Pasquarosa were also critical of the Polaroid top management's insensitivity to the interests of rank-and-file employees. They cited specifically the way that the bonus paid out of the Kodak settlement had been split between management and non-management personnel. And they claimed that at least once in recent times managers had received bonus payments that had been linked to performance targets which had not been met.

Whatever the truth may be in any particular instance, it seems probable that the balance of public opinion among Polaroid's rank-and-file employees will have interpreted the dissolution of the EC and its replacement by the EOIC as going against their interests and against the spirit of employee ownership. On the other hand, the strength of that shift of opinion, assuming that there was one, should not be overstated. Otherwise Ms Scivally would surely have attracted more signatures in her campaign for union recognition.

The New CEO As for the views of the new chairman and chief executive, Mr DiCamillo, on Polaroid's employee share ownership, their balance was starting to become clear towards the end of 1997. On the one hand there is no doubt at all about his support for the second infusion of employee ownership decided on in 1997. On the other hand there is some doubt about whether his commitment to employee ownership it total. The importance he attaches to a new scheme of performance-linked cash profit sharing, announced in May 1996, and his apparent downgrading (at least relative to other aspects of management) of the priority given earlier to the TQO programme are good evidence of his conventional capitalist thinking. But then, with a few individual exceptions, it seems doubtful whether there was ever a strong commitment to employee ownership by Polaroid's top managers, similar to that of, say, Tullis Russell in the UK. Given that the majority of Polaroid's shares have remained in the ownership of outside non-employee shareholders, it is perhaps inescapable that the level of commitment of its managers should be less.

None of which means that the ESOP at Polaroid has been a failure. And that is true even if it is also true that the company's then shareholders would have been financially better off if Shamrock had won the takeover battle in 1988/89 and they had walked away in early 1989 with a price of $42.50 a share. The point is that the value of a company to its employees, and to the national and local economy, may be very different from its immediate money value to absentee shareholders.

Moreover, from the employees' viewpoint it seems reasonable to claim that the employee ownership has been a success at least in the weak sense that in its absence their experience might well have been worse. In relation to Polaroid's second major restructuring exercise launched at the end of 1995, this point was put with force by Mr Ralph Norwood, vice president and treasurer, in a conversation with Mary Campbell in May 1996:

> In the USA, some 2,000 people have been involved in job losses. Numbers have gone down from 8,000 to 6,000. We have done that overwhelmingly on a voluntary basis, and with minimum disruption in terms of angry people. Without an ESOP people could say, you're doing that just for the interests of absentee shareholders . . . wealthy New York people .

Who knows? In Margaret Thatcher's splendid phrase it's a rum old world'. Who would have guessed that there would be sufficient rank-and-file support in 1997 behind a second infusion of employee ownership for management to introduce a new scheme? And who would have guessed the apparent reason behind it: a recognition of the value of forced saving?

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Allied Plywood: A Paradigm Case of a 'Neat Exit'

OPENING SNAPSHOT: JONAH AND ED SANDERS, THE FORMER OWNER

'How many houses have you got now, Jonah?'

'Well, there you are, Mr Sanders, it is still just the two.'

'And how many motor cars, Jonah?'

'Two again, Mr Sanders, yeah, just the two again.'

'And what's your ESOP account standing on, after the latest valuation, Jonah?'

''Bout $80,000 if I remember rightly, Mr Sanders. But then there's still a good few years before I reach fifty-nine and a half; and as you know there would be all that tax on the final sum if I were to cash him in before that. By then, most likely the 'count will be well into six figures.'

Jonah was not a high-flying executive in a financial services company, who benefited from a subsidised house mortgage, a company car, and a top management share option scheme. He was middle-aged and semi-skilled. At Allied Plywood Corporation's main warehouse in Alexandria, Virginia, just south of the Potomac River from Washington DC, he sometimes drove a forklift truck. Sometimes he was 'on deliveries'. And sometimes he did other jobs again.

I was lucky enough, early in 1988, to listen to that exchange between Jonah and Mr Ed Sanders, the former joint owner of Allied Plywood, a wholesale distributor of plywood and other building materials. Using an ESOP, and over a period of years starting in 1977, the business was sold to its workforce by Mr Sanders and his wife Phyllis, who had together built it up in the first place. They retired in 1982.

INTRODUCTORY OVERVIEW

When the ESOP was first introduced, Allied Plywood operated from the one Alexandria site and employed twenty people. Fifteen years later it had seven sites as far apart as Maryland, Georgia and South Carolina and employed 124. During the ten years to 1991 its turnover increased by nearly five times: from $6.2m in 1982 to $30.2m in 1992. By 1996 turnover had doubled again, employment was 180 and it operated from fourteen sites in five states.

So Allied Plywood has been a notable success; and part of the point of this case study is to illustrate the way that an employee-owned company can adjust itself to growth without losing the identification of interest between the individual employee and the whole. For readers in countries like Britain and France, it is also interesting for the reason I have given in the heading: as a 'Paradigm Case of a "Neat Exit"' – or '*une belle sortie*'. This French phrase was first used to me by a young Frenchman who had taken over as Président Directeur Général when the business he worked for in France was sold to its employees by its former *patron*. They had formed a co-op to buy it. (For the English translation, I am indebted to a headline in the *Financial Times*.)

Since the American ESOP legislation was introduced in the early 1970s, or more precisely since the 1980s when rollover relief was granted to those who sold to an ESOP trust, there have been hundreds of these 'neat exit' transactions. Ed and Phyllis Sanders sold without the benefit of rollover relief which was enacted only later. In fact the relevant provisions of the subsequent law became known as the 'Sanders amendment' because their example was used to persuade the Senate to be more generous in its encouragement of similar deals. Perhaps the single most important success of employee ownership advocates in Britain came in March 1994 when, with the removal of two previously crippling restrictions, the relevant UK rollover relief provisions became as good as or better than those in the USA.

Allied Plywood is also interesting for two further reasons. The first is that it operates, and has done for decades, the most spectacular scheme of profit-related pay that I have ever come across. It may be argued that this is irrelevant because the scheme predates majority employee ownership. But that is to miss the key point – the congruence between the two.

The case of Allied Plywood also highlights two alternative approaches to the valuation of shares in non-quoted and majority employee-owned businesses: the difference between a net asset based approach and one which calculates value mainly on the basis of market place data.

THE BUSINESS RECORD

From the Beginnings in Akron, Ohio, to the Retirement of Mr and Mrs Sanders in 1982 Allied Plywood was incorporated in Akron, Ohio, in August 1951. That area of Ohio, also the home ground of Republic Engineered Steels, is classically part of what has been called America's 'rust belt'. Even in the faraway 1950s, when times were still good for industries like steel, the local economy was not all that buoyant. After four years of uphill, even if just profitable, struggle, Mr Sanders came across a study which ranked different American districts by their current and forecast levels of building activity. Akron came close to the bottom; the neighbourhood of Washington DC, and especially its southward spillover into Virginia, came close to the top. With true American spirit Mr and Mrs Sanders upped sticks and moved to Alexandria. That was in 1956. They rented some warehouse space and started by employing no one except themselves. Later they hired one other person.

In its new home, the business began to prosper. Eventually the Sanders built their own warehouse and associated offices and moved out of the earlier rented premises. The workforce too started to expand – posing the challenge of employee motivation. The Sanderses' solution was essentially the radical scheme of profit-related pay which I describe later.

The first Allied ESOP, introduced in 1977, was a non-leveraged one. Mr and Mrs Sanders, who have no children, were beginning to think about what would happen to the business when the time came for them to retire. A part of Allied's profits was passed each year to the ESOP's trust; and the trustees used that money to buy Sanders' shares. A block of shares, about 12% of the equity, was also sold to Mr Robert Shaw, the man who became chief executive when Ed Sanders retired in 1982.

As a result of these sales, the Sanderses' shareholding was already, in 1981, below 50% of Allied's equity. In that year the ESOP trust was the largest single shareholder, with just five shares short of 50% of the issued total or 2,090 out of 4,190. Then, in 1982, to

coincide with the Sanderses' retirement, the ESOP trustees took a bank loan, and used the money to buy out the balance of the Sanderses' shares.

The year 1982 was one of sharp recession in the US economy. For the first time since Mr and Mrs Sanders moved to Alexandria, Allied's total sales fell below what they had been the year before. We get a more balanced picture of their achievement in the building up of the business if we take the statistics for 1981. Sales in that year came to \$7.8m and the net asset value of the business was \$1.3m. It was on the basis of that asset valuation that the remaining Sanders shares were bought out. However we should notice that the Alexandria warehouse and office accommodation were not included either in the net assets valuation or in the sale and purchase agreement by which Mr and Mrs Sanders were bought out.

Majority Employee Ownership 1981 to 1995 Total sales increased nearly tenfold between 1982 and 1995 and the workforce over seven times:

Allied Plywood: Sales and Employment 1982 to 1995

Year	Sales \$m	Employment
81/82	6.2	22
82/83	9.9	28
83/84	12.0	31
84/85	16.1	35
85/86	21.1	50
86/87	25.5	65
87/88	30.9	82
88/89	35.2	91
89/90	32.6	88
90/91	30.4	113
91/92	64.3*	124
92/93	45.8	132
93/94	56.3	149
94/95	58.7	166

* Includes a company which was bought and then resold

Note: Years are to end-September

We will leave on one side the effects of the recession between 1989 and 1991 and the impressive rebound since then. The first eight years of majority employee ownership saw sustained growth. Total sales increased by more than five times between 1981/2 and 1988/9. 1981/2 was a year of recession, but still using 1980/1, when sales were $7.8m, as a base year there is a more than fourfold increase in dollar sales between that year and 1988/9. Even after allowing for inflation, which was some 50% between 1980 and 1989, sales increased nearly three times between those same dates. It is a record of which a conventional capitalist business would be proud.

What drove the expansion of Allied in those years, as again from 1991, was acquisition, mainly of new warehouses and sales outlets. But in one case a small hardwood manufacturing operation, Austin Hardwoods in Lorton, Virginia, which had previously been a supplier, was also acquired. The major early phase of acquisitions was between 1985 and 1988. Apart from Austin Hardwoods, Allied acquired new warehouses and sales outlets in places as far apart as Atlanta, Georgia, and Frederick, Maryland. In 1996 the company's fourteen sites were in Virginia, Maryland, Georgia, North Carolina, and Tennessee. Though it does not sell direct to retail customers, the products filling its sales outlets were spread over six states: they ranged from kitchen units (including laminated worktops which it manufactures itself) through to 'lap siding' (with or without plasticised coating) – the wooden boards used horizontally as the cladding on the outside walls in so many homes in the USA.

A policy of growth by acquisition became possible in the middle 1980s partly because by that time, ahead of schedule, the money borrowed to buy out the final Sanders shareholding had been completely paid off. Another positive factor, which has continued, was Allied's strong cash flow. Given that acquisitions were thus possible, market opportunities determined whether they were actually made. For example, it seems to have been a special market opportunity which explains the decision to acquire a substantial new warehouse and sales outlet in Charlotte, North Carolina. That happened in 1991, as the US economy started to pull itself out of recession.

The architects of this policy of growth by acquisition were the two members of the team which took over from Ed Sanders in 1982: Mr Robert Shaw as chief executive and Mr Gene Scales as secretary/treasurer. In the early days of the expansion, Mr Shaw is

emphatic that the objective of expansion was not set in advance. However, looking back in 1996, he commented that the policy would have been unavoidable if success was to continue because the big suppliers have increasingly required their distributors to cover a lot of ground. Allied's suppliers include companies like Georgia Pacific Lumber Company, Weyerhaeuser, Boise Cascade and, for hardwood, Columbia Products. 'If you can't deliver multiple markets, they're not interested,' says Robert Shaw. For this reason alone, Allied's expansion in future is also likely to be geographical, and especially in the southern states. Vertical integration, say into more manufacture, is not on its current agenda.

Allied has also enjoyed the confidence which has come from its success in operating its own particular version of employee ownership, including its profit-related pay scheme. This success has encouraged a belief that if the Allied formula is applied to the businesses which it acquires, their performance will improve. However, while Allied has retained the original principles of its employee-ownership and profit-related pay, expansion has meant changes in the way these are implemented.

Profit-Related Pay Allied introduced its radical scheme of profit-related pay (PRP) in response to the challenge of getting a growing workforce motivated. Its two eyecatching features are a basic wage somewhat below market rates coupled with an equal share of 30% of operating profits, paid monthly in arrears. It seems designed to promote not only individual employee motivation but also solidarity within the workforce, including solidarity between management and blue collar workers.

The most important condition for the acceptability of this trade off to the blue collar employees whom it was chiefly designed to motivate was higher levels of monthly financial rewards than would be available under the conventional alternative of a market-determined rate of pay, and/or one negotiated by a union. Except for special cases (e.g. for staff in newly opened branches) the scheme yielded more than market rates in all but about half a dozen months between when it was first introduced in the mid-1960s and the late 1990s – more than thirty years later.

Still, the outcome of such a trade off cannot be known for certain in advance. So there remains an obvious problem of how to introduce so radical a scheme in the first place. Ed Sanders's solution was to make it initially voluntary. Those employed by Allied when the scheme was first introduced were given the choice: to soldier on with their existing rates of pay; or to accept a cut of what was apparently some 20%, in return for that 30% equal profit share. Eventually, nearly all those employed at the time the scheme was introduced decided to switch into it. After 1977, when ownership of Allied started to move to the ESOP, all those who participated in the ESOP arrangements were required to accept the radical scheme of PRP. On the other hand, new recruits normally have to wait up to twelve months before they become ESOP participants. During that period they are paid conventionally at prevailing market rates.

The motivational impact of the scheme is backed by up-to-the-minute reporting of the score. Performance, measured by financial results, is recorded daily as it happens. There is an announcement each month to mark the achievement of the break even point. Thereafter profits are continuously reported as they occur, in units of $500 'goals'. Since every one in the scheme qualifies for an equal share in 30% of these, i.e. an equal share in $150, he or she needed only to know the total numbers in the scheme to calculate his or her share.

There is more to the PRP scheme at Allied than this equal monthly share. There is also an annual cash profit distribution, going back all the way to the far-off beginnings of the business in Akron, Ohio. But unlike its monthly counterpart, this annual distribution does not go in equal parts to participants. It takes place on the basis of a weighted points system. The number of days worked during the year, the importance of the job, and the employee's length of service have the main weight in determining the points score. But so also does an assessment which each employee is given by his or her peers: a rule which extends to the company's president, Mr Robert Shaw, whose performance is assessed by the other members of the top management team.

There have been specially good years when, taken together, the monthly and year-end cash bonus has exceeded annual basic pay. And that, of course, is not counting the value of shares allocated to employees under the ESOP. In more typical years the two bonuses together have comfortably exceeded 50% of basic pay. For example, in both 1988 and 1989 they amounted to 58% and were still equivalent to 40% in the recession year of 1990. Later, increasing market-place uncertainty brought into question the proportion of profits distributed; but aggregate bonuses in 1995 were still big.

From the early 1990s onwards, issues arising from the company's expansion have caused the profit-sharing system to be somewhat changed. As the company expanded, the relationship between the individual's productivity and the company's profitability was at risk of being diluted. The central problem was that different branches made different levels of profit. The monthly profit share received by each employee was changed to become based on the profits of the particular site where the employee works. Moreover, central administrative staff who serve all the branches ceased to get monthly profit shares: instead, their share of the 30% of profit is paid to them quarterly in arrears and based on the overall performance of all the branches over this longer period.

As the company expanded, it also took on board some other characteristics of more traditional capitalist undertakings. For example, healthcare insurance became part of the standard remuneration package. On the other hand, Allied's pension arrangements remained similar to most majority ESOP companies in the USA. Only in the final years before retirement may an employee-owner shift his or her ESOP nest-egg outside Allied into other investments, and at no stage can they be converted into cash without a swingeing loss of tax advantages.

In one notable respect the company has resisted the luxury often associated with growth and success. Once the head office could no longer be on the same site as one of the branches without risking charges of favouritism from the others, it was moved into a six-room condominium in a cul-de-sac. The latter is so obscure that even local taxi drivers do not know where it is.

Two key characteristics of capitalist owners are their attention to profits and the closeness of the link between those profits and their personal rewards. There are examples of profit-related pay in all or almost all of the case studies brought together in this book. That at Allied Plywood stands out as the one which most closely ties the fortunes of the individual to those of the firm.

The ESOP, the Shares and their Valuation Already, well before the introduction of the ESOP, and before they even knew about the existence of ESOPs, Mr and Mrs Sanders had become concerned about how to turn their shares in Allied into cash to provide a capital sum for their retirement. The question was how and to whom should the business be sold. Explaining what was eventually decided, Ed Sanders is fond of saying that he and his wife felt that, at the very least, the workers should have the 'first crack' at buying it, because they, after all, 'had made it grow'. When pressed, Ed Sanders does not deny that he and his wife might well have got a higher price by selling to a third party. His reasons for favouring a sale to the workforce were 'a sense of fairness and gratitude'.

As a way of starting down that road, before he had any knowledge of ESOPs, Mr Sanders sold a few shares to some employees at book values in the early 1970s. These included Robert Shaw and Gene Scales. But it soon became clear that individual employees did not have the personal savings or access to credit to buy out the Sanderses' shareholding.

Not to be easily frustrated, Mr Sanders next explored a rather different possibility: that Allied Plywood should itself start to buy his shareholding at its book value. There would have been nothing remotely illegal or improper about such a transaction. It might have been an American counterpart to the main ownership transfer transaction at what became the Baxi Partnership in Britain. But, though it would not have been illegal, Mr and Mrs Sanders soon discovered that it would have had seriously adverse consequences for their personal tax liability. It was established that America's Internal Revenue Service would treat the proceeds of such a sale as a 'distribution', meaning that first corporate and then personal income tax would be payable.

When Mr and Mrs Sanders became aware of the possibilities opened up by America's ESOP legislation, they quickly recognised that it offered a solution: and one which, if not ideal from a tax view point, was practicable and at least just acceptable. So a simple ESOP was introduced at Allied Plywood. It was simple in the technical sense that it was not 'leveraged' (i.e. not associated with any borrowing).

When this ESOP was introduced in 1977, the Sanderses' shareholding amounted to 83% of Allied Plywood's equity. In each of the next five years, taking advantage of the then available tax reliefs, a percentage of the company's pre-tax profits was passed to the ESOP's trustees. It was next applied to buy shares from Mr and Mrs Sanders at net book values. As a result, the Sanderses' shareholding had fallen to 36.5% of the equity by 1981. By the same year the ESOP's shareholding had reached just below 50% of the total.

After the Sanderses retired in 1982 the ESOP borrowed the money necessary to buy out the balance of their shareholding, again on the basis of net asset values. They had now achieved their twin objectives of turning their ownership of Allied Plywood into cash and turning the employees of the business into its new owners. The sale proceeds did *not* enjoy the important tax advantage which is called rollover relief on both sides of the Atlantic. If they had chosen to sell to a quoted third party, by what is technically known as a 'merger' or an 'exchange of stock', the proceeds of the sale would have qualified for rollover relief: no capital gains tax would have been payable unless and until the shares acquired in the initial transaction were themselves sold.

The loans taken out to buy the shares had been fully paid off, ahead of schedule, by the end of 1985. Up to that point the numbers of Allied Plywood shares in issue remained essentially unchanged. The annual contribution to the ESOP was made in cash so as to pay off those loans. The result was not the issuing of new shares; but a shift of existing ones – out of what amounted to an ESOP suspense account, and into the accounts of individual Allied employees.

On the other hand, once the repayment of the loans was completed, that changed. From then on, the annual contribution to the ESOP was largely made by issuing new shares with the obvious advantage of freeing up financial resources for investment. Cash was provided to meet the liability to buy back the shares of those employees who left Allied on reaching the retirement age of fifty-nine years and a half. But, given the age structure of the workforce during this period those numbers were small. Consequently, the number of Allied's issued shares more than doubled between 1981 and 1989 and then nearly doubled again in the subsequent six years.

Issued Shares & Ownership Breakdown

	1981	1989	1995
Mr and Mrs Sanders	1,528	–	–
Robert Shaw	520	456	230
Gene Scales	4	4	4
Others	48	30	30
ESOP	2,090	8,742	17,240
Total	4,190	9,232	17,504

For a better understanding of how the employee shareholdings evolved at Allied after the Sanderses' retirement, we need two further sets of statistics – the total value of the stockholders' equity and the the value of the shares:

Allied Plywood: Stockholders' Equity & Share Values

	Stockholders' Equity $m	Share Values $
1981	1.3	313
1982	0.9	241
1983	1.2	298
1984	1.6	369
1985	1.9	400
1986	2.3	403
1987	2.8	416
1988	3.3	414
1989*	3.9	417
1990	4.1	278
1991	4.3	224
1992	4.8	351
1993	5.7	463
1994	6.5	496
1995	7.4	503

*Professional evaluation from 1989 onwards

A few general points can be made about these rather striking statistics. To begin with, we may notice that the nominal value of the business's stockholders' equity, what in Britain would perhaps more normally be called its net asset value, increased between five and six times in the fourteen years from 1981 to 1995. Allowing for inflation, we can say that its value more than trebled. On the other hand, over the same period of a dozen years the nominal value of Allied's shares increased much more modestly: by about 60%. If we allow for inflation in this second case, the share values hardly increased at all.

What explains the very different movement? An important part of the answer is apparent from the earlier table, showing that numbers of issued shares more than quadrupled – from 4,190 to over 17,000 – between 1981 and 1995. Another was a change in 1987 in the official rules which govern the annual valuation of ESOP businesses in the USA. We shall come to that in a moment.

As can be seen from the table, both net asset value and the share price fell sharply in 1982, the year of the Sanderses' retirement, from $1.3m to $0.9m and from $313 to $241 respectively. These falls were essentially happenings in the world of accountancy rather than in that of real business experience. They reflect the sale of the outstanding balance of the Sanderses' shares to the ESOP, and the fact that since the borrowings associated with that transaction had not then started to be paid off, an appropriate debit was required by the accountants to figure in the balance sheet.

That is perhaps a specialist's point. Of more general interest and importance is the logic and the mechanics of the ESOP at Allied. Because new shares are continually issued annually to the ESOP and thus indirectly to the individual accounts of each person employed there, the employee ownership does not apply only to those who happened to be working at Allied at the time of the Sanderses' retirement, nor, for example, does it apply only to the people who worked there during the period of the repayment of the loans which made possible the final stages of the buy-out. On the contrary, this employee ownership in principle applies to future as well as current members of the workforce. It is solidaristic, one might say, as between successive incoming cohorts to the workforce; and has been designed, again at least in principle, to continue in this way indefinitely.

We should recall the difference in the source of ESOP shares allocated to Allied's employees as between what happened when the Sanderses' shareholding was being bought out, and what happened after the transaction had been finished. In the earlier phase it was the Sanderses' shares which were allocated to Allied's employee shareholders. Thereafter the allocation came mainly from newly issued shares.

The mechanics of issuing these new shares may be seen as a two-step 'loop' process. At the end of its financial year the company makes a cash contribution to the ESOP. The contribution is made out of pre-tax profits though limited to a maximum of 25% of the company's payroll. That cash contribution is step one. Step two is the purchase of newly issued shares from the company by the ESOP, using the money contributed by the company to it. All the money so used to make the purchase, which is not subject to tax, then goes to increase the stockholders' equity or net asset value of the business and is available for investment.

A by-product of this distribution system is that taxable profits are kept low. As in some other employee-owned companies cited in this book – the Carl-Zeiss-Stiftung for example – the key indicator watched by management is not so much profits as cash flow. After their share of operating profits had been distributed to employees, and 25% of the payroll had been given to the ESOP to buy shares, the results for 1988 actually showed small losses. But the main point is that for all or almost all of its history, Allied's taxable profits have traditonally been little more than negligible, both in actual numbers and in comparison to cash flow.

What about the value of the company? How is that arrived at? Before the Congress enacted a change in the relevant regulations in 1987, it was open to the managers of Allied, as to those of other private ESOP companies in the USA, to make their own valuation. After the 1987 change, which came into force in 1988, an independent valuation was required to be done by a firm of valuation specialists.

This change of responsibility for the valuation work was accompanied at Allied Plywood by a change of valuation method. Allied's own managers had made their valuation on the basis of the 'stockholders' equity' or net asset value in the annual balance sheet. They had taken the dollar number of the stockholders' equity as the dollar value of the business. The approach adopted by the external and independent valuers is more complex. It takes into account not only data about Allied, but also data about other supposedly comparable undertakings.

For the years down to 1987, when Allied's management was responsible for the valuation, the results of its net asset value approach come forward quite straightforwardly in the record. (The increase in share value was less than the increase in value of the business because new shares were issued each year – priced at the value of the year before.) Moreover, to ensure the maximum tax benefit, Allied's management sought to maximise the annual contribution from the business to the ESOP up to the legal limit of 25% of the payroll. This policy of issuing new shares had the further important result that new shares were available to newcomers who joined the scheme.

It is true that the policies of issuing new shares and of maximising the company's annual contribution to the ESOP continued to be applied, notwithstanding the new valuation rules and procedures, after 1988. On the other hand we can see from the table that for the five years 1988 to 1992 there is no longer an invariable identity of direction between the movement of Allied's 'stockholders' equity', or net asset value, and the movement in the value of its shares. The former continues the upward movement which dates back to 1982. The latter goes down as well as up. There is a notable drop between 1989 and 1990.

We know that Allied's 1990 valuation was significantly based – to the extent of 50% – on data about comparable businesses over the previous twelve months. The sharp fall in the value of Allied's shares in that year is explained to a large extent by the fact that the performance of the businesses with which it was being compared was worse, during the then prevailing conditions of recession, than its own. It is not altogether surprising that managers and non-managers at Allied Plywood have expressed dissatisfaction, and indeed more than that, over the imposed change in the valuation approach. Ed Sanders's comment on the 1990 valuation exercise was:

> To me the [evaluation] report is a good example of how the damn lawyers take you on a trip to a Never Never Land of pure guess work. Allied Plywood does what it does and who should care about competitors or the rest of the world if the stock is not publicly traded. I got dizzy reading it. All I could think about was the cost of making these 'evaluations'.

Ed Sanders's criticisms are cogent and persuasive. On the other hand it is clear that at the time of the change there was a widespread belief that the old system gave too much latitude to management and was subject to quite serious abuse. It is impossible to make an informed judgement on the extent to which these criticisms were justified. But there were certainly influential voices outside as well as inside the Congress which called for change and especially for the change to independent valuation. Among those voices was the United Steelworkers of America.

Ed Sanders himself acknowledges that there is a problem – which has grown significantly since the early 1980s: companies and their lawyers constantly find loopholes in the ESOP legislation, which just as constantly attract Congressional action to stop them up. According to Allied, this means there is a lot of work just keeping up with legislative and regulatory change. Companies' ESOP plans may now have to be rewritten every couple of years: Robert Shaw bemoans the increasing costs of running an ESOP – now $10,000 or $15,000 a year. Some of those who have long been involved with the company question whether the ESOP could have been set up at all if costs in 1977–82 had been as high as they are now – and whether any small company can any longer afford to establish an ESOP.

Fundamental as these points may be to the future growth of the US ESOP movement, they are something of a digression in the context of Allied Plywood. It remains for us to track the effect of the change in the valuation rules from the point of view of a sample employee. Let us take as our example the value of Jonah's shareholding – the Jonah we met in the opening snapshot and whose ESOP shareholding was then (in 1987) valued at about $80,000. From the table we can see that the share value in that year was near its peak, at $416. So in round numbers we can see that in that year Jonah held 190 shares. Five years later, as a result of annual allocations of new ESOP shares, there were a total of 367 shares in his account. At the provisional 1992 valuation of $351, Jonah's parcel of ESOP shares was then therefore worth between $125,000 and $130,000. However, my calculations suggest that in the previous year the value of his shareholding was significantly below what it had been in 1987. Of course he had more shares in 1991 – approximately 300 shares. But the increase in the number of shares which he held was insufficient to offset the reduction in the price: from $416 in 1987 to $224 in 1991. His shareholding which had been worth $80,000 in 1987 was thus probably not worth much more than $67,000 in 1991. Had Jonah's retirement fallen in that year and had he therefore been obliged to turn his shareholding into cash on the basis of the 1991 valuation, he might reasonably have felt that the change of approach by the new outside valuers had worked unfairly to his disadvantage. Under the then rules of the Allied Plywood ESOP, a retiring employee was immediately paid out on his shares in cash. Because of the zigzag pattern of valuations in the early 1990s, the Board of Trustees allowed employees the option to phase their withdrawals from the ESOP over five years.

Any change in the valuation rules is bound to disturb past patterns and may to that extent cause temporary unfairness. But Ed Sanders' criticism is different. He is challenging the entire logic of a large part of the independent valuers' work and arguing that data

about what has been happening to the valuations of comparable and competitor companies is simply not relevant in the case of a near 100% ESOP-owned business, none of whose shares are traded on a stock market.

It seems to me that so long as those two conditions apply, Ed Sanders's criticisms have undoubted force. In cases where those conditions apply it seems to me that annual share valuations should aim to meet just four criteria. First, they must be affordable, in the longer as well as the short term. That is to say that the valuation must be such that, on any reasonable assumptions of what the future is going to hold, the ESOP-owned business should be able to meet its buy-back liabilities. Second, though there is clearly some overlap between this and my first point, the valuation should be fair both to the employee shareholders who are leaving and to those who are staying on. Third, so far as possible, the valuation formula should include some link with profits, or in this particular case with cash flow, as a way of sharpening employee motivation. And fourth, the valuation approach should aim to reduce and smooth over the sharper fluctuations of stock market prices.

This is not the place to defend these proposals in any detail. But for what it's worth they would meet Ed Sanders's criticism of the new outside valuers' approach because the criteria they involve are essentially internal to the business. Moreover if fluctuations can be somewhat smoothed out, that would go some way to avoiding the 'unfairness' with which Jonah might have claimed to have been treated if he had retired in 1991.

But my own and Ed Sanders's criticisms should not be misunderstood. Neither of us would want, for a moment, to be associated with those who wring their hands at any suggestion that blue collar workers should ever be exposed to risk. On the contrary, one of the most important single lessons of Allied is that the degree of its financial success has been closely linked to the readiness of its workforce, blue collar as well as other, to take risks. Let us remember too that Jonah's ESOP shareholding is something which his counterpart in a conventional capitalist business simply does not have. Even in what the Americans call a 'worst case scenario', in which the value of Jonah's ESOP shareholding fell to zero, he would still be no worse off than his counterpart in a conventional capitalist business. In fact he would probably still be better off: for he would still enjoy what appear to be benefits which have resulted from his participation in Allied's radical scheme of profit related pay: his second house, for example.

To me the main conclusion from Allied Plywood's experience is that if we want improved business performance then we need to move away from both conventional systems of capitalist ownership and conventional systems of wage payment: no more than that, but equally no less.

Ownership and Control Finally, I need to say a brief word about how the ESOP ownership at Allied Plywood is reflected in its system of control. To begin with, under a combination of a company's own by-laws and the rules of its ESOP, the business is controlled, for the purposes of all normal decisions, by a five-member board of directors. Moreover, this board of directors doubles up as the trustees of Allied Plywood's ESOP and so, given that it is empowered to vote the ESOP shares in all but defined exceptional cases, it determines all normal issues of business policy. The composition of these two-in-one boards – of directors and trustees – is essentially paritarian. There is equal representation of shop floor and management; and there is an agreed independent to hold the balance between those two groups. Since the retirement of Mr Sanders in 1982, the two management representatives on these boards have been Mr Robert Shaw and Mr Gene Scales. There have been periodic changes in the identity of the board members elected by the shopfloor. There is also a management advisory committee which meets from time to time. Taking these various arrangements together, it seems reasonable to claim that the employees have a real voice, as well as far and away the largest financial stake, in the business.

In practice, on the other hand, it is probable that even the big decisions have been in effect taken by the management: because those lower down the company have been more satisfied than dissatisfied with the way the company is being run.

27
Co-operative Home Care Associates

INTRODUCTORY OVERVIEW

The emancipation of women and co-operative production are, I fully believe, the two great changes which will regenerate society. *John Stuart Mill*

After several months of successful employment, each individual has the option of becoming a worker-owner in her enterprise. Currently over 250 home health aides have chosen to become owners within their co-operative – receiving a yearly dividend and voting to elect their board of directors. *Peggy Powell, Home Care Associates Training Institute, The Bronx, New York*

Co-operative Home Care Associates (CHCA) supplies care to mainly elderly clients in the south Bronx and north Harlem neighbourhood of New York City. By mid-1996 it had completed its ninth successive year of profitable operations, and the eleventh year of its remarkable life. Including management and other support staff, it employed over 300 people. Its annual sales were around £6m.

In other words CHCA was established as a business success. But in at least two other important respects, it is notably different from the other successful businesses which appear in these pages. First, its direct labour force of home care aides, or health service 'paraprofessionals' as they tend to be called in CHCA, is overwhelmingly female, and very largely black and Hispanic. Second, they can be classified as belonging to the 'working poor'. In his writing about co-operative production John Stuart Mill frequently used the phrase 'associations of labourers': it is not fanciful to suppose the working poor is what he had in mind. Probably he saw co-operative production as offering special benefits to non-management employees. Where the latter are predominately women, as at CHCA, then, on the basis of the belief expressed by Mill, we may anticipate a double 'regeneration'.

CHCA's achievements have not come easily. Quite the contrary. In its first two years, it ran up big losses. During that period the top management position was held by three people who each failed in turn. More than once its backers were within an ace of pulling the plug. Moreover, there were major struggles even after the business had started to show a profit during its third year: for example, a struggle to persuade the relevant New York authorities to increase what they pay for work of this kind.

Still, the figures in the table leave no doubt about the fact of success:

CHCA 1985–1995 Key Statistics

Year*	Care Staff Nos	Sales $m	profit/Loss $000
1985	60	0.2	(187)
1986	116	0.6	(78)
1987	125	1.5	98
1988	160	2.0	95
1989	160	2.3	236
1990	200	2.7	170
1991	250	3.5	102
1992	260	4.1	128
1993	295	4.7	155
1994	303	5.7	208
1995	291	5.9	154
1996	320	5.9	139
1997†	380	6.5	180

* Years are to 30 September up to 1989; calendar years thereafter. There were separate accounts for the three months October/December 1989.
† Estimated

To make a fine judgement of CHCA's performance on the basis of these crude statistics would be a mistake. There have been considerable subsidies from charitable sources. By 1996 CHCA's notable enrolment training and education programmes had been separated from the main business and were charitably funded. On the other side the management has achieved at least some success in persuading the New York public authorities to increase the rates it pays for care work in people's homes. CHCA may have had help from various sources but conversely it has secured benefits which have spread out across the community.

Even with those qualifications the crude statistical record is impressive, considering that this was a new start-up undertaking. In fact the authors of a 1992 study claim that CHCA has the best growth performance of any new start-up American employee-owned business ever (Dawson and Kreiner 1992).

The still sceptical reader may be offered two independent pieces of evidence of success. The first is the continuing support of New York's Visiting Nursing Service (VNS). VNS is well known among the agencies which put out care work contracts in New York on two related grounds. It values quality of service and is prepared to pay slightly higher rates for it. VNS has in fact awarded contracts to CHCA since 1987. Towards the end of 1991, impressed by the quality of CHCA's work, it offered a substantially increased contract. By 1996 the Detroit equivalent of New York's VNS was considering setting up a joint operation with a local clone of CHCA.

The plan for a Mid-West cloning followed replications of CHCA in Philadelphia in February 1993 and in Boston the subsequent year – the second piece of independent evidence of CHCA's success. Each of these is now profitable. Two prominent American charities, the Mott and the Ford Foundations, had made available the finance necessary for this replication programme.

Thus, since 1987 the management team at CHCA headed by Rick Surpin has built a successful employee-owned business and provided jobs for many who at first glance might be classified as rather unpromising human material. Moreover, they have built a business, it seems to me, which has gradually begun to attract the loyalty of most of its home care staff, of whom a substantial majority are now its co-owners. It offers real opportunities to do worthwhile jobs and to enjoy feelings of self-respect when doing them. The statistical evidence for these assertions is to be found in the high proportion of the home care staff who are now paid-up employee owners, or are in the process of so becoming, for the not insignificant sum of $1,000 a head. It can also be seen in its low level of employee turnover – about 20% in 1995. This is understood to compare with an industry average of 30% to 40%. Those lucky enough to visit the business in the South Bronx are aware that CHCA's success is more than just statistical.

ORIGIN AND START UP

Because of a combination of generally higher costs in institutions and the ageing of populations, public authorities have long been looking to switch the delivery of health and care services from hospitals and nursing homes into clients' own homes. In New York State this trend had perhaps gone further by the mid-1980s than elsewhere in the USA. The state's nursing homes were the subject of a major scandal in the 1970s, with widespread convictions of nursing home owners for fraud. As a result the authorities put a moratorium on new nursing home construction. A minority of far-sighted local doctors had also been speaking up for many years about the benefits to patients of home care – as long ago as the late 1940s Dr E. M. Bluestone at the Montefiore Hospital in the Bronx had argued that patients should be treated in hospital only in situations of defined and exceptional emergency. It was with this same Montefiore Hospital that CHCA negotiated its first contract. That may be no more than a coincidence but the views of Dr Bluestone serve to remind us that there are medical as well as cost arguments for switching patients' care to their homes.

To supervise this home care, hospitals like Montefiore have built up major departments. The work itself is contracted out to the private sector. The supervising departments are known as the hospitals' certified home health agencies. When CHCA signed its first contract, it was with the Montefiore Hospital's certified home health agency rather than with the hospital itself. The public money to pay for the contract came from the two programmes on which Americans without private medical insurance depend: Medicare and Medicaid.

Already in the 1980s the US Department of Labour was classifying home care as a 'growth industry'. That was one of the features which made it attractive to Rick Surpin, CHCA's promoter, and to the New York charity, the Community Service Society (CSS), which was his principal backer. Another was the fact that the home care industry, in which the overwhelming majority of the undertakings are private, profit-seeking companies, was characterised in the mid-1980s by low wages, low status, and almost zero employment benefits. Those who did the actual work were almost all women and almost all black or Hispanic. Typically they were lone parent mothers and heads of families. As such they were eligible to receive state welfare cheques and Medicaid health cover for themselves and their children. The starting wage for home care work in New York in the middle 1980s was often as low as the statutory minimum rate of \$3.35 per hour, the jobs on offer were typically part time, and health insurance was almost never part of the contract. So the incentive for these women to move from public welfare into this employment was rather limited. Dawson and Kreiner tell us that '. . . the norm in the industry was for women to float back and forth between part-time . . . work and public assistance.'

For Rick Surpin and his CSS backers, home care provided the attraction of rising demand and thus an opportunity to create jobs. It also offered a further challenge: to make the new jobs good ones – with decent wages and other benefits, with full-time work for those who wanted it; and with appropriate training arrangements and promotion possibilities. And as if those challenges were not enough, it was decided that the jobs should be created within a business which, after an initial 'trusteeship' period, would be majority-owned by its employees and controlled by them on a democratic basis.

Mr Surpin had been operating as a kind of social entrepreneur in New York for some years before CHCA was ever conceived. While working with a community development organisation called the Mutual Aid Project, he had become attracted by the ideas of employee ownership and researched the possibility of promoting employee-owned cafés and restaurants. Nothing came of those particular studies but they seem to have strengthened Surpin's belief in employee ownership. His work with the Mutual Aid Project also brought him into contact with Peggy Powell, whose contribution to CHCA has probably been second only to his own.

In the early 1980s Mr Surpin became director of the Centre for Community Economic Development, one of the main operational agencies of New York's Community Service Society (CSS). This is a widely respected charitable organisation which can trace its origins back to 1848 and commands considerable resources. It had, for example, an income from all sources – endowment, donations and government grants – of nearly \$10m in 1986/7. CSS accepted his proposal that he should promote new jobs within the framework of employee-owned, or potentially employee-owned, businesses.

The first venture of this kind to which he was midwife, in association with two other local community groups, was a small carpentry operation. It failed – but Mr Surpin learnt important lessons. One was the need to make a really thorough study of any project of this kind before deciding to go for it. A second was the need to recruit an effective manager. He turned now to home care and produced a combination of a feasibility study and business plan.

Mr Surpin's plan attracted a sympathetic response from the Bronx's Montefiore Hospital. In particular, the staff of the hospital's certified home health agency approved his aim of improving on the industry's wages, conditions and status, including his linked objective of achieving a majority of full-time jobs. But the agency's staff made clear that in any contract they signed the hourly rate of pay specified could be no higher than for any other contractor. If Mr Surpin was going to pay more than the competition, the difference would have to come out of the allowance in the contract for profits and overheads – typically around 25% of the total – or else from donations made by the CSS or other well-wishers.

An important contribution to Mr Surpin's business plan was also made by Janet Saglio, the vice-president for business services of an employee ownership and co-operative promoting agency in Boston – the Industrial Co-operative Association, or the ICA Group as it later became.

The key features of the business plan which was duly approved by the CSS, and the project's other outside backers, were as follows:

–The goal of improving the conditions and status of the actual homecare workers would be reflected from the beginning in a starting hourly rate of pay which, at $4.25, was some 75 cents higher than the industry average; and in an annual uniform allowance of $100.

– The goal of achieving full-time work for 70% of the workforce was affirmed as a major commitment; but one to be achieved only by stages.

– Because of the need for a continuous reduction in overhead costs per unit of home care supplied, there would be a corresponding increase in workforce numbers up to an initial target of 200.

– The budget would allow for losses in the first year; but a break-even result moving on to a small profit would be projected for the second.

– So as to bring forward the receipt of the first income, the starting workforce would consist of people already trained for care work. Thereafter the project would train all its recruits itself and devise its own training programme.

– The project would be managed by a professional with experience of the industry.

– The initial board of directors would be chaired by Mr Surpin and would represent the CSS and other financial backers. But these would be transitional arrangements during which the outside directors would behave as 'trustees' for the project's prospective employee owners.

– At an appropriate stage, members of the workforce would be urged to become members of CHCA, and its employee owners, by subscribing for one share each. The shares would be priced at $1,000, but could be paid for by instalments.

– These employee owners would progressively elect directors who would progressively replace the original 'trustee' directors.

– The project would be endowed with its start-up equity by the CSS with further contributions from other well-wishers if possible.

About the time that Mr Surpin was completing this work, there was good news from the Montefiore Hospital: a firm offer of a contract if it proved possible to meet the various conditions for starting up, including the necessary finance. The financial needs were considerable. Working capital had to be high because of the long delay – 90 or 120 days – between the performance of services and the receipt of payment for them.

However, the support from the CSS sent a strong signal to progressively minded charitable funds. The involvement of the ICA Group did the same to funds with money to lend to co-operative and other employee-owned type ventures. A starting capital of $420,000 was, in fact, fairly quickly put together – with a little over 25% of that in donated equity ($115,000) and the balance in debt. Easily the biggest source of these funds was the CSS, which donated $50,000 in equity and lent a further $75,000 at 6% over five years. Other charitable backers included Christian sources – the Adrian Dominican Sisters, the Sisters of Charity in Ohio and the US Catholic Conference of Bishops' Campaign for Human Development. Among the co-operative backers was the Development Corporation of the National Co-operative Bank. With one exception, all the loan money came in at well below market rates. The exception was the loan from the revolving fund of the ICA Group:

$50,000 at 11% over 3.5 years. But the Group took over the essentially 'monitoring' responsibilities of lead lender, a far from costless function.

His experience with the failed carpentry venture had impressed on Mr Surpin the key importance of high quality professional management. But high credentials do not always correlate with actual business success, perhaps especially when managers move from a conventional to an employee-owned business. In the case of the man originally chosen to be the prospective CHCA's first chief executive we shall never know. As the former branch director of a national home care agency he had good credentials and the right experience. But two weeks before the completion of the start-up financial package he jumped ship and took a job in a major hospital: later it emerged that he had been mugged in the South Bronx some years before and was nervous in that neighbourhood. The replacement recruit, also with appropriate homecare industry experience, came from the Mid-West.

THE CHEQUERED ROAD TO PROFIT

As we saw at the outset, CHCA made significant losses in each of its first two financial years. But the amount of the loss was more than halved in the second year and both workforce and sales rose substantially.

The losses actually incurred were substantially higher than forecast. Essentially, it took longer than expected to build up work, and so the overhead burden was reduced more slowly. It was only in the financial year 1985/6 that the business secured a second contract – with New York City's Visiting Nurse Service (VNS). This was important because of VNS's special concern for the quality of care.

There was also what might be called a 'learning curve component' in the bigger than expected initial losses. Moreover there were repeated changes in top management. It is doubtful whether the second CEO ever felt comfortable with the employee ownership framework and he was asked to leave. He was followed by an experiment with a kind of collegiate top management which lasted for roughly ten months and was also judged to have failed – or anyway not to have worked well enough to justify going on. Finally, in August 1986, Mr Surpin himself took over the reins. Quite soon after that, CHCA began to prosper and has continued doing so.

The first two years of losses were a close-run thing. CHCA

would not have survived without the invaluable backing of the CSS. By August 1986, when Mr Surpin took over, CSS had increased its equity in the project from its initial $50,000 to $200,000; and its loan support from $75,000 to $125,000. In effect CSS injected new capital to offset the initial losses and a little more. Not only that. It also undertook to pay Mr Surpin's salary and those of two other senior staff, including Peggy Powell.

The first lesson of the story up to this point is: find a sympathetic charitable backer with a long purse. Dawson and Kreiner also suggest that the CHCA experience challenges conventional wisdom about what to look for in the top manager of a participative and employee-owned business. Someone with top management experience in a conventional capitalist business in the same industry may not necessarily be right in this sort of environment. Dawson and Kreiner point to CHCA's failure under the CEO from the Mid-West who had industry experience compared to the success under Mr Surpin, who had no such experience and who had never before managed a business employing over 100 people. There is obviously something in this contention: the experience of employee-owned businesses elsewhere certainly confirms that some managers whose experience has been confined to conventional businesses never succeed in adjusting to the different environment of employee ownership.

When Mr Surpin took over as CEO in August 1986, he found the office administration in poor shape, and he hired Kathleen Perez to take it over. She was an old colleague from Mutual Aid Project days both of himself and Peggy Powell, and thus there was a good chance that she would fit in.

On the other hand, though more contracts were still needed, the work load was by this time substantially larger than early on. Also important, the pattern of the contracts was such that around 50% of CHCA's care staff could work full-time. This was still below the business plan's target of 70%, but a big improvement on anything that had gone before. That perhaps partly explains another feature of the business at that time: divided morale among the care staff. Those with longer service felt critical of the project's failure to meet its own target of 70% full-time jobs; the more recent recruits tended to compare their wage rates and indeed other aspects of their work situation with what they had experienced elsewhere – to the advantage of CHCA.

A further feature of the scene when Mr Surpin took over was its training programme. Over the previous nine months, in conjunction with a local community college, CHCA had developed its own training programme for new recruits. The main architect of this was Peggy Powell. It was later to become, in conjunction with CHCA's sophisticated selection programme, one of the foundations of the venture's success.

Following Mr Surpin's takeover, CHCA grew fast. After little more than twelve months sales were up by 110% to $1.5m, and care staff by around 8%. He had achieved this virtuous pair of outcomes by pushing up the number of full-time jobs to the original target figure of 70% of the total. An annual loss of just under $80,000 had been turned into a profit of almost $100,000.

Morale also began to improve. Labour turnover started to fall sharply and already in early 1987 CHCA passed two important landmarks. In March, 40 of its workforce applied for membership and started to subscribe the $1,000 needed to buy the required single share. Shortly afterwards there were elections for a new board of directors on which elected 'worker directors' were to be in a majority. The end of the period of the project's 'trustee board' pre-dated by a few months the confirmation that it had become profitable.

SINCE 1988

At the time of writing, CHCA had been continuously profitable for nine years. However, while total sales increased about four times between 1987 and 1995, the *rate* of profit fell: expressed as a percentage of total sales the profit rate in 1995 was little more than a third of what it had been in 1987. We shall see why later.

Apart from survival and profitability, the main achievements of CHCA since 1987 have been:

– More than doubling the numbers employed from 125 to over 300, combined with real improvements in pay and working conditions;

– A steady improvement in the quality of the service provided.

– The replication programme.

– The establishment of the training system as a separate entity.

– The development of an agenda and organisational structure on the political field.

The slower growth rate in numbers employed, as compared with sales, reflects a shift to full-time working and some progress by CHCA in improving rates of pay. The original plan seems, at least in some sense, to have set a target wage at an annual rate of $15,000. Moreover, the project had showed its commitment to higher rates of pay for its staff by offering, as we saw earlier, a starting rate of $4.25 per hour to those who joined at the beginning in 1985, a premium of some 50 cents an hour over the industry norm.

Annual pay of $15,000 for a full-timer equates with an hourly rate of about $7.50. In July 1992 CHCA raised its hourly rate for new recruits to $6.00. Even after allowing for inflation since the business plan was written in 1984, Mr Surpin and his colleagues could claim real progress in improving basic wage rates. By 1995, CHCA claimed that the package it offered employees was 'among the best in the industry' – wages averaged over $7 per hour, with around $2.50 more in benefits including health insurance, paid vacation and sick time. An employee can also reckon on average hours of 35 per week – compared to an industry norm of 25-30 hours.

That progress can be seen as partly political – the result of pressure on the relevant New York State authorities to lift the rates paid by them for work under the Medicare and Medicaid programmes. Mr Surpin took the lead in the formation of a body which called itself the New York City Home Care Work Group and which represented a coalition of interested parties including 'unions, elderly and disabled consumer organisations, public policy advocates, provider agencies and academic researchers' (Dawson and Kreiner).

Late in 1988, the Work Group succeeded in persuading the authorities to raise pay rates by a modest amount. When that eventually came through in late 1989, the starting wage at CHCA was lifted above $5.50 for the first time.

As with wages, so with conditions. From the beginning new recruits were paid an annual uniform allowance of $100. Some paid holidays were first introduced in 1988. Soon afterwards the care staff and their children became covered by health insurance. In 1992, when cash was unusually tight, a decision was reached democratically to drop the health insurance for children.

A final point about wages and conditions concerns VNS which gave CHCA a second contract in 1991. This notable agency has developed a policy of rewarding higher quality work with higher volume. When VNS proposed its second contract to CHCA, so Dawson and Kreiner tell us, it 'offered to substantially re-direct its case load' towards the business. They explain what was clearly a most welcome offer by telling their readers that 'VNS had concluded that CHCA's quality of care was superior to all its other subcontractors'.

Judgements about the quality of work of this kind can be based on the numbers and intensity of patient complaints. CHCA keeps careful records of complaints against its care staff. They are evidently few compared to other companies. Co-ordinators at head office keep in daily touch with clients by telephone. By 1996, CHCA was handling about 250 cases at any one time, each of which might last six and nine weeks. Not least because of its careful initial screening programme of job applicants, it reckons to have five or less cases a year of theft.

It is also possible to quantify some less direct indicators of quality, especially when we remember the importance of continuity of service by the same provider, which partly depends on the labour turnover rate at the business which is supplying the service. By this measure the record of CHCA is notably superior to the average for the competition. Dawson and Kreiner link this with the growing number and percentage of the business's care staff who decided to become worker owners and either 'bought themselves in', by subscribing for a $1,000 share, or started to do so.

Sherman Kreiner, joint author of the study to which I have constantly referred, was hired by Mr Surpin in early 1990 'to design and lead a major strategic planning process', with finance from the Ford Foundation. He drew up a progamme of planned growth.

The substantial growth since Mr Surpin had taken over in 1986 had already called for extra finance. This had been provided by one of the venture's original backers, The National Co-operative Development Bank, in the form of a $250,000 line of credit to finance receivables. Growth was also shortly to require extra office space.

Mr Kreiner tells us that his first task was to help CHCA's 'senior managers to overcome their resistance to growth':

> If the co-operative was to meet its long-term hopes for higher quality jobs, it simply had to become more cost effective. The company was indeed stable and profitable, but higher revenues were essential to attain further improvements such as better wages, guaranteed salaries, and better health benefits. However, in such tight margin, labour intensive, business, only growth seemed to offer a significant answer – by providing an improved economy of scale [Dawson and Kreiner, 1992].

Accordingly, Mr Kreiner recommended that CHCA's care staff should increase at a rate of not less than 30 each year until the total had reached 500. Geographically, it was recommended that the co-operative should extend its reach beyond the South Bronx into northern Manhattan where a branch office would be opened in Harlem at an appropriate stage. In fact, 40 new care staff jobs were added during 1992. As a further detail for the New York expansion, the plan recommended that two specialised care services be developed for those suffering from Alzheimer's Disease and Aids.

Finally, outside New York, the plan recommended that expansion would take the form of a 'replication programme', and specifically that ventures designed on the CHCA model should be midwifed by the South Bronx prototype. This would also act as trustee for their prospective employee owners during the early stage. The plan went on to suggest that the first two of these might be launched in Philadelphia and Boston.

The formal developer of the cloning operation was the Home Care Associates Training Institute. Founded in 1991, 40% of its $2m annual budget came from the Charles Stewart Mott and Ford Foundations and other charities, with the remaining third provided by state and local governments. One of its functions was to organise homecare co-operatives modelled on CHCA. The premise of the replication programme was that the most effective way to influence a highly regulated industry was to demonstrate that changes were possible from within the industry – rather than trying to influence practice and regulations purely as an outside advocate. Apart from cloning, this Institute has now taken financial responsibility for the professional training of the home care workers, so that the accounts of the co-operatives providing the care reflect the activities of that business alone. Training at CHCA is a four-month process, starting with one month of classes, followed by three further months' 'on-the-job' training.

Founded in 1993, the Philadelphia clone employed over 75 care staff by 1995, of whom nearly half – virtually all of those who had reached the length-of-service eligibility criterion – were in the process of buying a \$500 share in the \$1.6m business; over 90% of them had previously been on public assistance. The most recent clone in Boston started with 14 staff in spring 1994, was running profitably within eight months and recorded 'sales' worth over \$800,000 in 1995. There were over 70 staff by mid-1996: about 70% of the 65 home health aides were former benefit claimants being paid \$7 per hour or more, plus differentials, and averaging close to 35 hours a week. The replication programme was being extended, with two in the Mid-West next on the list.

However, even if one priority is change from within the industry, the movement started by CHCA is not neglecting the political dimension. Another of the original functions of the Institute was to be an 'advocate for employment and service delivery reforms within the home health care industry'. Until the mid-1990s, the (non-party) political work of Rick Surpin and the rest of the movement had been concentrated at state or local level. By 1996 developing a political presence at the national level was an overt aim. A series of 'concept papers' were already in print.

The support from the Mott and Ford Foundations for the CHCA model and the work of the Institute do much to lay at rest the doubts about the adequacy of the co-operative's profits. And that seems to be a reasonable judgement despite the fact that, at the margin, income which might have made them larger has been applied to improving the pay and conditions of the care staff. The Foundation support suggests that this priority of the business from the start has been kept within the limits of proper prudence.

But the point on which to close this section is rather different. It is that by endorsing the replication programme the Ford and Mott Foundations have also passed a favourable verdict on other aspects of the CHCA formula: its co-operative, democratic, ownership and related arrangements. It is to these that we now turn.

CO-OPERATIVE AND RELATED ARRANGEMENTS

In the absence of specific co-operative legislation such as exists in Britain and some countries in Europe, the corporate form of CHCA is that of a company limited by its shares. But it is also formally organised under worker co-operative incorporation laws in the state of New York. Its share capital is divided into two categories:

class A common stock and class B common stock. Voting rights are restricted to the class A common stock which may be owned only by employees. The ownership of the class B stock is also restricted. It was owned at first exclusively by the project's parent and midwife – the Community Service Society of New York. It has since been given to the company, not to be allocated to individual employees, but to remain as collective capital.

To begin the discussion in this way is not, I hope, to assign undue weight or importance to CHCA's legal form and structure. On the whole I share the increasingly fashionable view that an organisation is shaped, and its culture – what the French call its *mentalité* – is coloured, as much by its informal arrangements and relationships as by its legal framework. I suspect that that applies quite strongly in this case.

All the same, the legal framework is important in itself because it provides an anchorage in law for the position of CHCA's employee owners in relation to the project as a whole and to the management. The rights and powers of CHCA's employee owners are grounded in law; they are not enjoyed simply by virtue of the grace and favour of the project's management or that of the CSS. To borrow a thought from Mr Surpin, CHCA's legal structure and employee ownership arrangements offer a guarantee against any backsliding by the management.

Across much of Europe and the USA in the late twentieth century the word 'co-operative' carries negative as well as positive connotations. Given its actual legal structure, CHCA would almost certainly not be permitted under British law to use the word in its name. But here we may emphasise a positive aspect of the word co-operative. It does carry with it the implication that, as between the co-operative's members, or more exactly in this case between CHCA's employee shareholders, democratic relationships will prevail. In the general meeting of the holders of its Class A common stock, which is CHCA's sovereign body, each employee owner has one and only one vote.

By 1992, 175 staff members had subscribed \$1,000 to purchase one share, or were in the process of doing so; 75% of those who were eligible. The only qualification for eligibility is the successful completion of a three-month probationary period. Given the prevailing incomes of the workforce and their low savings, it is entirely understandable that the acquisition of an employee share has not been made compulsory. The figures for worker owners in subsequent years were as follows:

1992	1993	1994	1995
197	182	243	256

The democracy in CHCA is, by all accounts, lively and active, though not to the point of destabilising the management. We saw earlier how in 1987 a majority of the project's board of directors came to be elected by its employee shareholders. Dawson and Kreiner report that there is vigorous competition for seats on the board of directors when the elections come round.

There is a reality too about the financial as well as the control dimension of the project's employee ownership. Cash bonuses of $500 – more strictly dividends – were paid to CHCA's employee shareholders for each of the two years preceding 1991 – a persuasive rate of return on a $1,000 share. Because of lower profits the dividend for 1991 was cut to $200. The consequences of that reduction were probably not all bad: the lessons that dividends are linked to profits, and that the latter can go down as well as up, are useful as well as painful. Moreover, in order to avoid any possible doubt, I should underline the fact that these payments are genuine dividends: they are not paid to those who are not employee shareholders.

Let us turn, finally, to some key features of the informal culture, spirit, or *mentalité*, at CHCA. Clearly the behaviour and openness of the management is of great importance. It does not seem too much to claim that Mr Surpin and the CHCA management team are perceived by the care staff as being on the same side as themselves and not as the enemy. The success of the project in reaching some of its original workforce goals – and in making progress towards others – must surely too be an important factor in keeping morale at a high level.

All of this seems to me to be underpinned by the project's training and education programmes; and especially by its training of new recruits and the associated screening of applicants. This is the province of Peggy Powell who was director of education and training until mid-1996, when she became full-time executive director of the Training Institute. Dawson and Kreiner place great emphasis on the care and attention which is put into the screening of applicants. They cited a remarkable pair of statistics about the success of this

whole process: on average 80% of those who entered the enrolment training programme in the early 1990s came to it from being on public assistance; and of these 80% completed the programme successfully. This picture remains basically unchanged: in a joint mid-1996 brochure, *The Co-operative Homecare Network*, the three care co-ops in New York, Philadelphia and Boston claimed that of the 200 participants enrolled in training that year, 150 would begin employment within five weeks from the day they enrolled, 120 would remain fully employed three months after placement and 100 would still be employed six months after placement: 'This retention rate – 50% of those entering the training program still employed after six months – is exceptional among welfare-to-work programs,' it says. The brochure goes on to list five key elements which contribute to this success:

– Clear selection standards which owe little to academic or professional achievement and much to character qualities like caring, and problem solving and communication potential.

– Supportive counselling to help resolve work and home-related problems including negotiating the maze of regulations on public financial assistance.

– Individual responsibility – 'candidates must demonstrate their commitment to employment, both before acceptance and throughout the program', which includes punctuality and completing homework assignments.

– Skill building and individualised attention, with special concentration on problem-solving and communication skills.

– Worker ownership – see epigraph.

Important initiatives of the late 1980s and early 1990s sought to provide personal development 'ladders' for those of the care staff who want higher qualifications, improved education, and more responsibility or any combination of these. The first was a programme to enable care staff to become, after an extended period of education and training, fully qualified professional nurses. It has been only a partial success for one main reason: the low educational starting points of a number of those who have attempted it. Because of the only moderate results it was decided in late 1992 to phase out that particular programme and provide opportunities for generalised educational upgrading instead. Two further initiatives were launched in 1992 with the same aim of providing opportunities for personal development and advancement – a pilot project to train Senior Home Care Aides, and a team leader training programme.

Common sense must insist that this remarkable training and education programme has an important, and positive, effect on the culture, morale, and *mentalité* of the CHCA project. It is not surprising that the CSS and others continued to finance large parts of it into the late 1990s.

28

United Airlines

INTRODUCTORY OUTLINE

We believe that our plan will catapult the Company light years ahead of its competitors by enabling it to serve the global community more flexibly than any other major American carrier and to compete head to head with 'low cost carriers' in the shorthaul domestic market place. *Letter to members of pilots' and machinists' unions at United Airlines introducing the proposed buy-out deal, December 1993*

Companies which operate in growth markets but find themselves becoming uncompetitive because of their rates of pay and benefits, face a clear choice. They can cut either jobs or their pay and benefits by the required adjustment percentage. If they choose the latter then, given the ESOP tax reliefs in both the US and UK, those who give up wages can be compensated by shares and the profits of the business can benefit from the tax reliefs. To overcome the crisis of the early 1990s, United Airlines chose to cut wages and benefits. By contrast, two of its main competitors, Delta Airlines and American Airlines (AMR), chose to cut jobs even if it is also true that the reduction was achieved on a largely voluntary basis at AMR. Readers must judge for themselves which of the two main alternatives they would prefer to go for. Investors scarcely need to make a judgement. At least in the summer of 1997, the arithmetic would have done the job for for them. Between the date of the deal and the end of June 1997, shares in the common stock of United outperformed those of Delta and AMR by a substantial margin.

I need also to emphasise at the outset that the deal that was completed in July 1994 was not merely the response to a crisis. For the Association of Airline Pilots of America (ALPA) at United it was indeed the culmination of a ten-year dream. On three previous occasions specific buy-out plans had been prepared, only to founder.

The deal has been variously described as an 'employee buy-out' and as a 'capital restructuring'. I shall argue that it was a bit of both. But whatever its essential character there can be no arguing about its main results: trustees acting on behalf of over 50,000 of United's then 69,000-strong America-based employees, members of ALPA and of the International Association of Machinists (IAM) and the entire non-unionised workforce, became the owners of 55% of its voting capital. What is more, those covered by the deal gained almost total employment security over the roughly six-year life of its main provisions as well as voices at the top table for a much longer period. At least as much as the new majority employee shareholding, these latter should be seen as the defining characteristics of a potentially historic bargain between capital and labour. On the labour side, only the cabin staff, organised as the Association of Flight Attendants (AFA), stayed out.

The former shareholders were compensated for what they gave up by an ingeniously mixed package which cannot easily be characterised by a one-word description, but of which a cash payment of $84.81 and a half share in the stock of a recapitalised United were the main ingredients. On their side, the majority employee shareholders gave up wages and made other concessions which were reckoned to have a so-called net present value (NPV) of $4.886bn. Measured both by that number and by the numbers of resulting employee shareholders, this was the largest ever transaction of an even remotely similar kind.

Readers will be immediately anxious to learn whether the glittering predictions made for it by Captain Roger Hall and Mr Ken Thiede (authors of the opening epigraph) were validated by United's subsequent performance. The best short answer must be 'yes and no'.

To begin with there can be no serious dispute about the surface quality of United's financial results following the deal's completion. For each of the two calendar years, 1995 and 1996, the company turned in results which were glitteringly good. Moreover, it was a good bet, when this was written in the summer of 1997, that a flow of apparently top class financial results would continue at least to the end of the century.

What is more, these results were unquestionably seen as good on Wall Street. The company's share price was among the top performers in the quoted airline sector over the period of thirty-six months from the completion of the deal to June 1997.

The non-employee shareholders, who retained a 45% stake after the deal was done, had no obvious cause for complaint at least over the deal's first three years. They were entirely free either to hold on or to say 'Thank you' for an attractive capital gain and move on. But in that last respect the position of the employee shareholders was different. Under the rules governing ESOP shareholding at United, they are in effect only free to sell when they stop being employed by the airline. However, and for what it is worth, with the price of United's shares above $70, as it was in June 1997, the employee shareholders had comfortably recouped on paper at least the cash component of what they had forgone in wages and other concessions up to then. In a notice to members dated 2 May 1997 – when the share price was around $75 – Mr Ken Thiede spelt out the value of shares already allocated to a 'lead' mechanic and contrasted that with 'his' investment: the numbers were $41,100 v. $17,400.

There is, however, still more compelling evidence as to whether the early union predictions were validated by the company's subsequent performance. A flow of friendly incoming telephone calls were received by the ALPA union office at United over much of 1996. They came from banks and other 'investment community' institutions. Their gist was that if the pilots got wind of any deals similar to that completed by them with United in 1994, they – the bankers and other 'investment community' people – would greatly welcome a tip-off.

This particular flow of friendly incoming telephone calls to United's ALPA office was interrupted in early January 1997. What had happened just before was that the members of the 'ESOP unions', first the pilots and later the more highly paid among the machinists, had voted to reject an offer of a 'mid-term wage adjustment' which had been provisionally negotiated by their leaders with the company.

This is not the place to go into details about either the offer or its rejection. But three key points have to be made. The first is that the union leaders accused the management of refusing to develop the kind of 'ESOP relationship' which they had expected and thought reasonable. Second, the management moved quickly to contain the damage, by making a new offer which included a real sweetener as well as improved pay increases. Third, it is possible that this whole episode may turn out in retrospect to have been a case of 'all's well that ends well'. In any event, following recommendations by their leaders, union members quickly voted to accept the new offer.

Nevertheless the episode shows that the management and the two 'ESOP unions' did not succeed in developing a trouble free relationship over the first two and a half years following the deal's completion. Despite the financial successes in 1995 and 1996, we cannot say without qualification that the prediction in the epigraph was validated by what then happened.

Arguably too, the results might have been better. On the face of it the numbers are first class. But a closer look is needed. It can tell us what were the sources of the main improvements and their relative weights. Well over 95% of the clearly demonstrable improvements can be attributed to four sources:

– Savings associated with the main wage reductions and other concessions agreed in the 1994 deal.

– ESOP tax reliefs, partly linked to United's share price, which had started to exceed projections by 1996.

– Improvements in demand, evident most concretely in improved 'load factors' (seat occupancy rates).

Improvements and savings resulting from the special deal associated with the so-called 'United Shuttle'.

The third of these four sources of improvement had not much to do with the deal. Its competitors were in principle as well placed as United to take advantage of it, though United did in fact succeed in increasing its share of 'premium' passengers.

As for the first two and the last, it is open to a discerning critic – or anyway a devil's advocate – to argue that the resulting improvements were no more than the 'mechanical and automatic' consequences of the 1994 transaction.

Sceptics may also argue that the size of the improvements which can be persuasively attributed to more ownership congruent behaviour were rather modest. Let it be clear at once that they are not negligible. But they are quite modest both in absolute numbers and relative to what has been achieved in some other of America's majority employee-owned companies. On the other hand it is open to those at United to argue that the scope for 'process improvement' savings is probably that much less in a service business, like theirs, than in a manufacturing business, like a steelworks. These are issues that can be easily discussed but not at all easily settled.

But it remains a common misconception that a switch to majority

employee ownership will of itself result in a change of culture, towards attitudes which are conducive to continuous and significant productivity improvements. Both management and the unions at United must know that that is not the case. It is also true that a number of important steps were taken in the two years following the deal to promote a culture more oriented towards productivity improvement. But the evidence is that, for one reason or another, those efforts were not sufficient to change attitudes very much.

The 1994 deal was a transaction notable not only for the numbers. It was even more notable for the pilots' union initiative that was the prime mover behind it. And it was notable too for the fact that though the unions were worried about employment security and the management about profits, it cannot reasonably be characterised as a 'crisis transaction'. More about this later.

Here we may note that their majority shareholding gave United's new employee owners a strong voice in the strategic decisions of the business. In that connection one specific point needs to be emphasised at once. The deal included changes at the apex of United's management team. Mr Stephen Wolf, the former CEO, stepped down together with his number two, Mr Jack Pope. Mr Gerald Greenwald and Mr John Edwardson came in as CEO and chief operating officer. Mr Greenwald was, and had indeed already been for a number of years, ALPA's favoured candidate for the top job. His status as a union-chosen CEO is both a detail and not a detail.

For America's airlines the years 1990 to 1993 were ferociously tough. With one exception, all the larger companies lost money and by the end of 1993 had chalked up total losses close to \$13bn. One of the country's most famous carriers, Pan American, went bankrupt just before the fighting started in the Gulf War. Because of its effects on fuel prices and its tendency to discourage the fainthearted from flying at all, that conflict was a part of the problem. But overcapacity and intensifying competition were the big factors behind the losses. Only Southwest Airlines, the no frills short haul operator, with routes mainly in the Texas-California triangle, avoided them.

Pan Am was not the only airline to go bust, simply the most famous. Eastern and Midway suffered similar fates. Others, TWA, Northwest and Continental, filed for protection under Chapter 11 of the bankruptcy code. All took steps to cut costs within their control, to move out of unprofitable routes and to reduce both labour expenditures and labour itself.

United, alongside American Airlines one of the country's 'big four' since before the war, and normally either the first or second airline in the US, was no exception. It made its then biggest loss ever, of $332m, in 1991 and in 1992 went much further into the red, with a figure nearly three times that.

In fact all its competitors except Southwest faced the same crisis in the early 1990s. But United was in a class of one in relation to the way out of the crisis which it chose. In the language of headlines, the instrument chosen to overcome the crisis was a massive employee buy-out. In the more prosy language of investment bankers, what happened was a massive 'capital restructuring exercise'.

In fact an enlightened bargain was struck, centred round pay cuts. Led by the pilots, over 50,000 of United's then 69,000-odd American-based workforce agreed to significant wage cuts and made various other concessions – including most importantly the acceptance by the pilots for a twelve-year period of a two-tier wage system. The concessions were estimated to have a net present value (NPV) of $4.886bn. In return those employees obtained, as well as their 55% shareholding, near total employment security for up to six years, an important voice at the high table and the choice of their two favoured top executives.

We shall have to look later at the details of this buy-out bargain and capital restructuring exercise. As so often in transactions of this kind, the deal could not have been done without the details. But some further general points about it are worth bringing out already at this stage.

Subject to a conditional qualification which in the event did not apply, both the percentage of the equity (55%) and the associated number of shares in the common stock (precisely 17,675,345) were fixed at the outset. On the other hand, not common stock but preferred shares were to be allocated to qualifying employees and were only to be changed into the former when employment came to an end. The eventual exchange, of preferred shares for shares in the common stock, was to take place on a one for one basis, regardless of the market value of the latter at the time the exchange took place. So United's employee shareholders stand either to gain or to lose depending on the actual share price levels when they come to sell. At the end of June 1997 that price, after allowing for a four to one split, was between two and three times what it had been when the deal was completed.

For a period roughly twice as long as the duration of its members' main wage reductions – 12 years against 5.75 – ALPA accepted what amounted to a two-tier wages and benefits arrangement: with pilots flying what was named the 'United Shuttle' or the 'U2' – up and down the north-south corridor on America's West Coast – receiving lower pay rates and flying longer hours than on the company's other routes. This was not an entirely new departure in the history of collective bargaining between ALPA and United. The agreement which followed ALPA's successful strike in 1985 offered a kind of precedent. But the duration of that earlier 'two-tier' agreement was far less extended: two years against twelve.

Notwithstanding the near total employment security provisions of the deal, the IAM agreed that up to 20% of United's aero-engine and airframe maintenance work might be outsourced for the same twelve years. It further agreed to specified changes in work rules – including an end to the paid half hour lunch break – over the twelve-year period.

ALPA's acceptance of a 'two-tier' wages-and-hours arrangement over a time span of twelve years is an especially important feature of what was agreed. Academic economists have been frequently listened to with respect when they have asserted that unions would never accept any such thing. That was one main reason why the deal at United was widely seen, at least until the turbulence over the mid-term wage increases, as one of special and path-breaking importance. It is true that by 1994 two-tier wage arrangements had been accepted by unions quite widely across America's airline industry, in other US industries and also in the UK. But something of a spotlight was switched on when that arrangement formed a key part of the deal at United.

The deal was partly seen as important because of the numbers, both of dollars and of employees. But it was mainly seen as special because of the union initiative behind it, and the fact that the initiative was not born of impending disaster or prospective close down. It was substantially born out of a decided preference for greater employment security over higher financial rewards in the medium term. But that is not a disaster indicator. And the same applies to the mounting losses which the airline had been accumulating. They were serious but not desperate. For both by its balance sheet and its market position United remained relatively strong.

No, the key point about the deal is that though partly born out of labour's concerns for employment security and management's for profits, it was also partly born out of a belief on the part of some of the key actors – and especially of the pilots and the new CEO – that majority employee ownership would make United both a more successful business and a more attractive one in which to work. As we shall see, it also happened because the pilots threatened to strike if the management chose to cut jobs and not pay, a threat which was evidently credible.

What then of the rejection by the pilots and the higher-paid machinists of mid-term wage deal as first proposed? I suggest that it should be seen as resulting from success rather than failure. More exactly it resulted from what was perceived by a majority of the 'ESOP Unions'' membership as an inequity in the distribution of 'extra' benefits that had flown from the deal. As we noted earlier, 1995 and 1996 were by various measures financially the best in United's history. What's more and to repeat for emphasis, from the deal's completion to the middle of 1997, the United share price had comfortably outperformed most of its airline competitors.

There is some evidence too of higher social morale and a better atmosphere at work during at least the first two years which followed the mid-1994 buy-out. Moreover, evidence from the length of applicants' waiting lists continued to show, throughout this period, that there were plenty of qualified pilots and qualified machinists who were quite ready to work for United at its new and lower than previous rates. Presumably they saw attractions in its enhanced employment security, employee shares, and the labour voices at the top table.

In the end we should probably see the rejection by the pilots and the higher-paid machinists of the mid-term pay adjustment, as originally proposed, as a protest – a protest against what they judged to be an unfair distribution of the big gains that had substantially flowed from their sacrifices. The pilots had given up over 15% of their salaries. For the machinists, when account is taken of an increase agreed earlier, the sacrifice was not much less. Against those numbers it is not surprising that offers of two 3% annual increases followed by two at 2% may have seemed less than generous when the company was proudly reporting record profits. Moreover, the first offer may have seemed galling as much for what it failed to contain as for what was in it. In the jargon it gave no guarantee of an automatic 'snap back' after the duration of the main wage cuts, no promise of wages being restored, to their pre-1994 levels.

As we all know, feelings of unfairness can 'well up', whatever may be laid down in a formal contract. The big increase in the share price over the two and a half years following the buy-out deal may indeed well have contributed to the feelings of unfairness. For this upward movement is bound to have been widely seen as driven by the employee sacrifices. Thus, even though the employee shareholders have been major beneficiaries, there could well be resentment against the gains of the outside shareholders in what will be seen as an essentially 'free ride'. We can imagine that there was some resentment too among the pilots and machinists when, following the successful achievement of profit and other targets in 1995, the company's 600 top managers received significant cash bonuses early in 1996. The fact that these bonuses and the logic behind them were widely known and understood before they came to be paid out, may well not have reduced the resentment by that much.

Similarly it seems reasonable to suppose that there was resentment among the unionised staff, as reported in the press, that the deal allowed some upward flexibility in rates of pay for those newly recruited into managerial posts, and some tolerance of accelerated management staff promotion. Such a flexibility is almost a necessary feature in situations of this kind if an employee-owned business is going to hire and hold on to the management people it needs. United is not the first example either of this asymmetry in the way unionised and management employees are treated during an agreed wage freeze, or of the potential resentment which that can cause. It was one of the factors which contributed to bankruptcy at the employee-owned Hyatt Clark in the early 1980s and it was a big factor in the breakdown of relations between the management and the Independent Steelworkers' Union at Weirton in the middle 1990s.

Against that background and United's ballooning share price and profits, the votes against the initial offer in the mid-term wage adjustment process can perhaps best be understood as conveying a clear double message: first, we are not getting our fair share of the extra wealth creation; second, it is unfair not to promise to restore to us our old wage rates when the period of the main deal comes to an end in the year 2000.

The truth is that over the first period of its employee ownership United suffered from the inflexibility of the initial deal in a way similar to what happened at Weirton Steel in its early employee owned years. But there is also a key difference. At Weirton the benefits of the initial inflexibility went substantially to labour. Indeed the union members had eventually to be persuaded to modify what had been the agreed rules and do so against their own short-term money interests. At United, by contrast, at least in the unions' eyes, the benefits of what almost everyone saw as the larger-than-expected improvements went to outside capital and top managers.

We have now reviewed at some length the main causes of the discontent which led to the rejection of what was first offered in the mid-term wage adjustment process. Here, for the benefit of those who believe that employee ownership can offer a better way than conventional capitalism, I make three main final points. First, to repeat for emphasis, the problems encountered in the first phase of employee ownership at United were at least partly the problems of success. Second, despite the apparent quality of the financial results in 1995 and 1996, the management, the ESOP unions, and the rank-and-file employees had made only fair progress in securing the improvements made possible by its majority employee ownership. There had been only limited progress in the vital task of squeezing inefficiencies out of the system. Limited progress in the early years gives scope for improvement later.

My final point is that we should see this labour capital bargain at United not only as a success in itself, but also, and indeed even more so, as compared with what was the most obvious alternative available under conventional capitalism: to cut costs by cutting jobs. That was the solution chosen, for example, both at Delta and at American Airlines (AMR), the two closest of United's competitors. At Delta, instead of an agreement to cut wages by up to 15%, there were imposed redundancies of the same order of magnitude. At AMR the reduction in jobs was of the same order of magnitude, though it was achieved, to be fair, on a largely voluntary basis.

The lucky ones at Delta who kept their jobs were not required to take any reduction in their wages. Clearly the savings directly achieved by similar percentage reductions in employment numbers on the one hand, and in wages and benefits on the other, are

themselves likely to be similar. But, as we shall see in some detail later, America's ESOP tax reliefs mean that the choice between the two solutions is not simply a matter of a higher or lower preference for employment security. The choice of cutting wages instead of cutting people carries with it important tax advantages. That is why the solution chosen at United could in principle be a 'win' for both capital and labour. At the time of writing, in the summer of 1997, that is how it should perhaps best be seen. Moreover, it can be seen in that way without prejudging the question of whether the majority employee ownership at United will turn out to be of longer or shorter duration. It is enough that it offered the best solution to an acute set of problems of transition.

As a highly specific footnote for highly specialist readers, it is just worth having on the record, the respective 'provisions' made for their employment reduction programmes by Delta and AMR. The numbers were approximately \$775m at AMR and \$115m at Delta.

THE BACKGROUND UP TO 1987

The origins of the deal completed at United in July 1994 go back a long way. I quote from Thomas Petzinger, Jr's *Hard Landing* (1995):

> As . . . Dubinsky saw it, buying United was the only way for the pilots to take control of their destiny – the only way to get the company out of the hotel business and the rental car business and to start rebuilding the *airline* again. United was once a premier carrier, he thought; under Ferris it was fast becoming an also-ran. The only strategy that made sense for the pilots was to bid for control of the entire airline; the Eastern unions, among others, had provided a painfully instructive example when they traded away hard fought wages for a minority interest and a few board seats, which proved meaningless. At other places the unions gave up concessions simply to keep their jobs. 'We will not buy our jobs,' Dubinsky declared. Buying jobs was indentured servitude. Instead, he said, 'we will buy the company'.

In the summer of 1985 the then chief executive of UAL, Dick Ferris, a graduate to the airline business from a hotel and catering background, took on ALPA in a full-dress strike and lost. About a year earlier – though this became public knowledge only long afterwards – Ferris had himself proposed to the board that the business be taken private, using what would have been essentially a management buy-out led by him. It was a proposal which, in the light of a hostile response from the directors, he hastily withdrew.

Roughly two years after losing to the pilots in the strike, Ferris resigned his top post. The ALPA leadership at United had just had a first crack at achieving a buy-out. That first attempt did not come off. But the response to the pilots' proposal from those to whom they then spoke in America's financial community was sufficiently positive to inspire them to try again.

It was at their fourth attempt – and the first to be backed by the members of the International Association of Machinists (IAM) working at United – that they succeeded in pulling it off. There is evidence that a buy-out project was in fact originally mooted in pilot discussions during the 1985 strike. In other words nearly ten years separated the first surfacing of the idea and its eventual implementation. We are not dealing here with an impulsive gambler's throw, or something which took everyone by surprise by just happening to come off. With the benefit of hindsight we can almost say that the transaction completed in July 1994 was an event waiting to happen.

Where did these developments come from?

More precisely the questions are:

– Why did the first deal of its kind in the US – a union led buy-out which aimed to use majority employee ownership to achieve co-determination in a big, succeessful and fundamentally strong company – take place in the airline industry rather than elsewehere in corporate America?

– Why, within the airline industry, did it take place at United?

– Why was the lead taken by ALPA, the pilots' union and not say the IAM, the machinists' union, which had much larger membership at United?

There are three key factors which offer partial answers to the first and the last questions. One is the high percentage of wage and salary expenditures, and especially the high percentage of pilots' pay, in the total costs of the airline industry. The second is the rather unusual culture of the pilots' union. Third, there is the character of the airline industry as essentially a top quality service operation and thus one in which success is supremely dependent on the efforts of individual employees, on what each of them puts in

and on what they achieve by working effectively in teams. Neither by themselves nor taken together do the three come near to being a sufficient condition of what happened. But they seem, at minimum, to have predisposed the stars towards it.

In 1993, the last full year before the transaction, United's total operating costs were $13bn. Within that total two items are worth highlighting, in dollars and as percentages:

1 Total salary and related costs: $4.75bn (36.5%)

2 Subtotal for pilots within above: $1.38bn (10.5%)

By themselves those numbers do no more than quantify what every regular airline user knows: that this is a business which employs lots of people and is to that extent labour intensive.

Both the pilots and the skilled personnel among the machinists are highly paid, the pilots of course very much so. A Harvard Business School Study in 1995 says that the pilots take home pay (after pension contributions and taxes) 'averaged over $100,000' and 'topped out at $180,000-$200,000'. It also says that just under 27,000 IAM members employed at UAL when the deal was completed had 'salary and related costs' of about $1.45bn. That suggests average take home pay of at least $45,000. The highly paid group of IAM members who actually maintain and repair frames and engines probably took home around $55,000; the less skilled group of baggage handlers and others, sometimes known collectively as 'ramp staff', about $35,000. Readers don't need reminding that a 15% – or any – pay cut is painful, however high a person's discretionary income. However, a 15% pay cut is easier to cope with if you take home $100,000 or $55,000 a year and not just, say, $25,000.

In the three years which preceded the 1994 deal, United's accounts show average annual losses of some $450m. The 'opportunity for doing a deal' may well have looked that much more promising in the light of the relationship between the total of salary and related expenditures, and those losses. For it will have suggested that a cut of 10% in salaries could have been sufficient to turn the results into modest profits. In the event the flight attendants, an important and then roughly 17,500-strong sub-group of the unionised workforce, decided to stay outside the deal. On the other hand any deal would also offer substantial ESOP tax reliefs.

The key business numbers in United's antecedent situation were conducive to – or at least did not seriously inhibit – the 1994 deal.

Because of the large numbers employed and the relatively high salaries of a significant percentage of the total, United may be said to be a 'labour intensive' undertaking. On the other hand, because of the hugely expensive equipment which it uses, it is also capital intensive. As against approximately $1.2bn of shareholders equity, UAL's 1993 accounts show non-current liabilities of close to $6.75bn.

United's dependence on debt must have strengthened the bargaining position of its unions, especially ALPA's which had triumphed in its full-dress strike against Dick Ferris in 1985. In his *Hard Landing*, Thomas Petzinger, Jr has a vivid account of what impelled Ferris to give in to the striking pilots:

> But ultimately there arose the issue of cash, which can make even the sturdiest CEO weak in the knees. This affliction hit Dick Ferris on about the seventh day of the strike. Watching cash fly out of the window at a dizzying pace, he called his senior managers together and said he was going to settle on the terms last agreed by the union.

The high level of debt was not the only reason cash had started to 'fly out the window at a dizzying pace'. But it was an important contributory factor. To the extent that it thus strengthened ALPA's bargaining position, it will also have strengthened its confidence in relation to a possible buy-out.

Finally it was not only the numbers themselves but the reaction to them of certain individuals and institutions that help us to explain the 1994 deal. As early as the ALPA buy-out bid which preceded the Ferris resignation in 1987 the pilots 'had conferred with [T.] Boone Pickens. They had consultants on the payroll. They knew what they were doing.'

The fact that the 1994 deal was ALPA's fourth attempt should not obscure the attractions to America's 'financial community' in the 1980s and 1990s of 'leveraged buy-outs', particularly those involving strong businesses, like United. Four points are worth making:

– So long as the operations of the business to be bought out are sufficiently profitable to cover interest charges and debt repayments, the 'arithmetic' will do a nice job for the holders of the equity – by shifting the price of their shares progressively higher.

– The banks and other financial institutions which provide the 'leverage' are likely to be more than content with the relationship between the interest rate they can charge and real level of risk.

– In cases where the new equity holders are substantially the employees of the business being leveraged, there are the extra attractions of the ESOP tax reliefs.

– Whatever may have been the case in earlier times, by the 1980s and 1990s, cash flow projections had probably become the single most important consideration which determined corporate bank lending decisions at least in the worlds of US and UK business. Airlines that can cover their costs are almost bound to have positive cash flows.

Striking evidence in support of these considerations was made available to inquiring visitors at ALPA's headquarters office for United pilots outside Chicago in the autumn of 1996. Evidently the office had received a fair number of friendly incoming phone calls from financial institutions, including the highly prestigious bankers J. P. Morgan. The gist of the message was, to repeat, the same in all cases: if you know of any further deals of the kind which you led in 1994 with United, we would be greatly interested to hear about them.

In the jargon of financiers we might say that the 1994 United deal provided a favourable opportunity for 'securitisation': to offer capital in return for an assured income. In this case, the markets were prepared to offer significant capital in return for payments from the cash flow linked to the salary reductions accepted by a majority of the workforce. We might imagine a senior banker at, say, J. P. Morgan, remarking to a group of pilots: 'Cut us in on the top slice of your income and we will lend you what you need to buy control of the airline.'

The Pilots' Union What then of my second key factor in the background to the 1994 deal? I have called it the 'culture' of the pilots' union, ALPA. The average pay of ALPA pilots must be among the highest of any trade union members anywhere in the world. What is more, up to the 1994 deal United's pilots were certainly among the highest paid of any airline in the US. After taking account of differences in hours flown, they cost in the early 1990s roughly 50% more than those of Southwest Airlines. Pilots also command high social status, both within the industry and in the wider world.

Undoubtedly the ALPA culture contains conservative elements.

Many of the unionised pilots have backgrounds in the armed services. There is also a strong link between pay and seniority, which is measured in years of employment and not normally transferable when a pilot switches between airlines. But it would be a great mistake to expect ALPA to bend over backwards to 'see management's point of view', or be less than wholly committed to the pursuit of normal 'labor union' objectives and the use of normal weapons, including strikes, to achieve them. ALPA's historian, George Hopkins, in his *Flying the Line*, leaves his readers in no doubt about this: 'Skill, courage, and devotion to duty have less to do with why modern professional airline pilots have the best salaried jobs in the world than do history and the Airline Pilots Association. ALPA is first and foremost a labor union, an AFL-CIO affiliate.'

ALPA, a union with a long and self-confident history, was the creation of one man, David Behncke. This remarkable if not altogether appealing man came from a poor farming backgound and had no higher – and not that much lower – formal education. By sheer force of personality he persuaded the military authorities to let him learn to fly in the First World War. His preferred career choice is said to have been as a commissioned pilot in the armed services. But his lack of education made that difficult if not impossible.

Towards the end of the 1920s Behncke was working for Boeing Air Transport – one of the original constituents of United Airlines – as a commercial pilot. Not later than 1929, in the face of concerted efforts by airline companies to cut back on wages following the Wall Street crash, he started spending much of his time as a freelance organiser for a full-blooded labour union of commercial airline pilots. Once set on that course, his behaviour became that of a man driven by a mission. ALPA was formally established in July 1931 and its affiliation to the AFL-CIO – America's equivalent of Britain's TUC – came in the same month.

David Behncke was a man with a truly Goliath-sized ego. Eventually, in what was partly a real tragedy and partly a piece of melodrama, it proved to be his undoing. His staff turned against him and even tried to form their own independent union. In the end he had to be removed from his top post by ALPA's top representative body.

More important for our purposes here is what we may call his cultural legacy to the union he created. I believe that that has two conceptually quite separate elements which in turn reflected two

quite separate 'drives' which impelled Behncke's work for ALPA. One was the straightforward 'class interest' of 'labour' against 'capital' (or 'labour' against top management as the agents of capital). His poor farm home background and lack of education may help to explain the intensity of this drive. The second drive was quite different: its aim was to secure recognition for ALPA as a body that was much more than just a labour union and deserved to be treated as an equal with government and top management in the controlling organs of the industry.

In his drive towards this second goal of ALPA as a co-leader in the industry, David Behncke developed something of a special relationship for the union with President Roosevelt. It was one that persisted under President Truman and has recurred in ALPA's relations with some of the Democratic party administrations since then. At least twice in its history the union has been saved from probable defeat in industrial disputes by Democratic administrations in the White House: by Roosevelt's in the 1930s, and prospectively by Harry Truman's in 1948.

A good illustration of this relationship is what happened in the wake of Harry Truman's victory in 1948. ALPA had chosen to go on strike against National Airlines and in the run-up to the early November vote of that year – in which Truman was pitted against Governor Thomas Dewey of New York – appeared to be losing. National, under its autocratic boss George (Ted) Baker, had evidently managed to replace many of the striking pilots with 'scab labor' and had also benefited from extra airmail subsidies passed on by the Civil Aeronautics Board. By late October ALPA's members had already been on strike for many months and the resources to sustain the action were rapidly running out.

Then, and since then, the informed consensus has been that if Dewey won, the company would have continued the fight and would have seen off ALPA in fairly quick time. But Truman's surprise victory and the resulting prospect of an ALPA-friendly government intervention changed all that. It also produced a classic *volte face*, or, more precisely, what Americans apparently call a 'foxhole conversion' on the part of National's chief executive, George (Ted) Baker (another man incidentally with a Goliath-sized ego):

> Baker suddenly announced that, owing to a deep religious conversion that had put Christian love in his heart and

forgiveness in his soul, he wished to settle. He became a devoted admirer of Dr Frank Buchman's Moral Re-Armament, a religious movement then much in vogue among corporate executives. Immediately after the presidential election, when Baker realised that he had backed the wrong horse, he departed for Dr. Buchman's headquarters on Mackinac Island, Michigan [Hopkins, *Flying the Line*].

Both this 1948 strike against National and the essentially political character of what determined its outcome are helpful to an understanding of ALPA's culture. One of the elements of that culture is clearly a readiness to embark on out-and-out strike action – what the French call 'les grèves à l'outrance'. A second is the assumption of a friendly relationship when a Democratic President is sitting in the White House.

Politically the relationship found its most consequential expression in two key pieces of legislation. One, which permits Government intervention in disputes between management and labour in the airline industry, was still in force when this was written and was indeed invoked by President Clinton, when he intervened in a dispute between American Airlines and its pilots, unionised in their own union, in February 1997. The second piece of law was the Civil Aeronautics Act of 1938. Its importance from ALPA's viewpoint was essentially threefold:

– It set maximum limits on pilots' flying hours.

– It gave legal protection to a formula which linked pilots' pay rates to miles flown. It thus gave them a built-in cut into productivity improvements associated with higher aircraft speeds.

– By giving the unionised pilots independent representation on the industry's safety watchdog, it went some way towards recognising ALPA as the third member, alongside top managements and Government itself, of an industry-wide ruling *troika*.

It is true that the provisions of this 1938 Act relating to pay and conditions were swept away by President Carter's deregulation measures of the late 1970s. On the other hand ALPA's independent representation on the industry's safety watchdog has survived. In my view this should be seen as an example of the way that ALPA both sees itself, and is seen by the public, as having something of a second personality in addition to that of a labour union: a second personality as something of an airline industry 'statesman'.

What is indisputable is that America's professional pilots were held in astonishingly high regard by sections of the public in the 1930s. George Hopkins quotes a telling passage from a speech made by Representative John Martin of Colorado in 1938:

> In my opinion the piloting of these great airplanes is the most responsible, the most skilful, occupation mankind has ever engaged in. It is a profession to which many are called but few are chosen. These men ought to be as free from worry about their economic condition or future as it is humanly and legislatively possible to achieve. If there is anything we can put in the legislation that will keep worry from the airline pilots, it ought to be done.

That such sentiments should have been expressed in the Congress is a remarkable tribute to the political skills of David Behncke and above all to his success at playing the 'safety card' in the interests of his members.

The Background at United We must next ask why it was at United, rather than at another of America's top airlines, that the first deal of its kind happened to take place. The analysis so far is of some help. The pay and allowances of United's pilots were above the average for the industry. Taken together with the company's strong balance sheet that tended to mean that the opportunity for a deal was probably more favourable at United than at most of the other US airlines.

A second strand of explanation arises from the evolution of relationships over the years between ALPA and UAL's top management and from the business philosophy and backgrounds of its successive chief executives. There were just four holders of the top post between the early 1930s – when United took on more or less its present form and became an airline rather than an airmail carrier – and 1987:

UAL's Top Managers: 1934 to 1987

Name	Dates	Industry Background	Orientation
W. A. Patterson	1934-66	Banking	Humanistic
George Keck	1966-70	Internal appointment	Unclear
Edward Carlson	1970-74	Hotels	Profit
Richard Ferris	1974-87	Hotels & catering	To own the world

There is evidence that before the first Roosevelt presidency and the New Deal which went with it, **Patterson** was unenthusiastic about unionised labour in general and a pilots' union in particular. But there is no doubt at all that he later came to accept ALPA, and even to see virtue in its role. Frank Taylor leaves no doubt on this point. After asserting (*High Horizons*, pp. 167–89) that 'unions have played an important role in Patterson's scheme of things' he goes on to quote the man's own words: 'When all the ideas are contributed from one side, it is impossible for an employer to know if he is doing everything he can for his people. Unions call your attention to things you will never notice.'

Given that United was able to achieve adequate profits, Patterson was a 'people oriented' businessman. In the 1950s, way before their time had come, he introduced a company-assisted employee share scheme. Though its active life seems to have lasted for hardly more than six years, it is clear evidence of the direction of his thinking. The same is true of his company pension plan, the first in the industry. He made his business philosophy quite explicit in what he wrote and said: 'The balance sheet of United Airlines places no dollar and cents value on our employees, but in my opinion they represent the most important asset the company has on its books.'

Evidently he had a habit of speaking about the company as if it were a responsible moral person rather than just a corporate entity. My second quote is if anything even more striking: 'I keep asking myself what kind of *person* is United Airlines.'

Patterson goes on to offer as his answer what he thinks it *ought* to be: 'A man who devotes the best years of his life to United is entitled to the assurance that the company, next to his family, is his best friend in time of need.'

And yet it would be a great mistake to think of Patterson as soft. Indeed he stood up to a pilots' strike and won. The contrast in this respect with Dick Ferris, his successor but two in the top post, could scarcely be sharper.

George Keck was hand-picked by Patterson from United's more youthful senior managers to succeed him. He was unlucky in the timing of his appointment. It coincided with the coming into service of the big new jumbo jets, which brought altogether new levels of overcapacity. Most of the country's top airlines started losing money. Keck was also unlucky in that during his innings United lost its near-monopoly position for flights between the West Coast and Hawaii.

For our puposes here, the Keck years are important for two reasons. The first is the losses sustained during them – which partly explain the degree of priority assigned by his successor to making profits. The second is that his final year marked the first step in a new policy of diversification into non-airline tourist businesses. In 1970, using the mechanism of a complex exchange of shares, the airline effectively took over Western International Hotels. What is more, when they sacked George Keck the board of directors offered the post to the man who was the hotel chain's chief executive, Edward Carlson.

By eliminating unprofitable routes and 'downsizing' manpower, **Carlson** succeeded in returning the business to profit in fairly quick time. The airline had run up losses of roughly $50m. in Keck's final year, 1970. The next three years saw a turnaround. 1971 . . . $5m loss; 1972 . . . $20m profit; 1973 . . . $51m profit.

Carlson's main goal was 'to make United the industry leader in effective profit ratios and the leader in earnings' (Johnson, *Airway One*, p. 182). Fair enough. Businessmen like the UK's Lord Hanson have adopted much the same goals with some success. But Patterson's stated goal – to make United the *best* airline – was rather different. Moreover it is hard to believe that Carlson's 'downsizing' exercise endeared him to the United unions.

But perhaps the biggest single factor in this analysis of why what happened happened at United, rather than elsewhere the pilots' pride in their profession. It is impossible not to believe that the pilots resented having a hotel man in the top position. From the thinking of the influential United pilot and successful ALPA strike leader, Rick Dubinsky, we know that there was strong pilot hostility to the policy of non-airline investments which had been started by George Keck and was continued by his two successors. What I am now suggesting is that the pilots may well also have resented the passing of the airline's leadership to a man from the hotel trade. It is true that much later their candidate for the top position, Jerry Greenwald, came from Chrysler, and not from the industry. But Greenwald's well-known sympathy with labour was sufficient to outweigh the negative factor of his non-industry background.

At Western International Hotels, Carlson had reached the top entirely through his own efforts. **Dick Ferris**, by contrast, was essentially a Carlson creation. As a young hotel manager he had caught Carlson's eye. Moreover it was Carlson, when he took over the top post at United, who invited Ferris to join him at the airline and become the manager of its kitchens and in-flight catering services. Finally, it was on Carlson's recommendation that United's board of directors accepted Ferris as Carlson's successor. He was then less than forty.

Two trends stand out in Dick Ferris's thirteen-year reign from 1974 to 1987. Each culminated in dramatic events. The first was the ever-increasing competition which followed President Carter's deregulation of the domestic American airline industry at the end of the 1970s. That was the key factor behind the dramatic pilots' strike which was courted by Ferris in 1985 and then lost by him. The second was an extension by Ferris of the policy of diversifying into non-airline tourist industry businesses which had been started by George Keck in 1970 and then continued by Carlson. The extension of that policy precipitated two dramatic events in quick succession: the first ALPA attempt at a buy-out of the business in 1987, and then, no more than weeks later, successful pressure by 'investors' to remove Ferris from his top post and to unwind all, or almost all, of the diversification which had taken place.

Partly because they had a big influence on the 1994 deal, the key specifics of the 1985 strike are worth spelling out. The airline had come to be faced by increasingly ferocious competition on its short haul routes especially in California and the south west, where Southwest Airlines was its main competitor. Though it was in fact at that time more, rather than less, unionised than UAL, Southwest had substantially lower pilot costs. So too, on its shorthaul flights, had American Airlines. Here Robert Crandall, Ferris's counterpart as CEO and arch-rival, had achieved a breakthrough deal some years before with his unionised, though non-ALPA, pilots: a two tier wage system such that pilots flying short haul services were paid significantly less than what had previously been the going rate for the job. What precipitated the 1985 strike at United was an attempt by Richard Ferris to impose on its pilots a long term two-tier wage scheme on lines similar to those negotiated by Robert Crandall. He failed. But it is also true that United's pilots had accepted such an arrangement, on a short term basis, even before

they came out on strike. What is more, that arrangement was in fact incorporated into the final strike settlement.

The pilots' success in their 1985 strike can have left them in no doubt of their power at United when they chose to play in their labour union role. It is a fair bet that Dick Ferris was a poor loser: 'Dick Ferris displayed all the caveman aggression that gripped Bob Crandall – the impatience for victory, the compulsion for control, the desire to dominate.' (Petzinger, p. 64.)

Ferris's subsequent sortie into major new acquisitions should be seen at least in part as a 'rebound response' to having lost the strike of 1985. In quick succession in late 1985 and in early 1986, he bought first Hertz, the car rental business, and then the Hilton hotel chain. United paid just under \$600m for Hertz and approximately \$1bn for the Hilton hotels. Huge sums of money were borrowed to finance these deals. On the other hand, given the prices at which they were later sold on, Dick Ferris is entitled to claim that they were bargain buys. Nevertheless these acquisitions were made at the expense of new investments in the actual airline businesses. This was the light in which they were fundamentally seen by Rick Dubinsky, the highly influential ALPA member at United who had been a key figure in the leadership of its great strike.

By Dick Ferris they were evidently seen as the major building blocks of a vast tripodic travel empire which would circle the world with its international airline routes and spread out all over it with hotels and hire cars. Every kind of wonderful 'synergy' was foreseen, and with advice from appropriate consultants the new 'vision' was even given a new name: the Allegis Corporation. Ferris was apparently 'thinking less and less about airplanes. He still had the number one airline, and on top of that the number one car rental outfit and the number one hotel chain in the world. As he later put it, "We were ready to own the world."'

It was not to be. Here indeed we may reasonably suggest that, as with David Behncke in the early 1950s, so with Dick Ferris in the middle 1980s, his Goliath-sized ego caused his downfall.

First it blinded him into a making a grave misjudgement about his own and ALPA's relative staying power in a trial of strength. He provoked ALPA, the labour union, into a strike which he lost. Second, his vision of 'empire' and the non-airline businesses which he acquired in pursuit of it, brought ALPA back on to the stage. But this time, in 1987, ALPA was playing its other role – as an airline industry statesman; and it was bidding to buy the business in order to save it from Ferris's imperial dreams.

That bid was not itself a success. Nevertheless it was a key stage in a process which led to a revolt by United's leading shareholders. They insisted that Ferris resign, that Hertz and the hotels be sold, and that a big part of the proceeds of sale be returned to shareholders.

THE WOLF YEARS: 1987–94

After an interregnum of a few months, and a search on both sides of the Atlantic, Stephen Wolf was brought in to the top executive position in the autumn of 1987. He was the third man to be offered the post, after Sir Colin Marshall at British Airways and Robert Crandall at American Airlines. Nevertheless, he is understood to have had the strong backing of the United director who became responsible in its later stages for leading the search for a successor: none other than the celebrated and moon-landing astronaut, Neil Armstrong. The deal agreed between the two men included options for Wolf over 250,000 UAL shares.

At the time of his appointment it was his industry experience rather than those options which were important. His instructions were to sell the non-airline travel businesses – the hotel chains and the Hertz car rental operation – which had been acquired under his three predecessors, and then concentrate all his energies on the airline itself.

Stephen Wolf was in fact a top industry professional having served a fifteen-year apprenticeship in senior positions at American Airlines. He had also built up something of a reputation for toughness: for having successfully carried through a number of wage and manpower reduction exercises. It was on these episodes that the pilots at United chose particularly to focus. The ALPA organisation at United was hostile to him from the start, partly because of his toughness and partly because many of them remained strongly committed to a pilot-led buy-out and saw the new top executive as an obstacle in the way of realising that goal. There was probably at least an undertow of pilot hostility to him throughout his seven years at United, and that notwithstanding the fact that in 1989 he joined ALPA in a failed buy-out attempt which he had been persuaded to lead.

At the low point of its fortunes in the ALPA strike year of 1985, the business made a loss of just under $50m on a turnover of some $5.25bn. By the end of 1988, the first full year of Wolf's watch, the results showed a dramatic turnaround to record profits of over $1.1bn. In between, the new chief executive had successfully sold off Hertz, the Hilton chain and the other hotels. The accounts for 1988 include a second dramatic number as well as the best ever profits. They show shareholders equity at just $1,226m, down from $2,922m in 1987. The non-airline businesses had been sold well and substantial capital gains had been returned to shareholders.

The 1989 Buy-Out Attempt: Stephen Wolf Joins ALPA At least as early as the 1985 strike, United's pilots had started to argue that investment in the airline was being starved to free up finance for the purchase of non-airline businesses. The return to shareholders of substantial capital gains resulting from the sale of Hertz and the hotels must surely have strengthened the position of those in the union who argued for a buy-out. For they became entitled to assert that unless and until ALPA had a main voice at the top table, the long-term interests of the airline were liable to be put behind those of financial 'investors'.

ALPA's determination to acquire a big say in strategic decision making was one factor behind the buy-out attempt of 1989. The other was an unsolicited $5.4bn bid for United which surfaced from a Californian 'investor', Marvin Davis, in the summer of 1989. It had the effect, if nothing else, of concentrating minds at United's headquarters outside Chicago: Stephen Wolf was persuaded to join forces with ALPA in an attempted 'internal' buy-out of the business which, if successful, would have taken the airline private under his leadership.

With an infusion of $750m. provisionally promised by Sir Colin Marshall at British Airways, Wolf and United's pilots put together a prospective offer of just under $7bn. It exceeded Davis's earlier bid by a comfortable margin and was indeed provisionally approved and accepted by the board of directors. On the other hand, it was to be massively financed by debt: by borrowings from banks scattered across the world, but with disproportionate involvement by banks in Japan.

On Friday 13 October 1989 the Japanese banks withdrew from the deal. The provisional bid put forward by United's ALPA members and Wolf instantly unwound. United's pilots tried yet again to mount a bid in the autumn of 1990 – this time on their own. Partly because of the nervousness which had followed Iraq's invasion of Kuwait, it proved impossible to raise the necessary finance. However, this third buy-out attempt by the pilots had one important legacy. They approached Gerald Greenwald and made him a conditional offer of the post of chief executive – conditional on the implementation of a pilot-led buy-out, then or later.

Increasing Competitive Pressures: 1989 to the Buy-Out Deal From their high point of $1,124m at the end of Wolf's first year, United's profits (net earnings) fell in each of the four years to 1992. There was something of a rebound in 1993, but not enough to return the airline to profit.

Results: Profits & Losses over Six Years to 1993. $m.

1988	Profit 1,124	1991	Loss 331
1989	Profit 324	1992	Loss 957
1990	Profit 94	1993	Loss 50

During the very difficult years of the early 1990s, United's performance was slightly less bad than the average. Nevertheless its huge 1992 losses of nearly $1 billion made the need for radical change inescapable.

Apart from general overcapacity and the effects of the Iraqi invasion of Kuwait, United faced a particular threat from Southwest Airlines, especially in California. Southwest had just a 2% share of the California market in 1988. That had grown to 47% by 1993. United's share of that market also increased but much less dramatically – from 14% in 1988 to 26% in 1993. Moreover, whereas United showed a loss on its West Coast operations at least from 1991 to 1993, its main rival in the region was continuously profitable. In competition with Southwest, the United cost base, at least down to the 1994 buy-out, was well out of line.

The biggest single element in United's higher costs was almost certainly that associated with paying its pilots. After adjusting for the longer hours flown by the latter, its pilots in California are understood to have been roughly 50% more expensive than Southwest's.

Wolf and his top management team made as their first proposal a $400m cost reduction plan. It included job reductions in the low thousands but did not touch the pilots.

It soon became clear that those measures would not be sufficient. At this point, in the early months of 1993, Wolf opened discussions about tougher measures with all the unions at United and especially with ALPA. The pilots reacted sharply:

> 'Downsizing', Roger Hall of ALPA told Wolf, 'means war'. It would be one of the most cataclysmic wars ever, Hall vowed. It would make the pilots' strike of 1985 look like a warm-up act. Hall warned Wolf that he had no idea how bad it could get: 'You've never been involved in one of those and I have.' [Petzinger.]

Given ALPA's victory in 1985, we must assume that the threat was not lightly dismissed. In any case soon afterwards the management switched from an active role in the resolution of the crisis to a more reactive one. In June 1993 it agreed to discuss with ALPA and the other unions the pilots' old scheme for an employee buy-out of the business. In putting forward this scheme once again, ALPA's leaders evidently indicated to Wolf that the sacrifices he was looking for might just be acceptable if enough stock could be offered in return and if there could be appropriate guarantees of employment security.

And that – as we know – was more or less the bargain which was eventually struck. Moreover, given the magnitude of the issues and the unprecedentedly high numbers, the negotiations between the parties which made the bargain possible seem, with just two main qualifications, to have been rather smooth. The only other main characteristic of the bargaining process will scarcely surprise many readers: the early offers to the United's existing shareholders had to be substantially raised.

There were two significant hitches. First, in the early autumn the cabin staff, organised in the Association of Flight Attendants (AFA), decided to withdraw. For one thing the AFA membership already had two pre-agreed annual wage increases of 4% in the pipeline. Those would have to have been forgone, as part of an agreed reduction, had the union remained within the deal. The AFA was also in dispute with United's management on at least two specific issues. The first was the recruitment of non-US attendants at a number of overseas centres to service selected international routes, and the second a set of weight restriction rules which were later lifted.

Mr Kevin Lum was the AFA's President at the time, and still held that position when this was written. He argues that the first of these issues was a specially serious problem for the union and its members because it had 'resulted in real job losses and greatly diminished earning power for flight attendants who have been long time United employees'. As for the weight restrictions which were later lifted, Lum sees them as a 'classic example of disparity between how flight attendants were treated at work versus the rest of them'. He argues that they were not the only example of relative discrimination against flight attendants.

Third, though the influence of this has been more inferred than demonstrated, the relatively low wages of the flight attendants are thought to have made wage reductions that much less acceptable to their members than was the case for members of ALPA and the IAM. For the record, the AFA fully accepts that the pay of many United employees in the non-union group is substantially lower than that of its own members.

Lum also criticises the two other unions. He claims that there was an understanding from the outset that the possible buy-out was a 'union coalition' project and that therefore if any one of the three unions felt obliged to withdraw, the other two would follow suit. Neither ALPA nor the IAM accept this claim.

The second hitch should perhaps be better described as a crisis. It involved not the AFA but the machinists, and it came close to derailing the whole negotiating process in November 1993 – only weeks before the approval of the provisional deal in December. Management announced a unilateral and non-negotiable decision to sell the airline's flight kitchens. An enormous number of IAM members, just over 5,000, were affected, and in consequence the whole buy-out project seemed to be briefly at risk. But as it was, the negotiations survived the crisis. It should also be put on the record that when the final deal was eventually signed it included higher redundancy payments for the luckless former kitchen staff.

Especially perhaps for the benefit of union readers in Britain, it is worth commenting briefly on the involvement of the IAM in this whole employee ownership project at United. It need hardly be emphasised that despite the very high skill levels of its aircraft maintenance membership, the IAM is a much more 'normal' union than ALPA. What is more, on each of the three earlier ALPA attempts at a buy-out of United, the IAM had said a firm and unequivocal 'No, thank you' when invited by the pilots to take part. If we ask why their leaders agreed to be involved on this occasion, the answer is both important and in no serious doubt. They judged that a combination of the prospective employment security and a voice in the top decision-making body would justify a deal if the right terms could be agreed. Evidently, if only by a small margin, this judgement survived the sacrifice of IAM members' jobs in United's former kitchens.

So much for the IAM. What of the bargaining process itself? In the formal document which went to existing shareholders and which is called in America a 'Proxy Statement/Joint Prospectus', there are brief references to the main stages of the process. What they show is that the 'coalition' of United's unions had to increase its earlier offers very substantially before agreement was eventually reached. At the start this applied to all three, but after the AFA's withdrawal, only to ALPA and the IAM. For example, on 11 November, a proposal presented by ALPA and the IAM is reported as having had a nominal value of \$3.496bn and a so-called net present value (at a 9% discount rate) of \$2.874bn. By contrast, as we know in the deal which was finally completed, the net present value of what was put on the table by the two unions and the non-union group together was \$4.886bn. That was on the basis of a 10% rather than a 9% discount rate. In pushing for that higher figure, those who represented the interests of the existing shareholders insisted, according to the prospectus-type document, on a 'key requirement in any transaction involving the transfer of control: to deliver an appropriate premium over market to the holders of old shares in a transaction that was fair to such stockholders'.

It only remains to be noted that in the final and critical stages of the bargaining process a key contribution was evidently made by Felix Rohatyn, a senior partner in the New York investment bank of Lazard Frères. As some readers will know, Mr Rohatyn is probably the most distinguished member of America's top financial community to have come out publicly and forcefully in favour of the widespread promotion of employee ownership and profit sharing. His bank has also had a hand in a number of the most important employee ownership deals in America since the early 1980s.

Rohatyn's involvement in the final stages of the bargaining process is a detail. But it was clearly important at the time. From a public relations and political viewpoint, it will continue to be so. But in any event a provisional buy-out deal was approved by the United board of directors on 21 December 1993. Effectively it offered over 50% of the corporation's voting equity, embodied in special voting preference shares, to a combination of members of the two unions which had stayed in the negotiations – ALPA and the IAM – and the airline's non-union staff. The share capital was offered in return for wages and other concessions estimated to have a prospective 'net present value' of about $4.886bn. The prospective employee owners were also offered solid employment guarantees through the approximately six-year lifespan of the main deal, and voices at the top table for a much longer time.

Between the provisional deal approved by the board of directors in December 1993 and the one completed in July 1994 there was perhaps one significant change, though it was evidently not too problematic. The percentage of the United stock to be acquired unconditionally by its employees was increased on the margin: from 53% to 55%. There were also some small changes in what was almost up to the last minute a package of money and securities offered to the existing owners in return for the reduction of their equity stake from 100% to 45%. But these latter are understood to have been essentially technical adjustments. For the record we should note that in the deal that was actually completed the existing shareholders, apart from their shares in the 'recapitalised' business, received just cash rather than the combination of cash and loan notes originally proposed.

We will set out the main details of the transaction in the next section. But here it is worth offering a comment or two on what might be called its ideology. The first is that it was evidently not popular with sections of what might be called the conventional capitalist establishment – for example with editorial writers on the *Wall Street Journal* and the London *Economist*. Conversely it was most popular with the ALPA pilots' organisation at United and its members. This is scarcely surprising given that an ALPA led buy-out had been a semi-explicit goal of the pilots for nearly ten years and that they were the prime movers behind the whole process.

We should note finally that in the case of ALPA the deal was approved by a comfortable majority of its so-called Master Executive Council at United. The ALPA leadership was evidently

sufficiently confident of its members' support not to go for a members' vote. On the other hand, in the case of the IAM a vote was taken among the members. The total numbers in favour were in a majority but by only a small margin. The result was indeed later challenged and the challenge only seen off with some difficulty.

THE DEAL

> *Within a close* [emphasis added] range, what are the employees going to be paying for this stock which should have a street value of approximately $85 per share?
>
> ... While it is our view that the employees in the aggregate are paying more than $1.00 of investment for $1.00 of stock (based on the Company's going-in projection of $85.00 per share of stock), there are a number of non-pecuniary benefits received by the employees, such as job security and governance provisions, the value of which it is impossible to quantify.

The above was one of a series of questions and part of the answer included with the information circulated to ALPA and IAM members with the letter of 22 December 1993, signed by Captain Hall and Mr Thiede, and quoted in this case study's epigraph.

Whether we call the transaction an 'employee buy-out' or a 'plan of recapitalisation', or indeed a hybrid, its logic and its arithmetic will only be understood if readers keep three key considerations in the front of their minds:

– When a business is basically strong, then, compared with the going price of its shares in public markets, the purchaser of a controlling interest must expect to pay a premium.

– Other things being equal, the premium will be that much higher if the original initiative for the transaction comes from the prospective buyer.

– Existing holders of what will become a minority interest, may favour the application of a part of the value put up by the buyers to a strengthening of the capital base of the ongoing business – rather than to an increase in the cash price they receive for the shares due to be sold by them under the deal.

The key to understanding this unusually complex hybrid deal – part buy-out and part recapitalisation – is, I think, in the last of those three points. Looked at from the viewpoint of the employee buyers, there is the $4.886bn of net present value which they eventually put on the bargaining table and which persuaded the existing shareholders to approve the deal.

On the other hand only a part of that $4.886bn was in fact transferred directly to the existing shareholders in a package which, for each of their old shares, combined a cash payment with a half share in the stock of the recapitalised business. The balance of the $4.886bn of value brought to the table by the employee shareholder buyers was not transferred to the sellers but is being – or will be – reinvested in the business for the benefit of both the business and the whole shareholder body. Using this breakdown, we might reasonably characterise that part of the value transfer that went to existing shareholders as a 'buy out', and the balance as a recapitalisation exercise.

It is an essentially linguistic and therefore trivial point whether we say that what the employee shareholders 'paid' for their shares was the whole of that $4.886bn of net present value which they brought to the table, or alternatively only that part of it which was of direct benefit to the existing shareholders and of benefit to them alone. What is more important is the breakdown of the $4.886bn into those two analytically separate components.

Against this background, we can now go on to look at some of the main numbers associated with the transaction.

Some 28.9m of United's old shares were outstanding when the deal was completed. As against that number the deal provided that trustees acting for the new employee shareholders would acquire a total of 17,675,345 new shares in the recapitalised business, representing 55% of its voting capital. That actual number of new shares was arrived at essentially by arithmetic. If half of the old 28.9m shares are to account for 45% of the shares in the recapitalised business, then the number of shares which corresponds to 55% is 17,675,345.

It remains to put a value on the package of cash and a half share in the recapitalised business for which the existing shareholders exchanged each of their old shares. In round figures and on the basis of the opening price at which the new shares were traded in July of 1994, the value was $130 per old share, of which roughly two thirds was the cash component.

For the record and for what it is worth we are now in a position to offer two alternative answers to the epigraph's question: 'What are employees going to be paying for this stock which should have a street value of approximately $85 per share?'

We get one answer to that question if we take the view that what the employees 'paid' for their 55% stakeholding in the recapitalised business was the whole of the $4.886bn of net present value which they eventually brought to the table. In that case, by dividing the $4.886bn number by those 17,675,345 shares we come out with a figure of roughly $277 per share.

On the other hand, if we take the view that what the employees paid was only that part of the $4.886bn needed to provide for the $130 of value with which, for each of their old shares, the existing shareholders emerged from the deal, then, of course, what the employees 'paid' for their shares was that much lower – something like $3.7bn in total and something over $200 per share.

If we have to choose between the two answers, there is a further specific argument which favours the second and lower pair of numbers. The deal provides that all the employee shares will be allocated to individuals by the end of the year 2000. But some key concessions in the make up of the $4.886bn will still at that date have a further six years to run.

Before going further we need a better understanding of the concept of 'net present value' (NPV). In the technical language of accountants the $4.886bn figure represents the *discounted* NPV, on the date of the transaction's completion, of the agreed employees 'investment'. The latter is a combination of the wage reductions accepted by them and of the other 'concessions' that they agreed to offer.

For those not fully at home with accountants' language, I hope a brief word of further explanation will suffice. The same table in the prospectus document which is the source of the $4.886bn estimate of the NPV, also offers a second big number: viz. the sum of all the money values year by year which are to be given up by the employees over the duration of the deal. That second number is not $4.886bn but $8.190bn. With minor qualifications the second number is reduced to the first by applying a progressive discount of 10% to the annual totals after year one. The amount of the discount was settled by negotiation but was also taken to reflect the weighted average cost to the business of the capital employed by it. Readers with a taste for detail may like to know that the then weighted average capital cost at United reflected a relatively small percentage of high cost equity and a much larger percentage of lower cost debt. This is the standard method of valuing 'future money' for the purposes of a transaction completed on a particular date. There can be arguments about whether the 10% discount rate was fair. Indeed the unions predictably argued for 9%. That would have increased the NPV of their wage cuts and other concessions. On the opposite side, others predictably argued for 11%. There can be reasonable disagreement about which discount rate most closely reflected the relevant realities. But no one could reasonably quarrel with the method used to make the valuation.

We will turn back just once more to the question about what the employees are paying for their stock raised in the epigraph. As we have seen, the two union leaders conceded in their letter that 'it is our view that the employees in the aggregate are paying more than $1.00 of investment for $1.00 of stock (based on the company's going in number of $85 of stock).'

But Captain Hall and Mr Thiede are careful in their subsequent discussion not to offer a numerical answer to the question at all. Instead the discussion introduces an array of qualifications, with the implicit aim of persuading the reader that the answer should not simply – and crudely – be found by setting the NPV of the employee concessions against the total number of shares acquired, and then reaching a price per share by long division. The qualifications were:

– That the number of shares to be purchased was not yet known.

– That valuing the employee concessions was an inexact exercise.

– That it was hard to be sure what alternative might have been on offer if the proposed transaction had fallen through.

– That in addition to the actual shares they were 'buying' with their wage reductions and other concessions, the employees also stood to benefit from 'a number of non-pecuniary benefits . . . such as (i) security and (ii) governance provisions'.

It makes sense to look at these briefly in turn.

About the first we are now in a position to take into account what actually happened within a range of possibilities set out in a formula contained in the July 1994 agreement. The range reflected different views, as between the company and the unions, about the evolution of the price of the new shares which would be traded on Wall Street after the deal.

Predictably the unions expressed their belief in a higher, and the

company in a lower price trajectory. What was agreed in negotiation was that if, in the twelve months after the deal's completion, the average price of the new shares exceeded $136, then the $4.886bn of NPV committed to the transaction would buy more than just 55% of the shares in the new stock. A sliding scale was in fact agreed such that in the limiting case – reached if the average share price over the first twelve months was to exceed $149.10 – the 55% would jump to 63%. However, as it turned out, and though the price of the new shares later climbed rapidly higher, the condition of exceeding the average price threshold of $136 agreed for the first twelve months was not met. And so, retrospectively, the first qualification fell away.

The second and third qualifications are about two separate difficulties: of putting a precise value on the employee concessions; and of comparing what is proposed with any alternative. In both, the concern again is to persuade the questioner that the employees are not being required to pay too much for their shares. One possible rejoinder in the first case is that the qualifications may cut either way. The estimated value put on the employee concessions may be too low as well as too high.

The qualification about the problem of comparing what is proposed with whatever might be the most likely 'non-deal' alternative is harder to evaluate convincingly. It is true that any alternative would almost certainly have involved compulsory redundancies. For example, at Delta Airlines, as we know, redundancies were imposed on between 10% and 15% of the total workforce. To that extent what we may in part be dealing with here is the security of employment offered by the deal to which we move on next. For the rest the reference to an alternative 'base case', and to the difficulty of assessing it, may in part reflect no more than the strong commitment of the ALPA leadership to the proposed deal.

Pursuing the qualifications, the sceptical commentator might even offer a 'could cut either way' rejoinder to the penultimate one: namely the extra employment security which will be enjoyed by the participants as a result of the deal. My point is that given the resulting reduction in the sources of possible management/labour disagreement, the 'bottom line' of the business, as well as the individual employee shareholders, may benefit from the new levels of employment security.

We are left with the final qualification in the response in the union leaders' letter to the key question: 'What price are the employees being asked to pay for the shares?'

This last is about what are called – perhaps a little quaintly – the 'governance provisions' in the deal: that is the provisions under which each of the two unions, and the non-union employee group, are to be represented on the board of directors and to have considerable other influence at board level as well. The provisions were flagged in the introduction. They are set out alongside other details at the end.

Put more robustly, this last qualification about the price paid by the employees for their shares, has to do with a 'control premium' which must be assumed to figure in a price which has to be paid for a shareholding in an essentially strong business, which confers control. In a business of the kind that United was in 1994, this premium would be significant as well as positive. We may remember too an important passage in the prospectus document where it reviews the bargaining process which led up to the deal, which was quoted earlier. This passage explicitly points up the requirement of a control premium. Prospectus readers are told of 'a key requirement in any transaction involving the transfer of control: to deliver an appropriate premium over market to the holders of old shares in a transaction that was fair to such stockholders'.

Given the earlier breakdown of the NPV of the employee concessions – into what was needed to cover the compensation to the existing shareholders and a reinvested balance – it seems to me impossible to make any persuasive estimate of the size of whatever was the control premium in this case.

In any event, it is clearly not possible to be sure that the existing shareholders could have been persuaded to do a deal in return for substantially less in the way of concessions than what was actually given up. Moreover, once the deal was agreed it became in a sense true by definition that the premium embedded in it – whatever that was – was simply what the 'market', essentially the existing shareholders, had demanded.

We may conclude this discussion about what the employees 'paid' for their shares by allowing for the possibility that there is likely to be a different emphasis in the answer offered to different groups. For a financial community audience, it must make obvious sense to put the emphasis on just how much was being paid, on *how reasonable* from the viewpoint of the sellers was the offer from the buyers, and *not* to subject the headline number of $4.886bn to a host of qualifications.

On the other hand, when the question is being answered for an audience of the buyers – of ALPA and IAM members and of the non-union employee group – the emphasis is likely to be different. To the buyers the deal needs to be defended against the charge that they are paying too much. So there will be an inevitable tendency to stress the qualifications to the headline number.

I come on next to three further and more or less general aspects of the deal. The small print details, to repeat, are spelt out at the end of this chapter.

The first was already flagged in the introduction and is reasonably straightforward. In shorthand it is referred to as the 'snap back' question: whether the deal provides for the wage reductions, and other concessions contributed by the employees, to be restored at the end of the deal's duration – that is at the end of either five years and nine months or six years in the case of the major sacrifices, and of twelve years in the case of the subsidiary ones.

As readers already know in a general way, the original answer to the 'snap back' question was radically changed in the agreement which eventually emerged from the 'mid-term wage adjustment process'; and was then ratified in a vote by the membership of the company's two ESOP unions, the pilots and machinists. Under that agreement the company became committed to restore the pre-ESOP wage rates once the duration of the main deal finishes in the year 2000. There will then, at minimum, be an automatic 'snap back' of the main wage cuts.

Up to the time of that 'mid-term' agreement there was no such commitment on the part of the company and thus no guarantee of a 'snap back'. But the change, which is certainly seen by the ALPA leadership as being of great psychological and political importance, is not quite the end of the story. For our purposes here it is enough to say that the automatic 'snap back' agreed in March 1997 does not apply to the set of subsidiary concessions which figured in the 1994 deal and which extend in time to 2006. For the pilots those concessions include the rates paid and hours flown on the 'Shuttle'. In the absence of further negotiated changes, these will remain below the fully 'snapped back' rates by the same percentage margin as provided in the original deal. For the machinists these longer term concessions include the continued giving up of their pre-1994 paid lunch break and an important concession about outsourcing: up to a 20% maximum of maintenance work outsourced until 2006.

Second, it is necessary to say a word about mechanics: how shares in the business reach the participating employees. What are initially allocated to employees are not shares in UAL's common stock but preferred shares which, however, also carry a vote. Normally preferred shares enjoy votes only in narrowly defined circumstances. On the other hand, in line with common practice, these preferred shares in United attract dividends year by year, but dividends in this case not in money but in the form of additional preferred shares. Dividend shares are allocated annually after the first year to the value of 8.89% of the accumulated balance of an employees' shareholding. For the rest only when an employee shareholder retires or leaves for other reasons are his or her preferred shares converted into shares in UAL's common stock. One main reason for this cumbersome process is tax efficiency.

But we should also acknowledge that these arrangements offer a quite unambiguous link between the ownership interest of United's employee shareholders and the value of the shares in the company's common stock on the date when the conversion from their preferred stock takes place. The total numbers of the preferred which may be distributed under the deal in a combination of straight allocations and dividends is, as we know, fixed at the figure of 17,675,345 already identified several times.

Up to the time of writing the price of the shares in the corresponding United common stock had easily outperformed those in other competing airlines. Moreover, in May 1996 each of the original shares had been split into four. In the absence of a major future price fall, the employee shareholders will convert their preferred shares at a dollar price way above the notional value of the preferred shares when the deal was completed. Those prospective gains, provided they remain secure, will do much to mitigate criticism of the 1994 deal to the effect that the 'price' paid by the employees was too high.

But we still have to raise one more big question: who has benefited from the ESOP tax reliefs associated with the 1994 transaction? Given that those reliefs over the period of the main employee concessions are estimated to apply to accounting charges

of some $4bn, the way that the tax reliefs have been treated in the deal is clearly not a marginal issue.

Here again a word of explanation may be helpful for lay readers. What is involved is the company receiving a tax relief relating to an 'approved accounting charge' which is not a cash payment. In this case United is able to claim a tax relief for 'payments' which it makes each year to the ESOP trustees to enable them to buy shares for employees. These, however, are then immediately returned by the trustees in exchange for shares purchased. So what is involved here is simply a set of book entries or 'accounting charges' with no actual cash payments at all. However, in cases of approved payments of this kind to ESOP trustees, American tax law allows companies to treat these 'charges' as if they were actual cash payments.

It may also be helpful to spell out how exactly the tax relief works and what it amounts to. There are three key points to grasp. The first is that the accounting charges are not themselves the same as the tax reliefs. The reliefs are just 40% of the charges – namely the amount of extra corporation tax which would have had to be paid in their absence. The second is that the accounting charges theoretically finance the purchase for employees of those preferred shares which we identified earlier. Third, the size of the charges from which United is permitted to benefit will vary in part with its share price: the higher the share price, then the higher the 'accounting charges' from which the company may benefit, although under the country's ESOP laws there is a maximum 'accounting' charge for which a business may claim benefit.

The Harvard 1995 study projects what then seemed to be the likely amounts of these accounting charges over the six-year life of the deal's main provisions. The assumptions on which the projected numbers were based have partly been overtaken since then. Nevertheless they will help readers to understand the orders of magnitude of what is involved.

Non-Cash ESOP Accounting Charges: Projections Years 1 to 6

Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
619	630	642	662	689	532

The projections enable us to have a useful order of magnitude estimate of the value of the associated ESOP tax reliefs over the six-year period. Added together, the six-year total of these projected charges comes to $3,774m. The corresponding tax relief, at 40% of that number, comes to just over $1,500m.

We are now in a position to understand rather more clearly the answer to the question posed earlier: who benefits from these substantial, $1,500m-odd, ESOP tax reliefs?

The short answer is that both the employee shareholders *and* the business benefit from these reliefs.

The letter from Captain Hall and Mr Thiede to union members from which I have already quoted more than once, is reassuring on this point. It tells its readers that the 'ESOP tax savings' are 'implicitly' recognised in the method used to value the employee investment. What they wrote is worth quoting:

> Q How was the $4 billion of ESOP tax savings factored into the value of our participation?
> A The ESOP tax savings are implicitly recognised in the method used to value the employee investment. Pre-tax, rather than after tax, cash flows were used to calculate the value of the employee investment. The employees were thus given credit for their concession as though those concessions did not represent taxable income to the company. If the ESOP tax shield was not available, the employee investments would be worth approximately 40% less to the company than the pre-tax cash flows.

To understand how that is so, we need to remind ourselves of three related points. If wages are cut by a fixed amount and all other variables are held constant, then profits will increase by the same amount; so the profit tax liability will go up correspondingly; and so the after tax savings will be less than the pre-tax values of the wage reductions.

On the other hand in this case the projected ESOP tax reliefs are roughly the same as the increase in the profit tax liability which is the crude 'first time round result' of the main wage reductions.

Here now, for the record, are the employee investment savings projected in the same Harvard Business school study over the period of the deal's first six years. All have been estimated on a pre-tax basis.

Projected Value of Employee 'Investment Savings'

Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
564	673	774	813	838	793

In the absence any offsetting ESOP tax reliefs, the after tax value of these savings to United would be reduced by 40%. As it is the value of the projected ESOP tax reliefs roughly equals the extra tax due on the projected values of the employee concessions. That is what lies behind the assurance offered to union members in the December 1993 letter from Captain Hall and Mr Thiede: 'The ESOP tax savings are implicitly recognised in the method used to value the employee savings.'

MAJORITY EMPLOYEE OWNERSHIP: THE FIRST TWO AND A HALF YEARS

For the second consecutive year, UAL posted record full-year earnings, with 1996 fully distributed net earnings surpassing the $1 billion mark.
United Airlines 'Fact Sheet', 28 January 1997

Readers will be looking for provisional answers to a number of questions from this final section:

– Given that the financial results were apparently the best ever, how have they compared with reasonable expectations before the deal's completion?

– What were the main sources of the improved financial performance and were the benefits fairly distributed among those who contributed to success?

– How significant, especially for the prospects of continued majority employee ownership, was the January 1997 rejection of the mid-term wage adjustment as originally proposed?

– Following the rejection of those proposals, how reasonable were union criticisms about management's failure to 'change the culture'?

– After nearly three years, should majority employee ownership be counted a success? Or was the London *Economist* right to imply in early January of 1997 that the sooner this experiment can be phased out, the better for everyone?

– Has United sustained its commitment to near total employment security over the life of the main deal? More generally, how does its recent employment record compare with the experience at other airlines?

At least up to the end of 1996, the cost savings associated with both the main labour concessions and with the ESOP reliefs were reasonably close to pre-deal projections, though the reliefs were lower than projected in 1994 and 1995 and higher in 1996. Largely because the new services were introduced more slowly than planned, the savings associated with the 'shuttle' were well below the projections. On the other hand there was an important bonus in the shape of higher 'load factors' – that is fewer empty seats – which had a disproportionately positive effect on profits. By contrast, the value of improvements which can be persuasively attributed to more ownership orientated attitudes, though far from negligible, seemed rather modest. That can of course be seen as an opportunity and challenge for the future as well as a criticism.

As important – or indeed perhaps more so – than any of the foregoing was United's employment record over the three years following the deal. According to its own figures, its US-based employment increased by more than 16% and its total numbers by even a bit more:

Employment at United Pre-ESOP and June 1997

	At Home	Abroad	Total
Pre-ESOP	68,862	6,462	75,324
June 1997	80,139	8,359	88,498

It is true that for the different period from end 1993 to end 1996, US Department of Transport figures show a not much better than marginal increase in the numbers of 'full time employment equivalents' at United: from 78,105 to 79,205. No doubt part of the difference is explained by the fact that United's figures count part timers as full units. It is also plausible to argue that the official numbers for end 1993 include those luckless 5,000 members of the machinists' union who were working in the kitchens when they were spun off. However, in another important respect these numbers are most striking. Those at United are in marked contrast to those at Delta and AMR, the two airlines in the US which are most closely comparable with United.

Employment Numbers for Three Airlines*

	End 1993	End 1996	Growth/ (Decline)
United	78,105	79,205	1,100
Delta	69,5375	58,839	(10,698)
AMR	91,773	78,902	(12,871)

* Full time equivalents.

The eloquence of the numbers makes comment superfluous.

Savings in Labour Costs The table summarises operating results from 1993 to 1996 and also includes employment costs. Our focus here is on the lower costs associated with the wage cuts in the 1994 deal. For the years 1993 to 1996, spending on 'salaries and related costs' show a gentle fall and then a sharper rebound, though the 1996 figure remains below that for 1993.

All in $m	1996	1995	1994	1993
Operating revenues	16,632	14,943	13,950	13,325
Operating expenses	15,239	14,114	13,429	13,062
Earnings*	1,123	829	521	263
Salaries etc	4,719	4,524	4,679	4,760

*From operations

How can we best arrive at a reasonable estimate of the cost savings which are embodied in these actual figures? My own preferred answer involves estimating what the labour costs would have been if their ratio to a combination of sales and capacity had remained unchanged at 1993 levels, and then comparing those estimates with the actual salaries and related costs shown above.

For the volume of sales, I take the best measure to be what the airlines call 'revenue passenger miles', roughly the number of miles travelled by ticket buying passengers. For capacity I take the best measure to be so called 'available seat miles'.

In 1993 every dollar of labour cost yielded 21.3 revenue passengers miles and 31.65 miles of seat capacity. The table applies these rates to the actual miles flown in each of the subsequent years and then compares the resulting notional labour cost figures with the actual ones recorded above.

	1996	1995	1994	1993
Actual salaries & related costs ($m):	4,719	4,524	4,679	4,760
Revenue passenger miles (bn):	116.7	111.4	108.3	101.3
Labour costs ($m), 21.3 miles per $:	5,479	5,230	5,084	4,760
Estimated savings ($m):	760	706	405	n/a
Available seat miles (bn):	162.8	158.4	152.2	150.7
Labour costs ($m), 31.65 miles per $:	5,152	5,013	4,187	4,760
Estimated savings ($m):	433	489	138	n/a

We may make an estimate therefore of United's aggregate savings on labour costs, between 1994 and 1996. This would fall between $1.06bn, arrived at using the available capacity approach, and the $1.87bn yielded by the alternative revenue seat mile approach. The savings estimate linked to seat capacity takes no account of the load factor improvements which are captured by the alternative revenue seat mile approach.

In the operation of an airline, the link between labour costs and seat capacity is, no doubt, much closer than the links between those same costs and the numbers of seats filled by paying passengers. At most, it is probably reasonable to raise the lower of the two figures by 10% to arrive at what might be called a 'best guesstimate' of the savings actually achieved. That 'best guesstimate' figure would then be around $1.2bn.

I must acknowledge that this whole 'constant ratio' approach to the question of labour cost savings is inescapably rough and ready. There are no precisely constant ratios in fields of this kind. Moreover the changes in the percentage of labour costs not only reflect changes in those costs themselves but also changes in other costs. For example a rise in fuel costs, as in 1996, cannot leave the labour cost percentage unchanged.

How does my 'best guesstimate' of $1.2bn of labour cost savings compare with earlier projections of what they were going to be? The most authoritative projections are in the prospectus document:

Labour Savings Projected in the Prospectus. $m

1994	231
1995	511
1996	591
Total	1,333

I am almost inclined to claim that the two numbers are elegantly close. But that should not perhaps be the source of excessive surprise. After all, these savings in labour costs flowed in a sense 'automatically' from the deal. We know too, as a matter of fact from the testimony of the finance department, that the actual wage reductions embodied in the deal, and forming the largest part of the 'labour savings' total, have been scrupulously followed. There is thus almost a sense in which, at least up to the onset of the mid-term wage adjustment increases, we should in fact *expect* those projections in the prospectus to be more or less echoed by the actual numbers. As for the proviso about the mid-term wage adjustment, it is no more than a footnote. It is apparently the case that the labour savings projections in the prospectus assume a rather smaller wage increase in the mid-term adjustment than what was actually agreed. But that discrepancy will show up in the relationship between the projections and reality only from mid-1997 onwards.

The ESOP Tax Reliefs For the three years 1994 to 1996, the table reproduces the so-called 'ESOP Accounting Charges' shown in United's annual accounts together with my estimates of the associated tax reliefs, taken as being just 40% of the charges.

Actual ESOP Charges & Associated Tax Reliefs. $m

1994	182	73
1995	504	202
1996	685	274
Totals	$1371	$549

The ESOP accounting charges projected in the Harvard study totalled $1.57bn – for the first three years. So for the first two and a half years there is a reasonable correspondence. But there are important differences in the year by year numbers. The key point of explanation is the link between United's share price and the maximum ESOP charges it is allowed to claim. The Harvard study's projections were too high in 1994 and 1995, and too low in 1996.

In summary, two and a half years into the life of the deal, the delivery of its two single most important financial results – its lower wage costs and its ESOP tax reliefs – was pretty well on track. As a bonus there were extra financial improvements, probably worth a much as $400m over the same two and a half year period. These which resulted from higher levels of demand, were precisely reflected in higher load factors.

What about the 'Shuttle' and the savings expected to flow from it? The prospectus document specifies a target of achieving this new service with a total of 130 aircraft by year five. It also specifies a target cost of 7.4 cents per available seat mile. As for the resulting savings, the prospectus projects that they will have reached a cumulative total of $275m after two and a half years.

The latest progress reports that had been made public by management when this was written in early July 1997 were to the effect that there were 56 aircraft in the new service and that costs per available seat mile were down to 8 cents. Management had no doubt that the results had been positive and that real savings had been achieved. But it was unwilling or unable to quantify these – or both. Given the difficulties of comparing the new service with what went before, it is easy to sympathise with management in this case.

Indirect Cost Savings and Mid-Term Blues I turn now to savings and improvements which in no sense flowed automatically from the 1994 deal, but which can plausibly be seen as being among its indirect results. In the autumn of 1996, that is before the rejection by a majority of the two unions of the originally proposed mid-term wage adjustment, the management claimed cumulative cost improvements worth a little over $60m in this general category:

Savings from reduced sick pay	$22m
Savings in lost time due to injuries	$10m
Value of work team improvements	$30m
Total	$62m

The savings from lower sick pay and injury time may be characterised without too much hyperbole as being among the exemplary indirect benefits which should flow from majority employee ownership if it is working at all well. So, though in a different way, are the improvements attributable to work teams. The former reflect a greater readiness on the part of employee owners to refrain from anti-social behaviour at least on the margin. The latter reflect, again at least on the margin, a greater employee readiness to apply their specialised knowledge and experience to improving their own productivity and service quality, and to reducing unnecessary cost.

On the other hand, in discussions at United's international headquarters office outside Chicago in the autumn of 1996, it was freely acknowledged that the quite sharp reductions in sickness and injury costs which characterised the first year or eighteen months after the deal of July 1994 had later started to fall away. For what it is worth, an initial 'honeymoon' followed by a 'cool-off' is a frequent pattern in businesses which have become majority employee owned. The same pattern indeed frequently occurs in the wake of other innovations at the workplace.

A second qualification which may limit any surge of enthusiasm about these improvements is their size. Put bluntly they *seem* modest, amounting as they do in total to less than half of one percent of United's annual cost base. True, we are talking about the achievements of not much more than a two-year period. Nevertheless there are a number of majority employee-owned businesses in the US and the UK which have set themselves significantly higher targets for cost savings of this kind and then gone on to achieve them or at least come close.

But the rather modest total of the savings linked to 'voluntary' improvements, if indeed they are modest given the whole environment at United, may surely also be explained by a deterioration in relations between top management and the two ESOP unions once the post-deal honeymoon period was over. Certainly the rejection by pilots and the machinists of the first mid-term wage adjustment points in that direction. Without much doubt the key factor behind that rejection was an inequity, or more exactly a perceived inequity, in the distribution of the benefits that had flowed from the deal.

Assuming a starting value for the new shares in the recapitalised airline of $85 – the price taken for the purpose of the deal's calculations and roughly the price at which trading in them started in July 1994 – then it is plain that the outside or public shareholders had already enjoyed considerable capital gains between July 1994 and the end of December 1996. They were entirely free to cash these in. If we allow for the 4:1 share split, we can say that the share price increased by between two and three times by December of 1996.

It is true that over the same period the notional value of the shares allocated to employees under the deal went up by the same percentage figure. But while the public and outside shareholders are free to sell at any time, the employee shareholders may only do so when they leave. Moreover, at least among the pilots, there is a direct link between salaries and length of service. So the number who leave before reaching retirement age is small.

On this analysis it may well have seemed in December 1996 that the benefits of the savings achieved under the deal had gone disproportionately to the outside public shareholders. And that seems to be a fair and valid conclusion, even if it is also true that if we take the value on paper of the employee shareholdings, by the end of 1996 that already exceeded, by a fair margin, the sum of net wages which had been given up over the same thirty months. Rather later, in May 1997, Ken Thiede, the IAM leader, cited in a notice to his members a rather striking calculation about the value of the shares then held by a 'lead mechanic' and the amount of the associated investment saving up to that time. On the basis of a then share price of $75, the share value was calculated at just over $41,000 against total investment saving of some $17,500. For others among United's employee shareholders the actual numbers in May 1997 will have been different, but the relationship between share value and investment savings will have been similar.

In this discussion of the chief beneficiaries of the 1994 deal, a number of further points are worth making. The first is that the outside public shareholders are perhaps better seen as beneficiaries – not to the full extent of the capital gains enjoyed by them between July 1994 and end December 1996, but to the extent that these gains exceeded the average for the industry's shares between those two dates. If we switch to that second measurement formula, the size of their gains is reduced.

Second, it seems reasonable to include among the beneficiaries of the 1994 deal the additional employees taken on by United between July 1994 and June 1997. According to United's own statistics, that increase in American-based jobs alone was astonishingly high – over 11,000. The actual numbers have already been cited – 68,862 and 80,139. Perhaps, as we also saw earlier, that increase should be qualified by the rather different official numbers of the US Department of Transport. But a qualification on those lines must not be allowed to obscure what is the main and most important fact: that over its first three years, the deal was highly positive for jobs at United. It was highly positive in itself, and that much more so, as we have seen, when compared with what happened at Delta Airlines and AMR.

In this discussion of how the benefits of the 1994 deal were distributed or, more exactly, how at the end of 1996 they were perceived by union members to have been distributed, my final point is rather different. It seems to me reasonable for members of the two ESOP unions to argue that over its early life, the deal offered disproportionate benefits to United's top managers. That is because of the substantial bonus component in the 'compensation packages' of its 600 most senior managers. Once profits started to come through in line with the projections on which the deal had been based, big bonuses became payable to these top managers. I am not for a moment claiming that there was anything unethical in the way the bonuses were paid. On the contrary, they are a long-established feature of top people's pay at United. Nevertheless it seems clear that there was quite widespead resentment when they came to be paid. The feeling was that the profits had been largely driven by the sacrifices of the non-management staff. It was thus seen as inequitable that big 'extra' rewards should go to top managers.

For management staff below the top levels, union members apparently believe that there has been a tolerance of some upward flexibility, through promotion and the upward adjustment of management posts. They also believe that the deal's freeze of salaries was not therefore fully effective over its first two and a half years. In permitting such a flexibility, assuming it has done so, the top management at United may reasonably claim to have been constrained by economic necessity. Without it, the airline might easily have found itself unable to hold on to the services of key people and/or to hire in new recruits. Management may also point to the precedents of similar tolerances in other majority employee-owned companies. And yet, however reasonable the management case, it is unlikely to have been sufficiently so to overcome feelings of resentment.

Based on feelings of inequity, resentments among rank-and-file union members were, I think, an important part of the background music when the first mid-term wage adjustment proposal was rejected. The actual facts of what happened at the end of 1996 and in early 1997 are not themselves in dispute:

– After some months of negotiation with the elected ALPA leadership, management announced at the end of November that the two parties had reached provisional agreement about the wage rises to be recommended under the provisions of the mid-term 'wage adjustment process' in the 1994 deal.

– After similar negotiations with the IAM leadership, management announced in early December that a similar provisional agreement had been reached with the IAM.

Though there were some differences over non-wage points which figured in each of the two provisional agreements, the wage numbers were the same in both: an increase of 3% in each of the two years 1997 and 1998, followed by further increases of 2% in 1999 and in 2000. All increases to run from early July, that is from the anniversary of the deal's completion in 1994.

In mid-January United's ALPA members voted decisively, by a margin of 4 to 1, to reject what had been provisionally agreed by their leaders.

Less than a week later the IAM members voted. In line with their established practice they voted in two separate groups: the real mechanics – the people who actually maintain and repair the airframes and the aero-engines – in one group; the others, sometimes colloquially known as 'ramp staff', in a second. The first and more highly paid group voted to reject the proposal by a margin of about two to one. The second group voted to accept it. Though much lower paid than the first group, their rates, even after the cuts, evidently enjoyed a valuable margin over the competition.

Before the votes of the pilots had actually been counted, but when it must have become clear which way they were going to go, the elected ALPA leader at United, Captain Michael Glawe, announced in effect that his union would no longer co-operate with management.

The weeks that followed were marked by something approaching a war of words between the ALPA and the management. After contacts in early March between the leadership of the two unions and United's top management, the latter made a new offer. The two principal new features were:

– a lift to 5% from 3% in the annual wage adjustments offered to run from July 1997 and 1998;

– an undertaking by management that following the end of the main deal's duration in the year 2000, the wage rates applying before July 1994 would be restored.

Following the recommendations of their leaders the members of

the two unions voted by comfortable majorities to approve the new deal.

In the conventional 'two sides' language of labour relations, we can say that those two new features represented significant management concessions. Indeed the fact that there was a second offer at all represented a concession by management. For the terms of the original deal specified a binding arbitration process if no agreement could be reached in negotiation. Management would have been entirely within the contract if it had chosen to invoke that arbitration clause. Moreover the odds are thought to be that an arbitrator's ruling would have cost less than the management's second offer.

Critics are entitled to argue that if the second offer was at least in some sense affordable, it would have been wiser to have made it first time round. But it also makes sense to commend management's decision, after its initial mistake, to move fast to limit the damage.

The initial mistake, if it was one, seems to have reflected a major disagreement between management and the unions about how the basic logic of the provisions in the 1994 deal relating to the mid-term wage adjustment process should be interpreted. The language of the key opening clause of these provisions is the same for both ALPA's and the IAM's members:

> At the end of the second year of the agreement, the parties will meet to establish increases, if any, in both the book rates of pay and the actual rates of pay for the Wage Adjustment Period. If the parties do not reach agreement by the end of the thirtieth month of the agreement, the increases, if any, in such rates of pay will be determined by expedited arbitration before a neutral arbitrator (it being understood that the company will retain the right to contend that no increase of any type should be granted).

There is also an identity of language in the final clause of these provisions in the agreements with the two unions:

> In no event will the arbitrator establish i) any pay rate that is less favourable to [union-]represented employees than the pay rates in effect when wage rates for the adjustment period are submitted to interest arbitration under this wage adjustment process; or ii) any pay rate in either the fourth or the fifth year

that is more than five (5) percent above the actual rate in effect in the previous year.

What was in dispute at the time of the rejection of management's initial offer was whether the apparent open-endedness of the first clause, which does not itself limit the amount of the adjustment that the parties may agree, is restricted in fact – if not in law – by the limits laid down in the final clause. Clearly it was always open to each side either a) not to reach agreement in their discussions under the first clause, or b) to reach an agreement that the union memberships were almost bound to reject, and so c) to shift the decision to binding arbitration under terms that clearly are subject in law to tight numerical limits. In that sense, or so it seems to me, the final clause cast its shadow over the whole bargaining process. On the other hand it would not be easy for management to rebut a fairly simple argument which may well have been advanced by the unions in relation to what they took to be a real and genuine open-endedness in law of the first clause: namely that if the intention had been that the clause should limit what might be agreed under it, then that could without too much difficulty have been made explicit.

If we stand back a moment from the details of the language, the combination of the first and last clause together appeared to offer management a decisive advantage if its main aim in the negotiations was to restrict any wage adjustment to 5%. In the first discussions which preceded the negative union votes on a package which was freely negotiated below the two-year 10% target, management declined to forgo that advantage. The subsequent protests of the ALPA leadership at United amounted to the claim that, given the new majority employee ownership and against the background of higher than projected cost savings and other financial improvements, it was unreasonable by management to press the advantage offered to them by the language of the two key clauses.

In the event, as we know, management's second offer also remained within the 5% limit. But as well as the increase to 5% from 3% compared with what had originally been proposed, it contained a second sweetener: the undertaking that the pre-ESOP wage rates would be restored in the year 2000. For Captain Glawe, it was the new 'guaranteed snap back' provision which was the key to his members' acceptance of the second offer.

Following the acceptance of the second offer, management seemed anxious to put the whole episode behind it. It signalled this intention by a change at the apex of its bargaining team, bringing in a top labour relations lawyer, Bill Hobgood, with long experience in the mediation field. A good test of his skills in that respect came quickly. Negotiations on a new labour contract with the Association of Flight Attendants (the AFA) – the one union which remains outside the United ESOP – got under way in late April, and appeared to reach a successful conclusion in July. The AFA leadership later recommended that its members accept a new labour contract to run for ten whole years. Albeit by a narrow margin, the membership vote in the autumn was to accept.

But, following his apparent success with the AFA, Hobgood faces a wider challenge; or rather there is a challenge which will have to be faced both by the entire top management team at United and by the leadership of the two ESOP unions. The challenge is to develop a new 'culture' of management/union relationships which is more congruent with majority employee ownership. The goal to be aimed at is easy to identify but much harder to achieve. Within a framework of shared and reliable information – including agreed projections of what is likely to happen – the goal is to reach rational and agreed decisions about (a) how 'extra profits' if any, should be shared as between higher wages and investment, and (b), in the painful eventuality of reduced available resources, to reach agreed decisions in advance about what should be cut back.

That is all in the future. What we need to acknowledge about the past and present is that the whole ESOP project at United was breaking new ground from the day the deal was completed in July 1994. Indeed it was moving the company into a world for which the rule books have not yet been written.

What also needs to be said is that the record of United over the first thirty months following the deal was on the surface stunningly successful. Quite apart from the financial results, it increased total employment according to its own figures by, to repeat, an astonishing 11,000 jobs. What is more, it did so over a period when employment numbers at Delta and American Airlines, its two closest competitors, were cut by roughly the same amount.

In the long run a combination of greater employment security and greater employment buoyancy may well come to be seen as the real potential blessing of majority employee ownership. In that respect United did wonderfully well in the first two and a half years after the 1994 deal.

Given this success in relation to jobs, many readers will be surprised by the relative performance of the United share price over the first phase of its ESOP deal. A share which is a top relative performer over one period may always do that much less well in the next. Nevertheless the stock market performance of United, relative to that of its main competitors, between the end of April 1994 and May 1997 is so striking – and in some ways, to repeat, so surprising – that it demands to be put on the record. What is measured is what the Americans call the 'Cumulative Total Return on Equity' (CTRE).

Three Airlines, an Airline Index and the Dow Jones Industrial Average: CTRE April 1994 to May 1997

April 1994 equals 100. Values for May 1997

United	362.620
Delta	207.847
AMR	179.864
S & P Airlines*	163.158
Dow Jones IA	209.929

* 9 Airlines in S & P 1500. United not included
Source: American Capital Strategies in Maryland

But to return to management union relationships at United. By highlighting the turbulence associated with the mid-term wage adjustment I have intentionally left the impression that much needs to be changed if United is to benefit from the full potential of its employee ownership. However, it is also right to argue that during the first phase of that ownership relationships began to change and that more voices, including union and other employee representative voices, were heard round the tables at which the top decisions are made. The headline example is well worth some emphasis: the decision *not* to attempt a takeover of US Air. I suggest that it should be seen positively as reflecting a proper bias of majority employee-owned companies towards employment security. For what it is worth, it is also apparently true that top management eventually came round to the unions' view that a bid would be a mistake. Nevertheless, the fact of the union and other employee-

representative involvement in that decision is what marks a really dramatic change with, and departure from, the past.

In the end it will not be easy for ideological critics to argue convincingly that the disadvantages of this majority employee ownership at United, at least over its first two and a half years, have outweighed its advantages. For the outside shareholders the benefits are unquestionable. But both financially and otherwise, the company's employee shareholders have also gained. So long as the share price can be sustained at about its level in early 1997, the employee shareholders will do that much better than they could reasonably have expected when they voted for the deal in 1994. More precisely, if we see the wage reductions which they voted to accept as self-imposed savings, then, with the same proviso about the future level of the share price, we can say that the financial return that they may expect to enjoy on those savings looks as if it will be rather attractive.

Of course we must not fudge the proviso about the future level of the share price. It may not stay at even roughly its early 1997 level. And yes, it may come down and perhaps do so rather sharply. But that is the logic of employee ownership. Those who are averse to the risks should not vote for the arrangement.

As for the national economy, research does not yet permit a balanced conclusion. Of course we know about the 'first round' costs to the American budget of the ESOP tax reliefs. But the overall and 'net' tax costs are a different matter. Without the buy-out would profits have risen so much? If not, the higher taxation liability arising from United's higher profits would not have existed anyway. Would employment have risen? If not, there would have been no extra taxes paid by United's newly recruited employees. And what about the additional future welfare which, given the now familiar proviso about the share price, will eventually be enjoyed by UAL's employee shareholders and their families?

This raises what seems to me to be one key challenge for America's 'ESOP Community': to come up with a persuasive balance sheet of what has been achieved from the viewpoint of the national budget and the welfare of America's citizens.

There is also a second and final challenge: how to make majority employee ownership indefinitely sustainable.

We know that there are significant players in the financial community, for example J. P. Morgan, who have expressed a readiness in principle to get involved. Friendly and patient finance would be a necessary condition of success. A second necessary condition is that management, the unions and the rank-and-file employees should want to keep their present majority employee ownership, and want it enough to be willing to make new sacrifices for it. If those two conditions were satisfied then it seems to me that there would be a fair chance of securing a third: some necessary changes in the present ESOP laws.

On the other hand, if those conditions cannot be satisfied, this United Airlines experience will end up being just another example of successful but temporary majority employee ownership in America. It should not at all be dismissed for that reason. It is indeed a splendid vindication of the good sense, where that is possible, of choosing to cut employment costs rather than employment. But it will be a matter of regret to some that the life of this bold and path-breaking experiment in employee ownership will have been necessarily limited.

But I cannot leave this United Airlines experience without repeating a general observation about it. It is a conclusion that may be specially commended in a Europe where jobs have become the overriding political and economic issue. It should be of interest to stock market investors as well as to those concerned about employment security. My observation is that companies which operate in growth markets, but which find themselves becoming uncompetitive because of their rates of pay and benefits, face a clear choice. They can cut either jobs, or pay and benefits by the required percentage. If they choose the latter then, given the ESOP tax reliefs in both the US and the UK, those who give up wages can be compensated by shares, and the profits of the business can benefit from tax reliefs. To overcome the crisis of the early 1990s, United chose to cut wages and benefits. By contrast, two of its main competitors, Delta Airlines and American Airlines (AMR), chose to cut jobs – even if it is also true that the reduction was achieved on a largely voluntary basis at AMR. Readers must judge for themselves which of the two main alternatives they would prefer to go for. Investors scarcely need to make a judgement. The arithmetic will do the job for them. Between the date of the deal and the end of May 1997, shares in the common stock of United outperformed those of Delta and AMR by a substantial margin.

APPENDIX: DETAILS OF THE 1994 DEAL

Employee Shares Subject to a conditional qualification which in the event did not apply, both the employee-owned percentage of the equity (55%) and the associated number of shares in the common stock (precisely 17,675,345) were fixed at the outset. The agreed mechanics are that qualifying employees are allocated preferred shares: to be converted into ordinary ones only when employment ends, whether through retirement or otherwise. The eventual exchange of preferred shares for shares in the common stock takes place on a one for one basis regardless of the market value of the common stock at the time the exchange happens. So when they come to cash their shares in, the employee shareholders stand either to gain or to lose depending on the actual price level when they sell. At the end of the first quarter of 1997, that price, after allowing for a 4:1 split, was between two and three times what it had been when the deal was completed. As between the three employee shareholder groups – ALPA and IAM members and the non-union group – the distribution of what may be called 'investment-related' shares is proportionate to the total value of wages and benefits given up in each case. The actual percentage share going to each of the three main groups is: pilots, 46.23%; machinists, 37.13%; and the non-union group, 16.64%. Within each group, the distribution is proportionate to pay. There are also dividend shares (see below).

Non-Employee Shareholders The existing shareholders were paid $84.81 in cash for each of their shares in the old common stock, and issued with one share in the new common stock for every two they had held in the old. The money payments were funded by a combination of running down cash reserves and borrowing on the security of the employees' agreement to wage cuts and other concessions.

Wage Cuts The pilots (ALPA) took a 15.7% cut in wages over a period of 5.75 years, the machinists (IAM) took a 14.7% wage cut (which included the forgoing of a previously agreed increase due to have taken effect in May 1994) for a six-year period, and the non-union group took a cut of 8.25% over 5.75 years. For ALPA members, company pension contributions were cut from 9% of old wage levels to 1% of the new (lower) ones.

Other Concessions For a period lasting twelve years, ALPA accepted a two-tier wages and benefits arrangement whereby pilots assigned to flying the 'United Shuttle' up and down the north-south corridor on America's West Coast, do so at lower pay rates and longer hours than when flying the 'non- shuttle routes'. The IAM agreed that up to 20% of United's aero-engine and airframe maintenance work might be outsourced for twelve years. They also agreed to specified changes in work rules, including an end for twelve years to the paid half-hour lunch break. For the same twelve-year period the non-union staff accepted a two-tier wage arrangement for non-management grade people, with new recruits to be paid at 'market rates'. By virtue of the latter, maximum compensation rates for newly recruited non-management and non-union staff come down to about 50% of their former levels. These new recruits are also required to make a 25% contribution to their medical costs.

Employment Security Almost total job security for all those ALPA and IAM employees and those in the non-union employee group for the periods of the main wage cuts – 5.75 years for the pilots and non-union people and six years for the machinists.

No Strike Clauses The new labour contracts with ALPA and the IAM included no strike clauses for the duration of the main wage cuts and the associated periods of employment security.

Corporate Goverment ALPA, the IAM, and the non-union employee group each appoints one member of the twelve-person board of directors. Of the remaining nine members, two are United's top executives, three are elected by the non-employee shareholders, and the remaining four are independents, initially selected jointly by ALPA, the IAM, and the CEO, and later to be approved by at least one of the union directors. Among the first group of independents to be chosen was Paul Volcker, previously chairman of the country's Federal Reserve. The three employee appointees to the board enjoy rights of veto in certain sensitive areas: mergers and substantial non-airline investments and asset sales worth over £200m.

Sunset Arrangements These provisions will continue for so long as

the employee shareholding exceeds 20%, actuarially estimated to last until about the year 2016.

Mechanics of 'Investment Related' Share and Dividend Share Allocations The deal provided that the total of 17,675 345 shares – four times that number after the May 1996 stock split – will be allocated out in tranches. In each of the five full years between 1994 and 1999 a total of 3,073,973 shares will be allocated. For the months covered by the main deal in 1994 and 2000, the numbers are 1,448,384 and 857,096 respectively. From the 1995 allocation onwards, the employee shareholders receive dividend shares as well as their so-called investment related ones. The dividend shares are calculated on the basis that employee shareholders should enjoy an 8.89% return on the value of their outstanding balance of preference shares. The latter are the subject of independent valuation. The number of dividend shares that the 8.89% return will 'buy' depends ultimately on the market price of shares in the common stock. The value of the preference shares is linked to this by a prespecified formula. The allocation of 'investment related' shares takes place, from the 1995 allocation onwards, only after the numbers needed for dividend shares have been calculated and deducted from the pre-set tranche total.

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Tullis Russell

INTRODUCTORY OVERVIEW

In a letter dated 17 June 1994, the family shareholders in Tullis Russell, a long-established family paper mill business in Scotland's county of Fife, were made an offer. By the time it closed less than a month later, they had all accepted. Already by the summer of 1995 a majority (52%) of Tullis Russell's shares had come to be held either by its employees as individuals, or on their behalf by one or more employee trusts. A charitable foundation, the Russell Trust, held the balance of 48%, having had voting control for some twenty years before.

The business is sizeable as well as profitable. For the 55% of the share capital which they were holding in the summer of 1994, the family shareholders received the equivalent, essentially in loan stock, of £19m, in an offer which valued the company at £36.9m. The company proudly claims that it is the third largest private paper-making business to remain independent in the whole of Western Europe (after two in Germany). Despite two significant employment cutbacks in the 1980s and early 1990s and a productivity explosion in 1994/5, the workforce at Tullis Russell's pair of neighbouring paper mills, the Auchmuty mill and the Rothes mill, still numbered over 850 in late 1995. In the twelve months to end-March 1995 those employed in Fife had broken all their previous production records by a large margin, achieving a total output of 106,000 tonnes of paper. Subsidiaries elsewhere were also flourishing.

Before the ownership changes of 1994, Tullis Russell had been an almost quintessentially family business for nearly 200 years. The Tullis family and then the Russells were in control one after the other, with an overlap period when a controlling interest was shared between the two families during the fifty years from 1874 to

1924. The most recent family chairman, David Erdal, who took over in 1985 and stood down to become simply a non-executive director, was in fact the fourth generation of that family to lead the business: his late mother was born Sheila Russell.

Tullis Russell: Some Production Milestones: Tons & Tonnes

Year	Milestone
1900	5,000 tons exceeded
1916	10,000 " "
1928	15,000 " "
1938	20,000 " "
1950	25,000 " "
1971	50,000 " "
1993/4	80,000 tonnes "
1994/5	106,000 " "
1995/6	108,000 " "

Calculations on the basis of the much higher figures of the mid-1990s show that Tullis Russell's paper output was then roughly the same, in proportion to domestic UK consumption, as it had been in the 1860s. The key achievements of the company over nearly 200 years – or perhaps more exactly of the two families which have successfully guided its destinies – seem therefore to have been three. First, to have grown with Britain's market; second, to have adapted to a continuing flow of changes; and third, to have declined to sell out to a competitor. This has happened over a period when the domestic industry's share of the home market has fallen to 50%.

The acceptance of the buy-out offer by the family shareholders was an act of enlightened self-interest. Had the sale been made to a competitor the prices would almost certainly have been fixed at a level higher than the 80p per voting share and the 72p per non-voting share which were accepted. But that would have been possible only if the payment for the Tullis Russell shares had been made in the shares of the buyer. The non-diversified consequences for the family shareholders of that would have been notably inferior to what they actually accepted.

The ownership outcome of the process set in motion by the acceptance of the June 1994 offer – with a majority of the share capital already split a year later between the employees as individuals and an employee trust or trusts – has been designed to be sustainable over an indefinite future. The French have a phrase for this, *'la perennité de l'entreprise'* – the potential everlastingness of the business. As for the current process of ownership transition, projections indicate that it will be completed some time between 2002 and 2009, when the shareholding of the Russell Trust will have been reduced to about 25%. Having been founded in 1809, the year 2009 will mark the start of the company's third century.

The team which designed the offer and the eventual ownership outcome was led by David Erdal, the company's non-executive chairman who is also a family shareholder. In his own and the team's view the scheme had three main attractions:

– For the family shareholders, the unlocking of capital at a price which, taken together with the tax reliefs, was certainly acceptable and perhaps attractive.

– For the future employee-owned business, the opportunity to remain independent indefinitely, perhaps for ever.

– For current employees, a good chance that, if they remain so employed till the process of ownership transformation is complete, they will have built up a nest egg of capital worth at least one year's wages.

This combination is widely seen as a winner by advocates of employee ownership. It was made possible by key changes in Britain's employee-ownership law, changes which were accepted by the Government only in late March 1994, barely three months before the offer to Tullis Russell's shareholders was made.

Three earlier case studies cover what I have called 'employee ownership by benefaction': John Lewis and Baxi in the UK and the Carl-Zeiss-Stiftung in Germany. In all those cases, and in a number of other similar examples in Britain and elsewhere in Europe, the ownership arrangements are indeed, as at Tullis Russell, intended to be indefinitely sustainable. On the other hand, the former owners of those three businesses transferred their ownership rights either as complete gifts or at deep discounts. This was a price that their former owners were in effect prepared to pay, because by doing so they gave maximum protection to the independence of the successor employee-owned businesses. Because of the 1994 changes in the UK's relevant ESOP laws, the family shareholders of Tullis Russell were not required to make a similar sacrifice.

Even after the 1994 changes, Britain's ESOP legislation is of course far from perfect. Nevertheless, the example of Tullis Russell

shows what may well be widely possible for the owners of family businesses who face problems of ownership succession. But only time will show the extent to which this exemplary ownership change is going to be followed.

The Two Families and the Business: 1809–1994 It may come as some surprise that there are still four separate paper-making businesses within the Scottish county of Fife, north-east of Edinburgh. Two of them, Tullis Russell and the much smaller Smith Anderson, are still privately owned. The county's high level of pre-industrial prosperity is perhaps a factor. This can be traced back at least to the 1400s and the establishment at St Andrews of Britain's third – and Scotland's first – university. But the main explanation seems to lie in Fife's swollen and fast-flowing rivers. The chief attraction was probably water power. Water is also a vital ingredient of the paper-making process: a rule of thumb among paper-makers is that 100 tons of water is needed for every ton of paper produced, though the net figure is less after recycling.

Tradition has it that when Robert Tullis converted a grain mill at Auchmuty in 1809, it was because Napoleon's blockade threatened paper supplies for his existing business. This combined printing and publishing with the sale of books and stationery in the market town of Cupar ten miles away. Robert never seems to have shifted his main interest to paper making – indeed, in the 1820s he founded a local newspaper, the *Fife Herald*.

After his death, the Cupar businesses were taken on by his eldest son, George. It was left to the two younger sons, William and Robert, to make a go of paper making. Robert died young but not before a second mill had been acquired in 1836, at Rothes, less than a mile downstream from Auchmuty. To this day, the key processes of Tullis Russell's paper making continue at these two mills.

The year 1836 is a good starting point for a more detailed look at the history of the business. For with the acquisition of the Rothes mill and its so-called Fourdrinier machine, the undertaking ceased to be essentially a dependent supplier of paper to the founder's mini-conglomerate in Cupar, and struck out on a path and destiny of its own. I will first trace the family thread of the story, running as we have seen from Tullis to Russell, with a kind of condominium of the two families in between. I will then move to the business record.

Leaving Robert the founder behind us, the key figure in the paper-making business for the first phase of this 150-year period was his son William. It is true that the eldest brother George, who had taken over the family interests in Cupar, remained a partner in the paper business for many years. But his partnership was of the financial, and essentially sleeping, kind. So, after the third son Robert's untimely death in 1839, William carried the main paper-making responsibility alone.

In addition to paper making, in 1846 William acquired a small bleaching business on the banks of the Leven close by. In those days it was sometimes necessary for some of the material used in paper making to go through a preliminary bleaching process. The significance of the acquisition was that it formed part of the final settlement between the Tullis and the Russell families in the 1920s.

The Russells made their first appearance in this family story when Agnes Russell married William Tullis in 1846. The couple had no children. When William handed over the main reins of the business in the 1870s, they passed in effect jointly to his nephew Robert Tullis, the son of his elder brother George, and to his brother-in-law David Russell (senior), a brother of his wife Agnes. The former became a partner in the business in 1872 and the latter in 1874. What I have called the 'two-family condominium' then continued till 1924. Following the death of the 'senior' David Russell in 1906, his position in the joint leadership was taken over by his son, another David (knighted in 1946).

Just before he died, David (senior) had masterminded a change in the corporate status of the business – from a partnership to a private limited company.

The rest of the family story can be quickly told. In 1924 the second David Russell negotiated a deal which in effect bought out Robert Tullis mainly for cash. This settlement also involved the passing to the Tullis family of the bleaching business. At this point members of the Tullis family make their exit from this story, though it is pleasant to record that old Robert soldiered on for a dozen more years and that, having first become a working partner in 1872, he is said to have enjoyed what was surely a well-deserved retirement in his eighties and nineties, 'as a gentleman'. Perhaps what is surprising is that the condominium lasted as long as it did and that the business not only survived but was apparently stronger at its end than when it began.

For most of the period from 1874 to 1924, the Russell voice, first that of the father and then that of the son, seems to have been the dominant one. That is speculation: what is certain is that, other than their place in the name of the business, the Tullis family played no further part in this story after 1924.

When eventually, ten years after his knighthood, and fifty years after his father's death, Sir David Russell died in 1956, it was his eldest son, Dr David Russell, who took over the leadership of the business.

Sir David's second son, Patrick, had died of wounds during the Second World War, serving with the Artillery in the Italian campaign. The death of this younger brother explains the origin of the charitable foundation, the Russell Trust. The original Russell Trust was set up by Sir David Russell as early as 1947. He gave it a 25% stake in the equity capital of the business, seen as Patrick's inheritance had he lived.

Then, in 1969, Dr David set up a second trust, which he named the David and Catherine Russell Trust, after himself and his wife. He passed over to it some 30% of the then voting shares in the business, himself at that time retaining control in his own hands. Then, in 1975, he handed over a further block of voting shares, thereby passing voting control to the two trusts together. Finally, in 1985, these two trusts were amalgamated. From 1985 onwards they exercised voting control as a single entity.

That new unified trust was given a new trust deed. However, both in terms of its beneficiaries and its control arrangements, it is very similar to those of the two antecedent Russell Trusts. The beneficiaries are essentially charitable entities to which the Trust passes its dividend income. Control is shared by Tullis Russell's top management and members of the family. As a final point of clarification, from 1975 down to the 1994 employee buy-out, the ordinary share capital of Tullis Russell had been split 30:70% between voting and non-voting shares. That explains how it came about that at the time of the 1994 buy-out, it was possible at the same time for (a) the Russell Trust to enjoy control, and (b) the family to hold 55% of the shares.

We shall look later at the motives behind those benefactions. Here we may simply note that, as a result, the family had created a starting point which made an eventual transition to majority employee ownership much less problematic than it might otherwise have been.

The Business Record: 1836–1924 According to Coleman's history of Britain's paper industry, it was in the 1820s that the output of the country's machine-made paper first exceeded that made by hand. And yet it was only when they acquired the second mill at Rothes, in 1836, that the Tullis brothers, William and Robert, started to include machine production in their total output. One of the new so-called Fourdrinier machines had been installed there by the previous owner, evidently at some time between the mid-1820s and the early 1830s. There has been speculation that the machine may have been the source of difficulties, and we know that the disposal of the Rothes mill was a post-bankruptcy sale. We know too that the Fourdrinier at Rothes was one of the earliest in Scotland, perhaps even the second, following an installation by Lewis Smith in Aberdeen in the first decade of the century. In any event it seems that machine production at the original Tullis Auchmuty mill began not earlier than the 1840s and perhaps the early 1850s. Given the speculation about the difficulties at Rothes which lay behind its sale, there may have been an understandable nervousness on William Tullis's part about introducing too much machine production too soon.

The switch from hand to machine production in the textile industry during Britain's industrial revolution is well known: who has not heard of the handloom weavers and their sorry plight as the new machines spread through the industry over the fifty-odd years to 1840? The same applies to the names of the main textile industry inventors and of their new machines: Hargreaves's jenny, Arkwright's frame and Crompton's mule. On the other hand, the similar switch in the paper industry, if my own ignorance is at all typical, is hardly known outside the ranks of those actually working in paper. Hands up those who have heard of the Fourdrinier machine. Its basic design has barely changed – though there have been massive changes in size and speed – since the first working model was installed in England. This first machine, stemming from an original French invention, was installed in the first decade of the nineteenth century. Since this was the first serious technical problem encountered by the fledgling paper business at Rothes and Auchmuty, it seems worth describing the main features of the Fourdrinier machine and what was involved in the change:

> The Fourdrinier machine represents a straightforward mechanisation of what was formerly done by hand . . .

> The basic principle of Robert's [the French inventor of the Fourdrinier's precursor] machine was to form paper upon an endless belt of woven wire, instead of upon the separate moulds of the hand made process. This principle remained equally true when the invention was developed by Donkin and the Fourdriniers, and remains true of the modern Fourdrinier machines and the largest newsprint machines. The latter turn out newsprint at over 2,000 feet per minute.
>
> Two vital elements in the making process – the 'shake' which the vatman gave to the mould whilst forming the sheet, and the 'couching' of the wet sheets on to a felt – were incorporated in the machine. The former was carried out by imparting a side-to-side motion to the 'wire', the latter by running the newly-formed sheet of paper on to a felt-covered roller [Coleman, 1958].

Coleman quotes various more or less contemporary estimates of the savings in costs and labour which could be achieved by switching to machine production from production by hand in the middle years of the nineteenth century. For example, it was estimated that where a machine replaced seven vats, the savings in money might be as much as 72% (down to £734 from £2,604). The corresponding workforce reduction would be from forty-one persons to just nine. It would be well beyond the limits of this case study to explore these details any further. But two points are relevant to the early pioneering days at the Auchmuty and Rothes Mills. The first is that once a Fourdrinier machine had been properly established and bedded down, there were sharp reductions in costs, and thus potentially big increases of profit. The second is that if those mills had continued to produce mainly by hand after, say, the early 1850s, they would probably never have passed the milestone output of over 1,000 tons annually. Moreover, having fallen at that fence, they would surely not long have survived.

Though output records are not available, we may imagine that the next thirty-five years, from 1860 to the middle 1890s, were characterised by gently increasing annual production. The company's historian, Miss C. D. M. Ketelbey, suggests that there were neither major successes nor major disasters over these years. The tasks were those of maintaining output and profitability, and of pushing the latter gradually higher in the face of continually tough conditions both in the market and in securing raw material supply.

Higher output seems to have been achieved partly by adding new machines of the same specifications, and partly by replacing existing ones with larger and faster versions of the same basic Fourdrinier model. In any event, when some continuous records start to become available in the second half of the 1890s, annual output had increased by about four times, to approximately 4,500 tons, compared with that earlier peak of 1,133 tons quoted by Miss Ketelbey for 1858/9.

Annual Output: Five-Year Averages 1896 to 1925 in Tons

1896–1900	4,410
1901–1905	6,260
1906–1910	6,530
1911–1915	9,800
1916–1920	8,648
1920–1925	9,523

The second, and perhaps most remarkable of the hat trick of David Russells, took over the reins alone when he bought out the business from Robert Tullis – and thus ended the condominium – in 1924. Given his energy and his quite exceptional range of talents, and the fact that today's Tullis Russell still very much bears his stamp, it is perhaps inevitable that the Tullis family's contribution has been substantially overshadowed. Still, it is almost always harder to start successful businesses than to sustain them. The founder, and more especially his second son, William, deserve to be remembered for having established what later became a first-class business. It is to the particular credit of William that he successfully negotiated the tricky switch from hand-made to machine-made paper, and then went on to lay the foundations for substantial levels of machine-made output which were later achieved. As for the founder's grandson, William's nephew Robert Tullis, he must surely be given credit for the fact that the firm survived the fifty years of his condominium with two successive David Russells, and achieved much higher output. Finally, he must be given credit for accepting the buy-out offer from the second David Russell in 1924.

Thirty Years' Growth of Output and Sales: 1924–55 The period from the buy-out of the Tullis family interest in 1924 to the assumption of the chairmanship by David Erdal in 1985 is divided into two almost equal halves by the death in 1956 of the second of that remarkable trio of David Russells. Apart from half a century of outstanding business leadership, Sir David, as we will from now on for convenience call him, was a great benefactor of two of Scotland's most notable institutions: St Andrews University and the revived religious community on the island of Iona. He jointly started the Iona project with the Revd George Macleod and was one of those whose financial and other support enabled Macleod to bring the project to fulfilment.

In business, a typical indication of Sir David's values was an arrangement during the Second World War under which all Tullis Russell's employees serving in the forces continued to be paid by the company at the rate of ten shillings a week. Ten shillings in the money of the early 1940s is probably equivalent to about £15 today. Moreover, though paper making during the Second War conferred 'reserved occupation' status on those who worked in the industry, as many as 200 of the company's employees were beneficiaries of this unusually generous arrangement.

Sir David's contribution to the making of the modern Tullis Russell is a useful reminder that culture may be the single most important ingredient in determining the success of a business. The culture which Sir David stamped on Tullis Russell was in part, no doubt, no more than a reinforcement of what he inherited from its past. It combined family business paternalism with business leadership, treated essentially as a duty of service, almost in a sense of *noblesse oblige*. Some features of those values and of that culture may well be out of place in the rather different setting of employee ownership in the Tullis Russell of the 1990s. But this should not be allowed to call into question the contribution of paternalism to earlier phases of Tullis Russell's success – however politically unpalatable it may be in some quarters.

Telling evidence of both the impact of those values on the rank and file of the company's employees, and of the fact that they significantly predated Sir David's assumption of what the French call the *pouvoir* in 1924, comes from Tullis Russell's experience during the General Strike of 1926. Though there were complicating factors, as we shall see in a moment, the company historian is in no serious doubt about what underlay the behaviour of the company's workforce: 'Many mills in Scotland came out, as in England, but in the Tullis Russell Mills *the balance of conditions and sympathies was in favour of no action and not a man went on strike* [emphasis added]'.

The main complicating factor was that in the paper industry of those days two unions recruited members: the National Union of Printing, Bookbinding and Paper Workers (NUPB & PW) and the Amalgamated Society of Paper Makers (ASPM). As was already the norm, the former was affiliated to the TUC, the body which actually called workers out in the General Strike. On the other hand, for reasons which are not immediately clear, the ASPM had disaffiliated from the TUC not long before. To some extent, the response of the paper industry men to the strike call may have varied in line with the balance of the membership between the two unions.

However, Sir David did not always get it right – as was shown by an experiment in what might be called the cultural life of Tullis Russell during the Second World War. According to his biographer:

> In 1940 the Reverend George Macleod, founder of the Iona Community, had had the idea of a 'factory-community' with a minister having a room in a factory and sharing the experiences of the workforce. It was not a novel concept, since there were factory chaplains in the south. It was agreed that the Scottish experiment would begin at Tullis Russell, with the Reverend Ian Fraser taking up appointment in the mills as a minister in industry under the aegis of the Iona Community, from September 1942, for two years [Macintyre 1994].

The experiment led to quite sharp differences of opinion, and in October 1944 the Revd Ian Fraser's appointment was not extended but simply 'terminated'. Sir David's view had been, according to his biographer, that an industrial chaplain had to be 'part of management – in other words one whose sphere of activity would be the spiritual, mental and physical welfare of the people'. On the other hand Fraser, with the support of Macleod behind him, interpreted his duties to include those of challenging the status quo where he deemed it justified. In the case of the seating arrangements in the canteen he evidently took the view that a challenge was necessary and put a written warning on the record: 'Though not serious at the moment, this may be the beginning of a policy which will have serious consequences in the division of the mill into separated groups who squabble.'

Sir David's biographer goes on:

> The canteen dispute was compounded by an advertisement in the *Scotsman* for a lecture in Edinburgh on 'Common Wealth: Piety and Politics', given by the Reverend Alex Miller of the Iona Community. David Russell complained to Macleod:
>
> 'This has brought a shower of criticisms about my head. Is the Iona Community a Communistic organisation? etc, etc; and all this has been accentuated by one of the staff bringing in a copy of *World Digest* with an article, "A Parson in a Factory", in which this is said: "Unless the Church is prepared to stand for some form of communal control and ownership in business etc."'

This is perhaps already in danger of becoming an over-extended digression. But I cannot resist quoting the first sentence of of Macleod's reply to Sir David: 'Providence got us together on this first chaplaincy experiment and now honours us with difficulties, which is proof that something is really happening.'

Nor can I resist, finally, quoting from the jacket of the biography that Sir David was a 'pioneer of New Age thinking' and a close friend of Tudor Pole, who was in his turn almost certainly more gifted with psychic powers than any of his British contemporaries. There seems to be no serious doubt that, like Pole, Sir David believed in some sense in a life after death. As he looks down from his cloud on the employee ownership being pioneered by his grandson, one cannot help wondering what he is thinking.

To return to the record of Tullis Russell as a business. Among Sir David's earlier contributions, Miss Ketelbey rightly singles out his appointment before the First World War of an industrial chemist rather than an industrial chaplain. In making this appointment he was evidently well ahead of his times: it was the first step towards a research and development department.

Moreover, the historian of the family business leaves her readers in no doubt about the grand scale and comprehensiveness of Sir David's overall contribution:

He was a supreme organiser, and his reorganisation of all branches of the firm's business amounted almost to a refoundation. He overhauled production policy and methods; he revolutionised sales policy; he revised the costing and accounting system; he brought a welfare programme into the Mills; he enlarged the whole scale of the firm's operations, changed the character of its products and modernised its techniques, and he put the company into the front rank of Papermakers [*sic*].

At Auchmuty Mill he reduced the diversity of production and concentrated on high-grade twin-wire papers for printers, the now well-known Ivorex Boards, Mellotex offset Cartridge, Artine (an imitation art since discontinued) and cheque and security papers. He studied and met the needs of the printer. Twin wet ends were installed on the machines to give a uniformity of printing surface to both sides of the sheet. Esparto papers were for the first time mill-conditioned, ready for immediate use on the printing presses, and the printers' confidence was sought and won by strict attention to control of quality, shade and finish.

Rothes Mill was even more drastically reorganised. All the old wrappings, browns, long elephants of assorted sizes and colours were in time replaced by speciality papers for technical and industrial purposes, a relatively new field in which the firm has since achieved and maintained a leading position. Production there was gradually turned over to papers of this kind – insulating papers for power cables and telephones, base papers for plastics and electrical purposes and spool papers for photography. This exceptions to this were two lines, Sorbex blotting and Duplex envelope papers, which were, and still are, kept on the current list.

We will come back in a moment to the key technical concept of 'twin wire' papers. But here is the place for a brief look at production levels between Sir David's accession in 1924 and his death, thirty-two years later, in 1956.

Output of Paper in Tons: Five-Year Averages 1921–5 and 1951–5

1921–25	9,523
1926–30	16,224
1931–35	15,648
1936–40	19,418
1941–45	17,533
1946–50	23,434
1951–55	26,335

Partly because of the particular five-year periods they fall into and partly because they are five-year averages, those numbers understate the impact on Tullis Russell of the 1929 stock markets' collapse and of the resulting depression of the early 1930s. The annual output figures which reached a then all-time high of nearly 18,500 tons in 1929 fell some 20% to a low of just over 14,750 in 1933. Curiously enough the maximum impact of these external shocks on the Tullis Russell workforce seem to have preceded the low point in production: 'Auchmuty was on short time for eighteen months between July 1930 and December 1931, and Rothes for nine months from February to November 1931.'

Perhaps the lag is explained by the movement of stocks. But however that may be, the main comment on this whole experience should be rather different. It is that compared with many in other industries and perhaps in other paper-making companies, the Tullis Russell workforce came through the great depression of the 1930s relatively lightly. Though they suffered from extended periods of short-time working, they seem to have managed to escape actual unemployment. The same was certainly not true in the nearby coal pits of West Fife: good evidence for that was the victory of the Communist Party candidate, William Gallacher, in the Parliamentary constituency of West Fife at the general election in 1935. In fact he held on to that seat until the general election of 1950, a unique achievement in Britain's politics.

No doubt, if there had been no depression and no Second World War, Tullis Russell's rate of growth during Sir David's leadership years would have been greater than it was. Output more than doubled between 1925, the first year for which he was alone responsible, and 1955, the last year over which he can have had real influence. It reached a tonnage of 27,378 from 12,789. The average annual increase over this thirty-year period was around 2.5%.

It would be wrong to suggest that a verdict on Sir David's stewardship at Tullis Russell should be based merely on that record of production growth. During his time there was clearly a huge improvement in the quality of Tullis Russell's commercial activity. And though it happened in 1923, a year before Robert Tullis finally bowed out, Sir David should presumably be given the main credit for a particular innovation: Tullis Russell was one of the first – perhaps *the* first – of Britain's paper makers to install a special kind of 'twin wire or double machine', with the second wire reversed. The 'ordinary' twin wire machine produces a kind of two-ply paper with an acceptable quality surface for printing top and bottom. Those of the special kind installed at Tullis Russell have an extra competitive quality advantage because the flow along the wire of each of the two plies is so arranged that their two 'bad sides' come together in the middle. This apparently gives an ususual advantage when paper is of the heavier weights – above 180 grams per square metre – which are sometimes called 'boards' in the paper trade and of which Tullis Russell is evidently one of Britain's master suppliers. The 1923 installation of this machine was judged sufficiently important to merit a mention by the British industry's latest historian, Dr Richard Hills. He tells his readers that Tullis Russell's 'latest and largest [twin wire] machine, which started operating in 1979, has a capacity of 20,000 tonnes per annum'.

That is to anticipate. Here, for the final verdict on the years of Sir David's stewardship, I return to the issues of values and culture with which I started. In some respects Sir David was well ahead of his time. As an expression of the importance of continuous improvement and of his firm's commitment to it, you can scarcely do better than a sentence written by Sir David as long ago as 1930:

> The position we hold as a firm, commercially technically and socially, has been won through years of persistent effort. Such an effort has been stimulated always by the desire each day to see some improvement upon past records, some new ideas for the improvement of methods and conditions, some step forward to make each today an advance upon yesterday [Ketelbey].

But perhaps as important as Sir David's commitment to the value of continuous improvement was a commitment of a quite different kind. I can put that most simply by calling it an idea of family business leadership as a stewardship in which the interests of the business itself, had they clashed with those of the family during his years of control, would almost certainly have prevailed. Of course, which way a decision would have gone in the event of a 'one way or the other' clash can only be a matter of speculation. But Sir David's decision to pass to the Russell Trust the shares that his second son would have inherited had he survived must be a pointer towards that direction. And it was in the same direction that we must interpret the decisions of his son to set up and endow an additional Russell Trust, and to pass a further substantial shareholding to it, and to merge the two trusts into one. This continuing concept of business leadership as stewardship is elegantly congruent with the idea of an employee-owned future for Tullis Russell, which began to evolve under the third of the David Russells, Dr David.

More Growth in Output and Sales: 1955–1985 Sir David Russell's act must have been difficult to follow. All the more reason for a positive verdict on the thirty years which followed his death. These years of his son's *pouvoir* and stewardship were a most notable success. I begin with the company's performance.

Under the leadership of the man who became Dr David Russell when he was awarded an honorary doctorate by St Andrews University in the 1970s, the growth rate of the business, measured by the average annual increase in the weight of the company's physical output, continued to fluctuate around 2.5% a year, and to double, more or less, over thirty years. But whereas 'doubling production' meant adding a total of about 13,000 tons of additional paper in Sir David's time, it meant adding roughly twice that under his son. In 1956, the year of his father's death, Tullis Russell's output totalled just over 28,000 tons of paper. Thirty years later, when Dr David retired, the corresponding figure was just over 56,000 tons.

One explanation for the continuing increase between those two generations is the size and speed of the paper-making machinery: the extra production came in much larger chunks in Dr David's time than in his father's. We have seen that the new twin-wire machine installed in 1979 was capable on its own of producing paper at an annual rate of 20,000 tons. Arguably Dr David's replication of his father's growth rate was not just 'more of the same' but a new achievement in its own right. This is because when you reach the really high numbers attained during Dr David's stewardship you are entering quite new territory.

Where Dr David was undeniably innovative compared to his father was in adopting a policy of growth by acquisition. Three businesses were acquired as going concerns – Coated Papers in the Manchester region, Brittains in the Potteries, and Watson Grange outside Glasgow. Perhaps especially in the case of Brittains, these businesses commended themselves as prospective buyers of Tullis Russell's paper. But they were also attractive as potential sources of group profits during the characteristically sharp down-turns in a paper-maker's business cycle.

In the case of Coated Papers the name describes the product. As for Brittains, it has since achieved a commanding position in an international niche market – making special transfer papers for application in the quality porcelain and other businesses (see Appendix A). The main products manufactured by Watson Grange are book covers for hardbacks. In the mid-1980s, around the time of Dr Russell's retirement, they employed together just less than 350 people – or roughly a quarter of what was then the group's 1,400-odd workforce. By 1994/5 they employed fewer people but accounted for a higher proportion of group employment:

Tullis Russell Subsidiaries: Workforce Numbers 94/95

Brittains	110
Coated Papers	130
Watson Grange	70

Dr David was also more innovative than his father in his promotion of technical collaboration with Scottish universities. Examples include a battery separator papers project undertaken jointly with Heriot Watt; and special papers for cheque books and projects with St Andrews. In all cases the results of this collaborative work were eventually brought to the market.

But in other important respects Dr David followed his father. For example, towards the end of the Second War Sir David had broken quite sharply with what had previously been family tradition. He started appointing the top executives of the business – the top sales manager for example and the top production manager – to the board of directors. This practice was continued by Dr David. Moreover, as his father had done in 1947, so in 1969 Dr David set up a charitable trust, the David and Catherine Russell Trust, and transferred to it a significant block of shares.

In 1975 the two charitable trusts were merged into one. By a rearrangement of the equity into voting and non-voting shares, Dr David ensured that the merged charitable trust should enjoy voting control, though having no more than a minority of all the issued ordinary shares. What is more, at the same time he brought in the top managers of Tullis Russell as co-trustees with members of the family of the merged trust and gave them a right of veto over trust decisions. The result was an important distinction – between the beneficiaries of the newly merged trust (the charities enjoying its support), and its control. Over the latter the top management at the Tullis Russell business has the final say.

In a general way these arrangements may be seen as a logical culmination of what I suggested earlier was Sir David Russell's idea of stewardship in relation to the destinies of a substantial family business. If the interests of the family shareholders and of the business itself should ever conflict, then those of the latter should prevail. Almost precisely the same bias is reflected in the ownership arrangements of those employee-owned firms where control is vested not in the individual employee owners for the time being, but in a permanent employee trust. And behind that same bias is the same thinking.

But there is also evidence that when he thought about the future of the business after his own retirement, Dr David initially gave serious consideration to a more or less explicit arrangement of employee ownership. Under such an arrangement all the company's share capital would eventually have come to be owned by a trust of a kind similar to that of the John Lewis Partnership. According to family tradition he was argued out of that by a quick-talking financial adviser from Edinburgh. The adviser's key point was about the different social environment of a shopping business based in the south of England and a manufacturing one in Fife. What worked well in the former would involve unacceptable risks if transposed to the strongly unionised environment of East Fife.

There is another family tradition about Dr David's thinking on the question of ownership succession which his nephew David Erdal tells, partly as a joke against himself and his siblings and cousins. Having fought in the Second World War, so the story goes, Dr David was very much aware of the differences in values and climate between his own generation and the generation who came of age in the swinging sixties and early seventies. David Erdal interprets in *that* light his uncle's decision to vest final control with the merged trust, and thus indirectly with the company's top management. In other words, Dr David felt he could not risk leaving the business in the hands of a generation of anarchists and dangerous free thinkers. Perhaps this is understandable: David Erdal's political odyssey in the 1970s included spells in Britain's Workers' Revolutionary Party (WRP) and Mao's China, as well as at Harvard Business School.

Dr David initially opposed his nephew's insistence that he must spend two years at Harvard Business School if he was to take over the chairmanship. Yet, notwithstanding those spells with the WRP and in Mao's China, he chose David Erdal to succeed him. He and his wife had four daughters but no sons. Women were at that time scarcely eligible, because of prevailing industry opinion, for top positions of leadership. He had several nephews and David Erdal was only one of them. We know that Dr David, who lived on after his retirement for a few years, approved his nephew's first cautious steps towards employee ownership.

1985–1995: Rising Output and Declining Employment The main employee buy-out – 'sale by family shareholders' would be a more precise term – happened only in 1994, after changes in the law made it acceptable to the family shareholders. However, direct employee involvement started in 1985 with cash profit-sharing and a tax-assisted scheme whereby profits were used to buy shares for employees. In 1987 the process was taken one step further, when an Employee Benefit Trust was set up to borrow money to buy shares for employees. By 1994 employees owned 20%, either directly or collectively, through the trust. Detailed discussion of the whole employee buy-out process is left to the next section. However, the business performance of Tullis Russell in the intervening ten years must be viewed against the backdrop of increasing employee ownership and the expectation that it would accelerate.

To those outside it, the apparent ferocity of the business cycle in that part of the paper industry in which Tullis Russell's products are mainly concentrated is almost bound to cause surprise. And that remains true even though:

– The down-swings from the peaks to the troughs have been getting progressively less severe, whether measured in tonnes or percentages, over the last twenty-odd years.

– The company's two latest output peaks, in 1990 and then in 1994-5, were both way above anything which had been achieved earlier. (The figures for the following year showed a small further improvement.)

Over the last twenty years the largest fall, from a peak to the subsequent trough, was in the mid-1970s and associated presumably with the combined effects of the first oil price shock and the near runaway inflation at the start of the last Wilson Government in 1974. Measured in tonnes, the paper output of Tullis Russell fell over 30% from a high of 63,455 to a low of 43,572 just two years later. Next time round, between a 1980 peak and a 1983 trough, tonnage declined by 23%, or just under 14,000. The most recent fall was of 11% – 8,500 tonnes – between 1990 and 1992.

Further research would probably show that this softening in the ferocity of the business cycle down-turns for Tullis Russell is partly to be explained by the growth in the company's exports. In 1995 exports were some 40% by value of output compared with less than 10% twenty years before. But that is a detail. The eye-catching numbers of the Company's most recent output peaks compared as follows with earlier ones:

Production Peaks over the Last Fifteen Years in Tonnes

1980/81	59,107
1989/90	79,185
1994/95	106,000
1995/96	108,000

(Financial years to end-March)

There is a special supply side explanation for much of the 'great leap forward' in output from the 1993/4 figure of 83,575 tonnes to the 1994/5 peak number. This was associated with a major change in working arrangements – a move from discontinous to continuous production achieved by a change from a three-shift to a five-shift system. Similar moves have been made in recent times by paper manufacturers elsewhere. But Tullis Russell believes that it was on its own in the time needed to discuss and implement the changes: just five months compared with an industry average of two years. It attributes its success in part to the relationships of higher trust which have been made possible by its employee ownership.

The strongly rising trend of production, notwithstanding the down-turns of the business cycle, was in marked contrast to a continuous fall in employment. When Mr Erdal took over the top position in the New Year of 1985, the total number employed in paper making was 1,160. Production that year was just under 52,000 tons. Ten years later, although production had doubled, employment was down 27% to 844. Thus annual output per employee rose from about 45 tonnes of paper to nearly 130 tonnes. That ten-year improvement in labour productivity corresponds to an annual rate of close on 9%. It is best seen as the company's response to the competitive pressures of the market.

The odds must be that the same competitive pressures will force a similar response in the years ahead which in turn will make further manpower reductions inescapable. Even in a growing market and with an increasing market share, the company will be unable to increase its sales at the same pace as its labour productivity improvement.

It is often felt, and sometimes argued, that conditions of continuing manpower reductions are inimical to the success of employee-owned firms. No doubt it is always easier to achieve business success in conditions where demand is rising so fast that employment is also rising. Such conditions are also good for employee morale. On the other hand, those conditions will be satisfied rarely, if at all, in the mature industries of developed countries. So if employee ownership has to confine itself to those rare cases, it is unlikely to become at all widespread.

Mr Erdal and some others are inclined to turn this argument on its head. Their main point is that under a regime of employee ownership any necessary manpower reductions are likely to be managed in ways which minimise the pain and are thus likely to be more acceptable and, in the long term, less costly. This analysis is strongly endorsed by America's two large and substantially employee-owned steel companies – Republic Engineered Steels and Weirton – which faced similar market conditions for years. The argument is attractive and in many ways persuasive. But only time will tell whether employee ownership has given Tullis Russell a cost advantage over its competitors.

Manpower reductions tend to be associated in the public mind

with the blue collar sections of a workforce. But in the early years of employee ownership there is often a tendency to move towards a flatter organisation and fewer management layers. It seems that at Tullis Russell, in the ten years following Mr Erdal's appointment as chairman, the manpower reductions were proportionately as big or bigger among the management staff as among the rank and file.

Changes of management personnel have also resulted from an inability on the part of a significant minority of the management staff to adjust to the new world of employee ownership and the changed relationships which it ushers in. Those managers unable to make the necessary adjustments have had to leave.

On the other side of what evidently used to be quite a high adversarial fence, there have been those among the elected shop stewards on the work site who have found the adjustment hard to make, or anyway hard to accept. The elected convenor of shop stewards is said to have lamented more than once the loss of his power base, a loss which he attributes to the company's employee ownership. That, or so he is alleged to have observed, effectively eviscerated his authority, by removing the credibility of a strike threat. Once again only time will tell whether that change, if a change indeed it is, will turn out to be permanent.

Mainly because of sharp fluctuations in the price of the pulp which the company buys in, there seems to be no very consistent relationship between higher output and higher operating profits:

Paper Output in Tonnes and Operating Profits (Losses)
1985 to 1996 (Years to End-March)

Output	Tonnes	Operating Profits £000
1985	56,476	(19)
1986	59,318	4,118
1987	70,853	5,484
1988	77,733	5,576
1989	79,083	4,791
1990	79,185	3,432
1991	77,729	289
1992	70,514	801
1993	71,200	(1,242)
1994	83,575	1,649
1995	106,000	3,727
1996	108,000	4,700

This twelve-year record of the company's paper-making activities offers no evidence of consistently improved performance, whether related to employee ownership or otherwise. But it points us towards an important result of the earlier business acquisitions by Mr Erdal's uncle and predecessor, Dr David Russell. For the profits of these acquired subsidiaries were sufficient to change 1993's operating loss of £1,242 into a group operating profit of £2.7m, to increase the 1994 figures to nearly £3m, and those for the twelve months to end March 1995 to just over £6m. The star performer among the subsidiaries was Brittains, the specialist manufacturer of transfer papers. Those acquisitions by Dr David Russell have therefore served the whole business rather well. For they have enabled the profitability of the whole undertaking to be maintained through the cyclical down-turn in Tullis Russell's paper-making activities. This has made it possible for shares to go on being distributed to employees out of profits, even if at a reduced level.

Efforts to Create an Ownership Culture The 'ownership culture' at Tullis Russell has not yet had time to get bedded down, not least because typical shareholdings of individual employees have not yet reached a significant size. Some believe that employee ownership will make no significant impact on productivity before the value of those individual shareholdings reaches at least five figures. Bryan Greene, a friend of the whole project and until 1996, when he acepted a managerial post, one of the company's most senior elected share councillors, is on record that the necessary cultural change may be forty years away. In fact, evidence elsewhere suggests that with the right policies, appropriate leadership, and effective involvement and communications systems, changes of attitude and behaviour can happen quite quickly.

It is already clear that significant numbers of the company's managers were unable to adjust to the new relationships implicit in a set-up involving employee ownership. To repeat, they had to leave. The phrase 'participative management' is widely used to describe what employee ownership requires even if it is still somewhat elusive to pin down. What is clear is what employee ownership excludes – namely styles of management which are authoritarian, militaristic and/or, though perhaps to a lesser extent, paternalistic. It clearly involves some relinquishment of control by

management and conversely a readiness to enable rank-and-file employees to contribute more to decisions and to have more say. Mr Erdal offered a compressed account of these matters at a workshop in Cape Town in August 1995. Having told his audience that the chief purpose of sharing ownership with employees is to improve performance, he went on:

> There is now considerable evidence that this enhancement of performance does not take place unless the managers move to a participative style. *For most managers, who like to control things, this is a major change which takes time* [emphasis added]. It involves a massive amount of communication and consultation, of training and team working, and of quality improvement groups. There are many ways to skin this particular cat, but it is clear that participative management is necessary.

We can conclude this discussion of efforts at Tullis Russell to promote an 'ownership culture' with a look at changes and developments in the linked areas of 'the two Cs – Communication and Consultation'.

In the area of communication, or more accurately of company journalism, Tullis Russell's most eye-catching innovation has been borrowed with full acknowledgement from John Lewis. A new company magazine is distributed to all employees. At least a part of it is believed to be almost universally read: the magazine's letters column. Following the radical tradition pioneered by John Lewis, employees are strongly encouraged to write in, whether in their own names or anonymously. Called *Points of View*, there is an undertaking by the magazine's editor to publish virtually anything and everything sent in. The only exceptions have to do with material which is commercially sensitive or where references to individuals would be likely to cause unacceptable pain. But in the latter case the letter will not normally be censored. The reference to a particular individual or individuals will simply be edited out. Here again, in relation to these details, Tullis Russell is following the John Lewis model. And it follows that model too in the magazine's rule that if letters are of the kind which call for a management answer, that will be provided with a minimum of delay.

Mr Erdal had to use all his chairman's authority to launch *Points* *of View*, which was fiercely opposed before the event by a large majority of managers. On the other hand most of those who were originally opposed now concede that they were quite wrong. So far from mainly undermining its authority, the anonymous letters make management's task that much easier – by acting as an early warning about sources of shop-floor complaints. And there is a second major benefit. The replies by managers to complaints and criticisms are widely read.

Moreover, *Points of View*, including its anonymous letters column and rules for management reply, has since been copied at the Baxi Partnership, of which Mr Erdal was appointed non-executive chairman in 1994. There is no greater praise than to be copied. It is surely a fair bet that the company journalism pioneered by John Lewis in the *Partnership Gazette* will be increasingly followed by employee-owned businesses elsewhere.

Finally, consultation. The need for some elected representative body of employee shareholders was identified early on in the process of moving towards employee ownership. Since 1992 the resulting institution has been called the Share Council. Members are elected to it by geographical constituencies and have regular, rule-established, meetings with Tullis Russell's top executive bodies. The council also appoints half of the trustee members of each of two employee trusts.

In the summer of 1996, these arrangements at Tullis Russell were being re-examined by an *ad hoc* committee of 'wise persons' drawn from both the share council and the group management board.

First Steps towards Employee Ownership and the 1994 Buy-Out On the eve of the 1994 buy-out, the ownership of Tullis Russell business divided four ways. The family shareholders accounted for the largest block, with 55% of the equity. On the other hand, control lay with the Russell Trust, by virtue of its 51% holding of voting shares: of the combined voting and non-voting shares together its holding was just 25%. Employees held the remaining 20% either directly as individuals (7%) or via the Employee Benefit Trust (13%).

Both types of employee shareholding had been built up since David Erdal took over in 1985, when he also introduced cash profit sharing, perhaps the classic first step for those heading in an employee-ownership direction. The cash scheme is notable in two respects. It provides that an unusually large fixed percentage of

pre-tax profits – 15.7% – be allocated annually to employees in proportion to their basic rates of pay. Second, so that the link with individual efforts may be as close as possible, the relevant profits are not those of Tullis Russell and its subsidiaries taken together, but those of the individual businesses for which the employees are working.

The Inland Revenue approved employee share scheme introduced in that same year is linked with the profits of Tullis Russell as a whole. Here again the scheme provided for a fixed percentage of profits – in this case 7.5% – to be allocated annually to buy shares for employees. As with the cash scheme, allocation was proportionate to basic rates of pay, at least initially. Later, as a result of perhaps predictable pressure from the subsequently formed Share Council, that formula was modified in a more egalitarian direction. Under the new formula only 70% of the pool is allocated pro-rata with pay, the balance being distributed equally. The issue was still the subject of lively debate when this case study was being finally revised.

Unlike the arrangements for cash profit sharing by employees, the share scheme had the extra advantage of providing a mechanism to enable the family shareholders to find a buyer, at least for small parcels of their shares. For the annual 7.5% of profits was deliberately used to buy from existing family shareholders rather than, as the law also permits, to subscribe for new shares.

But though these two processes could go forward hand in hand, it is easy to see that they could do so only at a painfully slow pace. If the business were valued at ten times its pre-tax profits, over 130 years would be needed to complete the transfer of the ownership at an annual rate of transfer of just 7.5% of those pre-tax profits. In fact, the price agreed for the 1994 buy-out reflected a multiple of pre-tax profits slightly higher than ten.

To speed up the purchase of shares from family members, a third step was taken in 1987. By establishing a special kind of employee benefit trust (EBT), the company was able to operate what has come to be known in the jargon as a 'case law ESOP'. Given careful attention to legal technicalities, the EBT could borrow money to buy shares from existing shareholders and could hold those shares on behalf of the employees. Above all – and thanks to the precedent of a series of case law judgments that have gone against the Inland Revenue – the company was and is permitted to pass money from *pre-tax* profits to the EBT. This enabled the latter to pay back its borrowings, including the principal as well as interest charges.

Approximately £5m was borrowed from two banks, the Royal Bank of Scotland, and the trade-union-controlled Unity Trust Bank. This was used to buy the 13% shareholding owned by the EBT on the eve of the 1994 buy-out. In this one transaction the family shareholders were able to sell almost twice as many of their shares as via the employee share scheme mechanism which had started in 1987.

So the EBT sharply speeded up the rate at which the family shareholders were enabled to sell. But even after this improvement, family shareholders were anxious, given the company's objective of buying them out completely, to secure a further acceleration. This was not unreasonable. For in the absence of anything new, they faced the prospect that even if the EBT and the employee share scheme were used jointly and separately to best effect, it could well be twenty-five years before they could unlock the last of their capital from Tullis Russell. Moreover, on the basis of past experience, they could scarcely expect a very generous flow of dividend income during the intervening years. And they had to face the prospect that, except for quite modest annual reliefs, they would have to accept full capital gains tax liability on the proceeds of their continuing sales of Tullis Russell shares.

It is not therefore surprising that new ways were sought to speed up, and make more tax-efficient, the process of transferring ownership from the family shareholders to the individual employee shareholders and the EBT. After the Government had given its blessing to so-called statutory ESOPs in 1989, and more especially after it had approved in 1990 a conditional rollover relief from capital gains tax on the proceeds of sales of shares to them, the company and its advisors, spearheaded by its chairman, combed through the new legislation to see whether any seriously practicable new opportunities had been opened up.

But as readers with a taste for detail in matters of this kind may remember, the Government had attached to its new statutory ESOPs two conditions which had such a deterrent effect on possible users that for the five years after 1989 the take-up was virtually zero. One of these deterrent conditions provided that a majority of the trustees of the statutory ESOP had to be elected by a majority of the whole workforce. Because of the control of voting shares

held by the Russell Trust, that was something which Tullis Russell might have lived with. But after extended research and the projection of a range of possible 'scenarios' the company decided that the other condition was unacceptable: namely that all the shares acquired by the statutory ESOP must be distributed to individual employees over a maximum period of about seven years – on pain of a claw back of all earlier tax reliefs. After extensively 'modelling the future' the company decided that, partly because of the severity of the business cycle in the paper industry, that was a risk it could not reasonably take.

At the end of March 1994, the Government announced significant relaxations in those two deterrent conditions. In particular, the period allowed for the distribution to individual employees of shares in the statutory ESOP trust, was extended from seven years to twenty years. Tullis Russell embarked on a new round of 'modelling the future'. The conclusion was that it would now be safe to use a statutory ESOP as the key new mechanism for achieving both the desired speed up and an enhancement in the tax efficiency of the ownership transfer.

It must be acknowledged that what we are dealing with here is a fairly complex set of transactions. For employee ownership fans at least, there is a certain elegance about this complexity and it does not immediately give rise to thoughts about lawyers' fees. However, now that Tullis Russell has shown how to negotiate the legal and tax pitfalls, any other family-owned companies who wish to sell to their employees should find it much easier. (For details of the 1994 buy-out deal, see Appendix B.)

What Tullis Russell has achieved is a winning combination: it has been judged by Mr Erdal to be a 'win, win, win buy-out'.

– A win for the family shareholders because it unlocked their capital at an acceptable price.

– A win for the company, because it is enabled to retain its independence on a sustainable basis.

– A win for the employee shareholders because, with any luck, they can look forward to shareholdings worth not less than the equivalent of one year's salary in the not *too* distant future, say by the time of Tullis Russell's bicentenary in 2009.

– It seems reasonable to suggest that the local community at Glenrothes, and those in the neighbourhoods of Tullis Russell's three subsidiaries, are also winners. For there can be a fair certainty that the new group will not be taken over by a competitor and that therefore the security of future employment will be higher than it otherwise would have been.

Is the country also a winner? If we set aside for a moment the narrow calculations of a cost accountant the answer must surely be yes. For, unless the buy-out has *adverse* effects on performance, the country must benefit from the greater spread of wealth which the deal has made possible. And there are also prospective intangible benefits. One of these comes in the form of a workforce with an understanding of business which, according to Mr Erdal, is being transformed by the employee ownership experience. Who knows, this might even turn out to be one of those rare cases where extra tax revenue arising from improved performance more than compensates for any taxes forgone as a result of the employee ownership reliefs. But it will be some time before it becomes possible to make the necessary calculations, if indeed it happens at all.

APPENDIX A: BRITTAINS (TR)

In January 1980, Brittains (TR) – with the TR standing for Tullis Russell – was formed to buy from the receivers the assets of what had previously been Brittains converters, whose parent company had gone bankrupt. Largely because of special factors in its first four months, trading showed a significant loss – of £142,000 on a turnover of just over £1.2m, in its first year. For the sixteen subsequent years, it was consistently and increasingly profitable. Trading profits reached new records in each of the four years down to 1994/5 when they were just over £2.25m on a turnover of just over £12.3m. The later results were achieved by a workforce of scarcely over 100. Basically because of higher paper prices, there was some decline in profits to £1.8m in 1995/6.

In fact, by the end of the 1980s Brittains' contribution to overall group profits, if measured against the size of its workforce, was way ahead of any other part of the business. As elsewhere in Tullis Russell, the new profit-sharing and employee-ownership incentives started around the mid-1980s. Especially through the profit-sharing scheme, Brittains' workforce participated handsomely in the outstanding results of the early 1990s.

As in all Tullis Russell businesses, a cash scheme allocates to the employees 15.7% of profits. This is at the generous end of any

spectrum. Still, if profits are modest and have to be shared between large numbers, the cash per employee may not be more than the equivalent of two or three weeks' pay. At Brittains in the two years down to the end of March 1995, the money per employee was equivalent, after taking into account the available tax reliefs, to over 30% on top of annual basic pay. When a forklift driver earning £12,000 a year (taxable) in basic pay receives an after-tax £3,000 as a cash profit share, he must, you would think, feel that things are changing somewhat in his world.

Brittains (TR) has just one product. It is made by applying special coatings to paper supplied by its sister company, Tullis Russell Papermakers, in Scotland. It is known by a wide range of technical names including, apparently, decalcomania paper. I expect that the one best known to the public is 'transfer paper', which can also be understood as a functional description. Readers of middle age will be familiar with 'transfers' from childhood: typically rather dark small postage-stamp-size pictures which go through a brightening up process of transformation when pressed off from their original backing onto a bright field of clean white paper. Brittains makes what can be simply understood as transfer backing paper for grown-up uses: for pressing brilliantly coloured decorations onto porcelain or enamel for example. Among its most important customers are the specialist printers who supply the up-market porcelain manufacturers, businesses like Wedgwood and Royal Doulton in the UK. Each of those two are close neighbours of Brittains in Stoke-on-Trent.

Turning from production to sales, it is not too much to claim that in the fifteen years since it came to be owned by Tullis Russell, Brittains has become one of two world leaders in a quintessentially niche market that is growing fast. Believing that the information would be helpful to its chief (German) competitor, the company does not publish a geographical breakdown of its sales. But it does acknowledge that well over three-quarters of its output is exported, and that at least since the start of the nineties sales growth has been especially buoyant in the Far East. The big question about further sales, according to the managing director, Mr Downes, is whether the porcelain manufacturers on mainland China are going to move significantly to a decoration technique based on waterslide transfer paper. Up to the time of writing they had only just started to take a very first step down that road.

A key feature in the detail of the Brittains experience in the fifteen-odd years since its acquisition by Tullis Russell has a striking similarity with that of its Scottish parent: after marking time for a bit, output went up sharply but employment came almost continually down. Here are the two series:

	Area of Paper Sold	Numbers Employed
1980/81	113,000	n.a.
1981/82	109,000	188
1982/83	108,000	171
1983/84	115,000	153
1984/85	123,000	161
1985/86	117,000	158
1986/87	120,000	136
1987/88	129,000	134
1988/89	133,000	132
1989/90	167,000	120
1990/91	190,000	123
1991/92	177,000	108
1992/93	188,000	107
1993/94	221,000	108
1994/95	232,000	107

As a technical footnote for the specialist reader, it is worth putting on record the units in which the area of output is measured. They are so called 'medium reams' containing 500 sheets of transfer paper in the dimensions 18" x 23".

Of more general interest in relation to the statistics of output and employment is the proud claim of Brittains' management that the 'downsizing' of its workforce has been achieved without anyone becoming unemployed. Attrition and early retirement have been used as extensively as possible. When, in any year, they have not gone far enough, great and largely successful efforts have been made to help those affected by the restructuring to find acceptable alternative jobs in the Stoke-on-Trent area. Apparently there has been only one employee over the whole period covered by the table whose job had to go and for whom it has not been possible to find alternative work elsewhere. She has been kept on to do simple odd tasks as they come up.

The management is also keen to emphasise that the reason why the restructuring has been relatively painless is that since the computerisation of the production process in the mid-1980s, Brittains' employees have accepted what amounts to almost total job flexibility. Unusually for a managing director, Mr Downes is prepared to commit himself explicitly to the proposition that the acceptance of near-total 'work flexibility' by the employees is linked, at least psychologically, to their situation as cash profit sharers and shareholders in the business.

In the absence of any convincing alternative explanation, Mr Downes also attributes to Brittains' ownership and cash profit sharing arrangements a rather startling *événement* which took place shortly before he took over the top job in 1992. One Monday morning, and without prior warning, a deputation of all Brittains' shop stewards 'waited on' Mr Downes outside his office. When the knock came at his door he was, he reports, quite at a loss about what to expect. But what they proposed was, he further reports, well beyond anything he had anticipated or even dreamed of. Their proposal was simple: that they and the whole union arrangement in the company should disband – as having finished its useful shelf life. Faced with this bombshell, Mr Downes's response was surely the right one. He suggested that no decision be taken until the unions and company had jointly sought advice from the statutory Arbitration and Conciliation Service (ACAS). To shorten a potentially longer story, ACAS duly advised that the functions previously performed by the unions should be taken over by an elected works council. That has since happened and the arrangements are said to be working well.

It is no doubt too early to say that an 'ownership culture' is properly, let alone irreversibly, 'bedded down' at Brittains any more than it is anywhere else in the Tullis Russell group. But Mr Downes and his colleagues are ready to talk about the conditions which might make that happen. The main condition that they specify is that the value of an employee's shareholding should reach five figures, or, even better, come to equal one year's pay. As elsewhere in the group that goal is still some way off. But with one proviso it is not entirely out of reach. The proviso is essentially, of course, that the company should continue to be commercially successful and to make at least reasonable profits.

The great increase in Brittains' output over the eight years starting

1988 was partly a matter of an expanding world market and partly of the company's successful efforts to secure a larger share of it. The latter was essentially made possible by changes in the company. An important change was what amounted to the computerisation of most of the manufacturing process, coupled, as we have seen, with an acceptance by employees of almost completely flexible working.

Since its acquisition by Tullis Russell in 1979, Brittains has probably enjoyed, at least against its main German competitor, one specific supply side advantage: the fact that it is a one product business, and that all the efforts of both its production and sales staff are concentrated on transfer paper and nothing else. No doubt that makes it vulnerable in the very long run. But there is little doubt that it confers a real advantage over the short and medium term.

As a footnote to that contention, it is worth noting that the bankruptcy of the antecedent Brittains was widely attributed at the time to a rash of ill-considered 'diversification' in the 1960s and 1970s. From its original core activities of paper making and coating, the earlier Brittains had diversified by the middle of the 1970s into such non-contiguous fields as civil engineering, road haulage and insurance.

And that brings me to a final point which is unashamedly historical. Paper making and coating at the Brittains Ivy Mill site in Stoke-on-Trent did not start quite as early as 1809, when, as we know, what became known as Tullis Russell opened for business in Glenrothes. But the activities on the Stoke site do go back to the 1820s. There have been no bankruptcy discontinuities at Glenrothes; but on the Ivy Mill site in Stoke-on-Trent there have been not just one but two – the first in the 1830s. What then was the name of the original owners and paper makers who went bankrupt? It is a name as illustrious as any in the history of paper making and we ran into it in the main section of this case study. It is the name Fourdrinier.

APPENDIX B: THE BUY-OUT DETAILS

The buy-out deal was effected within the framework of an offer from a new company set up for the purpose. The new company was the Tullis Russell Group Ltd, and its offer was to buy the entire share capital of the existing business, Tullis Russell & Co. Ltd.

With minor exceptions, the shareholders in the existing business were offered a choice between two alternatives:

– To accept loan stock in return for their shares at a specified price and on specified interest rate terms and with a pre-specified exit at various dates in the future.

– To accept a shareholding in the new 'group' company which would be the same in all important respects as their shareholding in the existing one, in effect exchanging their old shares for new shares on a one-for-one basis.

As may be inferred, the first of these two alternatives was essentially aimed at the family shareholders and was designed to offer them a deferred exit. Conversely, the offer of shares in the new group was essentially aimed at the Russell Trust and the EBT. In fact, the two trusts' acceptance of the share alternative was recorded in the offer document.

As for the individual employee shareholders, the management's view was that an acceptance by them of either alternative was entirely reasonable even if a choice of the second would be seen as showing a higher level of commitment to Tullis Russell's employee-owned future.

When the offer closed, just three clear weeks after it had opened, family members had opted to exchange all their shares for loan stock. At the same time over 90% of the employee shareholders (representing over 90% of employee-owned shares) had chosen the share alternative.

It goes without saying that the pricing and other arrangements had to be acceptable both to the family shareholders and to the company. The two parties were separately advised. What appeared in the offer document was the result, essentially, of a negotiation between these two sets of advisers.

The background to the key negotiation about the share price was a series of annual valuations. As required by law, these had had to be agreed each year since 1986 with the Inland Revenue, as an essential component of Tullis Russell's tax-assisted employee share scheme. More precisely there were two series of annual share valuations, one series for the voting and a second for the non-voting shares. However, by custom and agreement the valuation of the latter was not fixed independently but set at 90% of the value of the former. For the five years down to 1993, the actual valuations in pence per share were:

	Voting Shares	Non-Voting
1989	81.5	73.3
1990	58.8	52.9
1991	57.9	52.1
1992	43.8	39.5
1993	45.3	40.8

Given these valuations in the years running up to the buy-out, the 72p price which was agreed for the non-voting shares – the category which accounted for almost all of the family members' shareholdings – may seem rather generous. On the other hand, it seems that it was already clear when the negotiation took place that the business was heading for far and away its best year of paper production and that, despite the high pulp price, profits were rising with the upturn in the business cycle.

There is also at least hearsay evidence that a higher price could have been negotiated if the buyer had been a quoted company competitor of Tullis Russell. A competitor will often offer the highest price for the business – so the hearsay evidence is persuasive. But so is the rejoinder to any suggestion that the family shareholders should therefore have been advised to approach such a buyer. Capital Gains Tax (CGT) rollover relief applied in both cases – to sale to the ESOP or to a competitor, with the competitor paying for Tullis Russell in its own shares. But the value of these two rollover reliefs – and this is the key point – is not the same. For in the first case – a sale to a statutory ESOP trust – the relief applies to what are in principle diversified portfolios of shares and other assets and financial instruments into which the proceeds of the sale to the ESOP trust might legitimately be reinvested. In the second case it is retsricted to a totally non-diversified shareholding in the paper of the quoted competitor. The professional advisers to the family shareholders evidently formed the view that the lower level of risk exposure involved in accepting the offer from the Tullis Russell group was at least adequate compensation for any higher price that could realistically have been expected from a competitor.

As for the rate of 7.5% interest on the loan stock, the offer document points out that compared with their dividend income over the recent past, this meant an increase of well over 200% for the family shareholders. The offer document further specifies that the interest rate payable would be hoisted to 9.5% if there was any slippage in the loan stock redemption timetable it lays down: namely redemption (at par) in three equal instalments, in 1996, 1999 and 2002. For the record, the date of the first of these instalments was in fact brought forward, and half of the first instalment was paid to the family shareholders in the summer of 1995.

I need to explain how these arrangements are linked in to the sale of the family members' shares to the statutory ESOP trust, and how therefore the eligibility for CGT rollover relief is secured. The answer is that immediately before the effective redemption and the pay-out of actual money, the loan stock is converted back into ordinary shares which are then bought by the statutory ESOP trust. What that trust pays for those shares is then paid out to the family shareholders. In this way they 'make a sale of their shares to the statutory ESOP trust' and so qualify for CGT relief on the assets into which the proceeds of the sale are reinvested.

Readers with a memory for detail in matters of this kind will realise that the shares so acquired by the statutory ESOP trust cannot, at least as the law stood in the autumn of 1995, hang about in there indefinitely. They must be 'got out' to individual employees within twenty years – on pain of a retrospective claw back of all the tax reliefs associated with the statutory ESOP. To make that 'getting out' out process tax effective in its turn, it will be achieved through the conduit of Tullis Russell's pre-existing employee profit share scheme. Furthermore, and in order that that process does not take for ever, the company will lift substantially from the present figure of 7.5 the percentage of pre-tax profits which it applies to finance that scheme.

There is one further point which needs to be taken into account and which is in fact a precondition for the achievement of ownership stability at Tullis Russell. If the 55% of the equity bought from family shareholders were to be held indefinitely by individual employees, the employee-ownership arrangements would simply not be sustainable. What we are dealing with here, if the phrase is permitted, is an example of a *sequential* Scylla and Charybdis. Tullis Russell's prospective employee-ownership path must first avoid the Scylla of the clawback. But having done so it must still, subsequently, avoid the Charybdis of unsustainability. It will avoid the second by taking steps to enable its long-established EBT, and the associated 'case law ESOP', to buy shares from individual employee shareholders to the extent needed if a sustainable equilibrium is to be achieved. The best estimate by Tullis Russell's top management is that sustainability requires that not more than 35% of the shares be held by individual employee shareholders at any one time.

Soon after the buy-out offer had been accepted, the company granted share options to approximately fifty top managers at a price of 69p per share. As provided in the offer document, these options were granted at 85% of the price of the shares in the buy-out transaction. The document also laid down limits on the total value of the options that any individual could be granted: not more than the equivalent of three times annual salary or (if greater) £100,000.

As the loan stock is converted back into shares at the point of its redemption, the number of shares in issue will steadily increase and more than double between the date when the options were granted and when the last redemption instalment is paid. Thus the business will have to achieve substantial success if these options are going to be worth very much. And, of course, if that success is achieved all the employee shareholders – not just those who have been granted options – will benefit from the higher share price. These points are worth making because the options, even if a detail, are an intrinsically important one. Also, this issue provoked lively debate in the Share Council and vigorous letters to *Points of View*.

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Concluding Remarks

A · THE CASE

In the middling and inferior stations of life, the road to virtue and that to fortune, to such fortune, at least, as men in such stations can reasonably expect to acquire, are, happily in most cases, very nearly the same. *Adam Smith, 'The Theory of Moral Sentiments'*

The starting point of this book is the still widespread, and in my view largely justified, discontent among ordinary people with the system of conventional private capitalism, especially as it is practised in the US and Britain. The fact is that however optimal it may look from the eagle's nest occupied by the editor of the *Economist* or from the trading floors where men – and 'superwomen' – could earn, with bonuses, well over £1m a year in the mid-1990s, the system's main features seem a good deal less than optimal to many; and almost certainly to a majority of those in Adam Smith's 'middling and inferior stations'. Among the system's particulars most subject to criticism are income differentials which offend against any reasonable idea of shared citizenship and barely acceptable levels of employment security. In more general terms, what is seen as the top downwards oppressiveness of the system is widely resented, as is the way in which it serves to perpetuate the subordination of one class to another.

From that starting point I go on to emphasise that these discontents are substantially non-existent in Japan, despite the fact that in law the Japanese system of corporate capitalism is very similar to what it is in the Anglo-Saxon world. Following Professor Ronald Dore, I then suggest that because of a Confucian component in Japanese culture, the living realities of its capitalism, even though not encompassed by its corporate law, have been modified and softened with immense benefits to the country's economy. Always following Professor Dore, the argument is that because of this softening the typical Japanese business is seen as a more or less acceptably fair and reasonable organisation by the majority of those working in it. In consequence the country's businesses attract high levels of employee commitment. As a further consequence Japan's trade unions behave for most of the time as if their members' interests are very closely linked to the success of the businesses for which they work. And that link is objectively reinforced by a typically high variable component in employee remuneration which moves up or down with financial results.

Given the obvious potential benefits if similar levels of employee commitment, and similarly union attitudes conducive to business success, could be achieved in the US and the UK, there is an obvious question: whether any effective method exists for injecting the desired Confucian component into other cultures. But if, as seems on the face of it more likely, there is no such method, then it makes sense to see whether there are any other means of achieving, in the Anglo-Saxon world and elsewhere, levels of employee commitment and pro-business trade union attitudes similar to those in Japan. The central hypothesis of this book is, of course, that employee ownership offers the most promising way forward.

Here as earlier, and in anticipation of wrongly targeted objections, I must again flag up some of the ways in which my own recommendation of the 'employee ownership alternative' needs to be qualified. Though myself committed to its promotion, I am still more fundamentally committed to a pluralism of corporate institutions and to voluntarism, assisted by tax reliefs where appropriate, as the only way to achieve changes that will endure. Employee ownership is not for everyone or every business and it should never, or anyway almost never, be imposed. For what it is worth, I think it is true that most, though certainly not all, of the employee ownership enthusiasts in my acquaintance are, like me, paid up members of the open, broad and pluralist 'church of tolerance'. Many have come to it through the writings of Karl Popper and of Isaiah Berlin.

My prior commitments to pluralism and voluntarism also partly explain why I do not favour the kind of full-blooded, and exclusive legal and moral endorsement of the democratic and employee owned firm advocated by some enthusiasts and most eloquently by Professor David Ellerman. I agree with Ellerman that there are *some* parallels between renting another person's labour and owning it. I think too that his intellectual contribution to the thinking

through of ownership and corporate government issues has been outstanding. Especially notable in my view has been his discussion of the asymmetry in the way in which employment law deals with questions of personal responsibility: essentially the law assigns full control in the driving seat to the employer and only assigns any real responsibilty to the employees when there is an accident. More generally I accept as persuasive, though not overriding, his arguments for the primacy of labour and for the democratic accountability of management if what we want are more truly just business structures. I also remember being delighted years ago by his discovery that ex-slaves who failed to 'make it' in Liberia and/or Sierra Leone in the 1840s and 1850s, and then returned to the southern states of the US, were liable to have to seek the permission of a court if they wished to 'resume the state of slavery'. I am fairly sure that the name of the ex-slave in the case to which he referred was Emile.

As against David Ellerman's 'whole hog' approach to employee ownership and democratic corporate government, I earlier characterised my own as pragmatic. For one thing I believe it would take at least 100 years – if indeed it could ever be done – to persuade a mature electorate that the employment contract is sufficiently like a contract of self-enslavement for it to be outlawed. I also believe that even in the relatively affluent welfare states of today's world, employment may be so important that it in any particular case it may make sense for employee shareholders to sell out if, for example, greater employment security can thereby be achieved. Had I been a bus driver in Fareham or Chesterfield in 1995, I would have voted to sell. And the same might well have been true had I been an employee shareholder in the Michigan copper mine which sold out to German buyers in the early 1990s. Who knows, I might also have been one of those who voted to sell the venerable co-operative glass works in Albi when it became apparent, again in the early 1990s, that that was the only way – in the absence of truly heroic sacrifices – in which a significant number of its jobs could be saved.

As well as being pragmatic my own approach is also incremental and incremental in two senses. First, I can see some virtue or at least potential virtue in the co-determination laws in Germany and those which prescribe profit sharing in France. Each can be seen as a halfway house to employee ownership, the former along the dimension of corporate government, the latter along that of financial participation. Second, I can also see some virtue or at least potential virtue in employee ownership which is less than 100%, whether no more than a significant minority stake as at Polaroid, or over 50% as at United Airlines.

The reference to *potential* virtue should serve to remind readers that the benefits of employee ownership are never, or at least only very rarely, automatic. Rather specific steps will normally have to be taken if ordinary employee owners are to be both motivated and enabled to improve the performance of the business in which they work. All or at least almost all of my case studies point to that truth. Naive employee ownership zealots who believe that by itself it will work to raise levels of 'x' efficiency are flying in the face of almost all the empirical evidence. There are striking parallels between the faith of these zealots in employee ownership and that of the orthodox Christian opponents of the Pelagian heretics in the early Church. The former believed that the grace of the holy spirit would do the job of making believers into genuine Christians. Against that the Pelagians argued that a good deal of personal effort was also required.

Given this approach, my case is not confounded by examples of failure. As we have seen, most American studies show that employee ownership by itself, without a supporting buttress of appropriate employee involvement in corporate government, makes no difference to business performance one way or the other. In the limiting case, ownership alone may even have negative consequences if it gives rise to expectations of a bigger say in corporate government which are then confounded.

But it would be absurd to go over all the empirical evidence once again. The question is whether what has been brought together in this book is sufficiently persuasive to justify further Government support on public interest grounds and a shift to more positive attitudes by the key players: by top management, by the trade unions, and by financial institutions.

Aside from the evidence of my own individual case studies and what they say about the quality of working life as well as about performance, it may just be worth reminding readers of the semi-aggregate evidence from sample studies in America. To repeat, the single most important piece was published by the American Government's General Accounting Office in 1987. Comparing a sample of 'significantly employee-owned firms' with a matched sample of conventionally owned ones, the study showed that those

among the former which had also introduced schemes of effective employee participation in decision making were the clear winners. By measures of both employment and profitability growth they were shown to outperform the conventionally owned competition. They were also shown to outperform themselves, in the period before their employee ownership started. What is more, not quite all but the great majority of a growing bookshelf of similar but academic American sample studies of matched ESOP and non-ESOP firms have come up with the same conclusion. Finally, and this only came to my attention early in 1997 when I had just started to think about this last chapter, an important new piece of evidence surfaced from reasearch work in Washington State in 1994. Again we are dealing with a matched sample study. But in this case a number of firms which were significantly employee owned and significantly participatory were set for comparison against a matching sample of firms which, though conventionally owned, had also introduced advanced schemes of employee participation. Those in the first group emerged as the winners in the study, strongly reinforcing the commonsense view that ownersip is an important independent variable which, when added on to participation, can produce extra benefits. (The title of this study is *Comparing Growth Rates in Employee Ownership Companies to their Participatory Competitors: A Supplement to Employment and Sales Growth in Washington State Employee Ownership Companies: A Comparative Analysis*. It is written by Peter Kardas, Ph.D. of the Washington State Employee Ownership Programme.)

With one possible qualification, my own view is that fair-minded readers, having absorbed and reflected upon the evidence, will see it as sufficiently positive to justify further steps of promotion. The qualification I will highlight at the conclusion of this chapter. It has to do with the performance of economies as a whole rather than that of individual firms or groups of firms. But in relation to the latter, I have no serious doubt that fair-minded readers will see the evidence as positive, notwithstanding the acknowledged examples of failure and notwithstanding the acknowledgement of special reasons for failure by employee-owned businesses. For it is true that those businesses, as I have shown with examples, may face difficulties linked to their ownership and corporate government structures as well as all the difficulties faced by any business in a competitive market economy.

The empirical evidence about the potential benefits to actual businesses of a combination of employee ownership and employee involvement in corporate government must be the primary and necessary condition for urging further steps in the same direction. Without that we should collapse the whole project like a tent and try something else. On the other hand, if that condition is satisfied, then it is reasonable to take account of changes which might be expected to follow outside the actual businesses: beneficial changes in the economy as a whole and perhaps also in the health and well-being of the communities in which these businesses are located.

I have space for no more than a really brief discussion of these likely consequential changes. In terms of the political priorities of the 1990s, the most important would be lower levels of unemployment. The case studies have shown this result in relation to particular businesses and business groups. Whole steel plants, as we have seen, can be saved from closure by employee ownership, and thus so can the communities which depend on the associated incomes. We have seen too, for example in the case of the Mondragon group, that these firms may deliver hugely more new jobs when the business cycle is in an expanding phase, and be hugely more successful at preserving jobs when it is contracting. Nearer home we have seen that partly because of the high but variable bonus component in the package of benefits enjoyed by its partners, the John Lewis Partnership has been more successful than its top British competitors in sustaining employment levels during recessions.

In relation to particular businesses I should also mention, for a fuller discussion shortly, the significant employment loss which results from the failure of private companies to solve problems of ownership succession. The potential of employee ownership for saving those jobs is obvious enough.

Standing aside from the employment generated and sustained and indeed lost by particular businesses, it can be plausibly argued that the more widespread the incidence of employee ownership and profit sharing in a market economy the higher will be the 'safe' level of economic growth which the authorities may target. Here we are referring to growth rates which will be compatible with non-accelerating rates of inflation. The hypothesis that that will be so is explained by the judgement that, other variables being equal, there will be lower pressure for big wage increases in employee-owned and/or profit-sharing firms. On the basis of these arguments a well-

known Wall Street investment banker, Felix Rohatyn, was in fact prepared to go on the public record in 1996 with a bold prediction: to the effect that if employee ownership and profit sharing were to become really significant features in the American economy, then it would become safe for the authorities to increase by a full percentage point their target rate of growth for the country's economy.

I would like to make one more point about the potential benefits 'outside the factory gates' that employee ownership, and the employee involvement which needs to go with it, might be expected to bring with them if sustained in a community, a region, or indeed a country, for any considerable period of time. My point here is in fact an old hypothesis which goes back at least as far as John Stuart Mill. But it is one which, so far as I know, only began to be seriously researched in early 1997. Put crudely, the hypothesis is that the two together, employee ownership and employee involvement, can result in measurably higher levels in the quality of a community's life – for example in the quality of its parenting, in the educational achievement of its children, in improved health, in reduced crime, in greater rates of citizen participation in civil society, perhaps even in less time spent watching the television. As some readers will know, apart from its intuitive appeal, the hypothesis appears to enjoy some tangential support from the work of scholars like Richard Wilkinson and Robert Putnam. I have no space for a proper discussion of their work here. But in summary Putnam's work seems to show a link between democratic participation and the quality of a community's life. The link which Wilkinson's work suggests is one between narrower income differentials and higher scores on some standard measures of public health and well being – for example, life expectancy and levels of crime. Putnam's data comes from Italy. Wilkinson's comes from a number of countries. The location of the new research is the small Italian town of Imola with which, from two of my case studies, readers will already be familiar.

B · MAIN OPPORTUNITIES

Those readers who are at least half persuaded of the case for promoting the gradual and voluntary spread across British business of employee ownership, and of its complementary employee participation in corporate government, may welcome a brief discussion here of the situations which offer the greatest promise for these changes. Having reviewed those situations we can then go on to ask whether, always within a framework of voluntarism, some additional measures of encouragement by the authorities would be appropriate.

The most common business problems to which employee ownership can offer attractive solutions are, as has already been argued, those of ownership succession in private companies, perhaps especially when those are family businesses. (By private I mean 'non-quoted', with their shares not listed on a stock exchange.) Listed companies do not have to face up to ownership succession problems, at least not in the same way as private companies. As their shares are bought and sold, ownership simply rolls over. In that process the employees are no more and no less than 'part of the furniture' of the business in which shares are being continuously bought and sold.

But it is not only argument which points to the ownership succession problems of unlisted companies as the most promising source for changes to employee ownership. The American evidence demonstrates that once employee ownership becomes reasonably well known and once hostilities to it (of one kind and another) have been at least partly damped down, that is what actually happens. In the the first half of the 1990s, as in the 1980s, the wish of main shareholders in private companies to be bought out was the starting point for the largest single cluster of moves in America to employee ownership. We are talking of annual US numbers in the middle hundreds of businesses. So we might reasonably look forward, once employee ownership becomes better known and more accepted in Britain, to annual numbers of between 50 and 100 in the UK.

Next I want to highlight a converse point: the cost measured by job losses and thus reduced employment if employee ownership is not seen, and therefore not used, as one solution to these problems. I know of no studies which have estimated the scale of the employment numbers lost in Britain for this reason. But a semi-official French study in the 1980s estimated that 10% of the country's combined annual total of bankruptcies and voluntary liquidations – perhaps an average annual total as high as 2,000 cases – result from a failure to cope with ownership succession problems. (Reported in brochure on *Loi sur le Développement de l'Initiative Economique, Ministère de l'Economie, des Finances, et du Budget,* 1984.) Since then the European Commission has come up with estimates running into the high tens of thousands, for the annual job losses from this source in the countries of the European Union as a whole. Yet the Commission's enthusiasm for recommending employee ownership to member countries as one means for reducing the numbers has been at best limp and watery, and for most of the time virtually zero.

After the ownership succession problems of private companies, the available evidence suggests that at least in the UK the spinning off of non-core activities by conglomerates – whether the latter are private or listed – is potentially the next most important starting point for changes to employee ownership. Indeed, with only minor and probably revenue neutral changes in the law, the numbers of businesses moving into employee ownership in the wake of corporate spin-off decisions could come in Britain to exceed those from all other sources and do so by a comfortable margin. That is because of the consistently high numbers of management buy-outs (MBOs) – and more recently also of management buy-ins (MBIs) – which have featured in Britain's business life at least since the early 1970s. According to the well-established Centre for Management Buy-out Research at Nottingham University, the annual number of these transactions averaged between 500 and 600 over the seven years down to 1996 and roughly two thirds were in the MBO category. The proportion that have subsequently failed has varied from year to year around 10%. Typically most of the survivors either go public, that is float their shares successfully on a stock exchange, after between five and ten years or are the subject of a trade sale. The resulting capital gains for those involved in the original transaction typically reach seven figures and often more.

To repeat, with relatively modest and probably revenue neutral changes in the law, many of these MBOs and MBIs could be replaced by what are now normally known as management-led employee buy-outs or MEBOs. Indeed the main obstacle which prevents that from starting to happen, as I shall come on to explain shortly, is not so much the law, let alone the availability of finance, but the typically hostile attitudes of both managers and trade union officials.

As exemplified by my two case studies from America's steel industry a third starting point for a move to employee ownership is the impending, and sometimes actual, close down of a more conventionally owned business. Of course, in the absence of a widespread readiness by employees to make truly heroic sacrifices, many 'impending closures' will have become inescapable by the eve of the closure happening, or indeed well before. On the other hand the best available evidence suggests that in an important minority of cases that calamity can be averted. Maybe all the jobs will not be saved but a worthwhile number can be. The United Steelworkers of America (USWA) must be given enormous credit for its role as the prime mover behind processes which successfully used employee ownership in the late 1980s, and then in the 1990s, to avert closures. Tens of thousands of jobs have been saved in this way through its advocacy and good offices. The union's experience in the late 1980s and the first half of the 1990s suggests that in 20% of all cases in which its help was sought, the threatened jobs, or at least a substantial percentage of them, were saved. Thereafter the success rate was over 90%.

My two British local bus company case studies and that of Britain's NFC point to privatisation as a further starting point for changes to employee ownership. So does the study of Hungary's Herend Porcelain Manufactory, a most exemplary MEBO privatisation, if ever there was one. As we know, the resulting employee ownership in my three British privatisation cases lasted no more than a few years. Sill it was not without its benefits nor indeed without its rank-and-file employee beneficiaries. But there is no need to go over that ground again. It makes more sense to point to another privatisation MEBO in Britain's local bus industry where its employee ownership, like that at Herend, was still very much alive and well when this was written in the spring of 1997. That other example is Preston Bus which operates in and around the Lancashire town from which it takes its name. With roughly 300 employees it is similar in size to each of the two local bus companies studied earlier in this book. Like Chesterfield Transport it was previously owned by the local authority. Its actual buy-out in 1993 has other points in common with Chesterfield's: for example it was very much a joint management and trade union effort.

In many ways Preston Bus deserves a full-length case study. Among other things its 100% post-privatisation employee ownership seems certain to survive into the next century. But I would risk presenting an unbalanced picture if I pursued it here. For the main point about the Thatcher and Major privatisation programmes in

Britain is that for employee ownership, except on the margin, they were missed opportunities on an unprecedented and probably never to be repeated scale. As for the similar opportunities thrown up by privatisation programmes in former Communist countries from 1989 onwards, I explained in the preface why, Herend always excepted, I have chosen to leave them out of this book.

What about the opportunities that could be thrown up by programmes of privatisation which might be enacted by the Blair Government? I keep an open mind about whether any new privatisation will in fact be enacted by Mr. Blair's Government. After all, given what was removed from the public sector by the successive Thatcher and Major programmes between the early 1980s and the spring of 1997, there was not much left for Mr Blair to privatise, at least not unless schools and hospitals are to be included as possible targets.

But two positive points are perhaps worth making. The first is that given their character as service undertakings, two of the largest still unprivatised businesses after the May 1997 election, the Post Office and the London Underground, look like rather promising candidates for employee ownership. Even more promising candidates, or so it seems to me – and this is my second point – are the residential care homes owned by the local authorities. Of course there are some formal and some real financial differences between residential care and care delivered in people's homes. All the same they are sufficiently similar for the now well established successes of employee ownership in home care to create a reasonable expectation that the same would happen in residential care. Readers can refresh their memories about the evidence for the former by turning back to the case study of Co-operative Home Care in New York. Or, nearer home, they might visit Sunderland Home Care Associates in the North East.

The wish of principal shareholders in private companies to be bought out when faced with problems of ownership succession, the decisions by conglomerates to spin off non-core activities, the privatisation programmes of Governments and local authorities, and lastly impending closures where a successful rescue is still possible, these will surely be the main starting points for the spread of significant employee ownership in the future. I say 'significant' advisedly. Readers may remember that in my view employee ownership, if it is to qualify as significant, must satisfy two tests.

First, taken together, the shareholdings of all the employees must exceed the threshold necessary to give them a defined collective voice in the corporate government of the business. Second, taken individually, the average employee ownership stake – or average annual bonus where that constitutes the main ownership reward – must be sufficient to have a real chance of influencing individual behaviour. An average bonus with the value of Christmas dinner won't do. Nor will an employee shareholding worth a few weeks' wages.

There may be other starting points for particular employee-ownership projects. Readers will remember the examples of Polaroid and of United Airlines from my case studies. At Polaroid, its employee ownership was introduced as a defence against a threat of take-over. At United Airlines the prime mover behind the project was the pilots' union, namely ALPA. The reasons which led ALPA to go for employee ownership, which it had tried three times to achieve before its eventual success in 1994, were fully discussed in the case study. But were other unions to follow the example of the ALPA pilots at United, and decide that employee ownership offers a better framework in which to exercise their calling, or at least that it is worth a try, then we might begin to see quite appreciable shifts in the prevailing corporate ownership furniture.

What is more, it can hardly be emphasised too much that the ESOP mechanism invented by the late Louis Kelso is almost protean in its range of possible applications. There will be new particular starting points, to add to take over defences and pioneering union initiatives. There will be a few cases too where the ESOP mechanism is used to help start up new businesses from scratch. Nevertheless it is not cases of those kinds, but ones that fall into the four main categories that we have just reviewed, which will best justify a public interest argument for new Government assistance. We must turn next to discuss what forms such assistance might most sensibly take. I will focus first on possible measures to encourage employee ownership to be used more frequently as the solution to problems of ownership succession in private companies.

The good news is that the most helpful new measure would be revenue neutral except in so far as it encouraged a bigger take up of existing reliefs. It can be easily and briefly specified, even if the language is inescapably technical and cumbersome. What is needed is that a key existing condition, relating to the tax reliefs available when shares are sold to a statutory ESOP trust, be modified. The relevant condition specifies that all shares which are sold to such a trust with the benefit of a rollover relief for capital gains tax, must eventually be got out to individual employees. The condition needs to be modified in such a way that the relief will also be available when an appropriate percentage of the share capital of the employee owned business is not got out to individual employees at all, but is held indefinitely on their behalf in a permanent employee trust.

The logic of what lies behind the need for a substantial percentage of employee shares to be held indefinitely on their behalf in an employee trust if the employee ownership is to be sustainable, was spelt out in some detail in the Tullis Russell case study. There is no need to go to such lengths again here. But three points are worth making.

Without a substantial holding of employee shares in a permanent trust, it will simply be impossible both a) to buy back shares from individuals who leave and b) to make the investments necessary to remain competitive.

What we are dealing with is a matter not of law but of business logic. So it applies to employee ownership in America – or indeed Hungary or indeed anywhere else – with precisely the same force as it does in the UK. The case studies of, for example, Weirton and Republic Engineered Steels provide unchallengeable evidence to that effect.

Some argue that there is no need for or virtue in sustainability and/or that it is at variance with America's more mobile culture and/or that the thinking behind it may be either unacceptably paternalistic or possibly unacceptably impious – by virtue of seeking to go on 'for ever'. There are three common-sense rejoinders. One is that people working in employee-owned firms are as free to leave them as people who work in more conventional ones. The second is that if employee ownership can deliver the benefits which the case studies of the best ones suggest is possible, then it is absurd to settle for a framework which makes that ownership necessarily unsustainable. And third, as a counter to the possible charge of impiety, it is worth pointing out that conventional companies are free under company law to plan corporate lives co-terminus with that of the planet.

What, next, about changes in the law to encourage a switch from MBOs or MBIs to MEBOs when conglomerates decide to spin off subsidiary businesses that are deemed to fall outside their inner core? In this case, to repeat, the main obstacles to change are almost certainly the reluctance of managers to share the potential capital gains with a wider group and the reluctance of union leaders and officials to push reasonable demands for their members to take part. The managers should be more enlightened and generous. The union leaders should show more courage and be prepared to bargain for defined employee 'MEBO rights' when corporate spin-offs take place. But of course it is much easier to offer prescriptions than to change attitudes .The latter will remain the biggest obstacles. They are at the heart of the wider problem of successful employee ownership promotion.

But to return to the legal issues. The company lawyers say that there is one rather specific and revenue neutral change which might be helpful in promoting a switch to wider employee involvement in spin-off deals. The point is almost unacceptably technical but perhaps just worth spelling out. Currently a subsidiary company may not form a statutory ESOP. Given that the value of such a company's shares is liable to manipulation, the case for a general prohibition is reasonable. However, an unintended consequence of what is otherwise sensible is that when a large company is selling a non-core subsidiary, the subsidiary cannot itself set up a statutory ESOP. Consequently it is that much more difficult, and may be relatively less tax effective, to include the rank-and-file employees in any associated buy-out. The consensus among lawyers, or at least among the small minority who are reasonably sympathetic to employee ownership, is that it should be possible to frame the desired exceptions to the general prohibition without any seriously adverse consequences.

What finally about extra encouragement by Government for employee ownership when businesses are threatened with closure – or have actually been closed – and when they are privatised? In relation to the first I don't think I can do more than commend and draw to the attention of a larger audience a rather specific measure of support which relates to situations following actual closures and which was enacted by the Italian Parliament in the 1980s. This is the so-called Marcora law, named after the senator who was the prime mover behind it but who has since died. Under it and so long as a number of well-designed conditions are satisfied, those made unemployed when a business is closed down are free to take a part

of their prospective unemployment benefit in a lump sum. An obvious proviso is that the lump sum must be invested within the framework of a plan to get the defunct business, or part of it, started again.

No doubt there will always be a vocal minority of ideological Schumpeterians who posit long-term benefits if the 'creative destruction' of capitalism is simply allowed to get on with doing its stuff without serious contrary interventions. There is obviously something in that view so long as it is taken to do no more than a recommendation of caution: in stopping the close down of businesses heading in that direction and in encouraging those which have already closed to re-open. Nevertheless both the experience and the procedures of the United Steelworkers of America (USWA) seem to provide us with excellent guidelines to follow. In relation to policy and procedures, as readers may remember, USWA will only be prepared to seek help for a failing or failed business if the chances of success have been shown to be reasonable or better on the basis of top quality feasibility studies and business plans. As noted earlier, USWA has supported efforts to get help in some 20% of the cases that have been brought to it. On the other hand, when help has been forthcoming there has then been a success rate of over 90%.

As for changes in the law to encourage more employee ownership outcomes of privatisation, the politicians face an extended spectrum of choice even if we confine ourselves, as we should, to a framework of voluntarism. No one in their senses would seek to *impose* an employee ownership outcome on a process of privatisation. Even in a country like Slovenia, where the main privatisation law is as employee ownership friendly as any that I know, the rank-and-file employees and their managers are free *not* to take advantage of what is on offer. Moreover they are required to put in either 'citizens vouchers' or money or both, if they are to take maximum advantage of the employee ownership opportunities available to them. For the record, in the case of most of the businesses in Slovenia's main privatisation programme, that maximum is such that the employees and ex-employees together can acquire up to 60% of the share capital of the business on a privileged basis.

At the other end of the spectrum is what was typical of the main privatisation projects under the successive Thatcher and Major administrations between the early 1980s and the election of 1997. If we exclude the local bus industry, NFC and few other one-off cases of MEBO privatisation, those responsible for selling off the state's industries offered no more than gestures to their employees. The gestures took the form of 'sweetener packages', typically consisting of a few giveaway shares worth the equivalent of say ten days' wages – offers to buy rather more at a discounted price, and the privilege of queue jumping over the general public's 'Sid and Doris' in the subscription for shares at the full issue price. In no case, so far as I know, did the acquisition of employee shares in this way satisfy the first of my two tests of significance and exceed in aggregate the number needed for a defined voice in corporate government. Of course some employees, especially among the higher paid, bought blocks of shares of undoubted financial significance to them as individuals. Many will indeed have made substantial killings. I sometimes think that an important unstated aim of the Tory privatisation strategy was to allow a small minority of the already well-off to become even richer. Certainly that seems like a plausible inference from the high numbers of management buy-outs which were waved through, especially in the local bus industry. Fair enough, or so some will say. But others may detect unacceptable class bias and wonder whether what happened is really compatible with the reasonable aim of moving in the direction of a less class-ridden society. Is it a sensible objective of public policy that the already well off should stand to be far and away the main beneficiaries of what are essentially *political* acts, namely privatisation programmes?

Moreover, it is not really plausible to argue that those responsible for the Thatcher and Major privatisations, the politicians, the civil servants and their advisers, acted as they did because there was no knowledge of any realistic alternatives. NFC, as was made clear in the case study, was one of the very first of the post-1979 privatisation projects. It happened in the life of the first Thatcher Government and had indeed been targeted for privatisation in the party's manifesto for the 1979 election.

As a commentary on all this I can do no better than remind readers of what the late Philip Mayo had to say about it. Philip's were the legal brains which enabled NFC's pioneering buy-out to happen. In politics he had started as a member of the Liberal Party but by the time of the buy-out in the early 1980s he had already for many years been prominent in his local Conservative party and as a

Conservative councillor in his home town of Hemel Hempstead. At the end of the NFC case study I shared with readers his commentary – part critique and part lament – on the Conservative Party's privatisation record down to the early 1990s. Given a combination of its force and his credentials for making it, it is well worth citing again. It figured in a letter written to me shortly before his most untimely death in early 1993:

> It is a sad expression of the dysfunctioning nature of capitalism in this country that the later privatisations took on board our experience in reaching out to ordinary people as investors; but only to use it to create a new sort of gambling chip for 'Sid' to play with. Not, as we hoped, a new sort of ownership for industry.

C · BIG CHALLENGES, DESPITE SOME REAL PROGRESS

I would speculate that the majority of the top Tory politicians of those years had no serious wish to see a 'new sort of ownership for industry'. In part, no doubt, that had to do with the close links between the party and the almost all powerful financial community in the City of London. It is true that Barclays Merchant Bank – as it then was – made a killing on its holding of NFC shares between the buy-out and the float. But my guess is that the overwhelming majority of top City people, like their top Tory counterparts, and indeed the top civil servants, had no serious wish then and still had no serious wish in early 1997, to see a 'new sort of ownership for industry'. To be fair, I have no real doubt that the same was true at that time of least a large majority of the country's top trade union leaders and top industrialists. And I suspect it was still true when Mr Major lost the election of 1 May 1997.

The fact is that despite quite a flow of rhetoric in favour of employee ownership and participation from managers and trade union leaders alike, there is a huge reluctance on both sides to make any really courageous moves to promote significant deals of any ESOP kind. Those close to the early stages of the railway privatisation deals in 1996 reported numerous examples of a proclaimed management interest in the involvement of rank-and-file employees in the deals they were hoping to clinch. At least one of the railway unions also made some supportive noises in favour of securing some employee ownership when the undertakings were privatised. But when real decision time came, the managers typically preferred to keep any prospective capital gains to themselves. On the other side the union leaders felt that they would be more comfortable if their familiar role was not exposed to any possibility of modification as a result of their members becoming significant employee shareholders.

The pity of it is that even when employee ownership has come about and has succeeded either in saving jobs or perhaps securing worthwhile capital gains for rank and file employees, or even both, there seems to be a very widespread propensity on both sides, by management and union people, to slip back into the old adversarial relationship and even to express satisfaction about having done so. Among the case studies Weirton Steel offers the most glaring example and Republic Engineering Steels is not far behind. But David Wheatcroft, the long-serving employee director on Chesterfield's buses and someone who has already made a number of appearances in this book, tells me that there are plenty of examples in the bus industry: of both managers and trade union leaders who have 'gone back' to the old adversarial relationships with relief and even with enthusiasm.

It is those attitudes rather than any deficiencies in the law, or any prospective financing difficulties, which will inhibit the spread of employee ownership in Britain – and indeed elsewhere – over the remaining years of this century and into the next one. I sometimes think that one day it may be possible to *shame* British managers and union leaders, by confronting them with the contradiction between their rhetoric and their actions, to make a serious commitment to a major employee-ownership project. I sometimes think too that the growing body of positive empirical evidence will eventually provoke a quite widespread change of mind.

And yet, it is also reasonable to point out that by comparison with anything of this kind which has ever happened before, the progress of employee ownership over the period of roughly twenty-five years, since Louis Kelso persuaded Russell Long to become the political champion of employee ownership in the US has been of a new kind. We need not go over the numbers again, nor the empirical evidence for success. But let me remind readers, with a a series of quick flash ups, of developments which would surely have been beyond anyone's dreams before the 'new era' started.

In 1996 one of the most famous of New York's investment banks, J. P. Morgan, makes a telephone call to a trade union office and

asks to be kept informed if the union officials get advance information of any buy-out deal similar to the one which they completed roughly two years before. Admittedly the union was not an altogether normal one but the Airline Pilots' Association (ALPA). And admittedly the company was a little bit special too – one of the foremost airlines in the US. But the point is that the deal had not been an affair measured in peanuts but in billions of dollars (from rather over $2bn to just less than $5bn depending on how measured).

After more that seven years' experience of 'employee ownership lending', Britain's Unity Trust Bank, in which the country's leading trade unions are the majority shareholders, reported in 1996 that its bad debts from that lending were sharply less than for its lending to more conventional businesses.

Over the twenty-five years to the middle 1990s those working in two of Britain's most long-established, but otherwise very different, employee-owned businesses – The John Lewis Partnership and Equity Shoes – enjoyed average annual bonuses, on top of fully competitive wages and salaries, of over 15%.

In Italy, the country with easily the largest population of industrial co-ops in today's Western Europe, a top manager in one of the most successful of them launched, in the autumn of 1996, a strong initiative aimed at introducing 'Anglo-Saxon style' employee ownership law in his country.

Contrary to the still overwhelming orthodoxy of the professional economists in the classical liberal tradition, a few brave voices started to ask important questions in the 1990s. Perhaps the key one was this. Is it likely that optimum performance will be achieved by systems of corporate government which put the interests of passive outside shareholders in the driving seat and exclude the vast majority of those whose task it is to deliver the desired performance?

Perhaps after all something has started to change. Perhaps if it goes on, well just perhaps, those who can be classified in Adam Smith's 'middling and inferior stations in life' will eventually find themselves among the beneficiaries. Perhaps, just perhaps, as a spin-off from these changes there will be both more jobs and more fairness, and even conceivably better parenting, less crime, and less sitting in front of the television. But don't count on it and don't for a moment expect the action to speed up of its own accord. The vested interests and class prejudices against that happening are far too strong. Even to prevent the process from sliding back is likely to require unusual efforts.

A POSSIBLE WAY FORWARD

It may not be too much to claim that starting from about 1995 the near consensus of mainstream intellectual, political and business support for the Reagan and Thatcherite economic policies of the 1980s and early 1990s began to show some cracks. In relation to America, I remember an important article by Simon Head which was published by the *New York Review of Books* in the spring of 1996 and given a striking title: 'The New Ruthless Capitalism'. Its theme, later to be re-echoed all over America and elsewhere, was that despite the continued growth of the country's productivity, the real wages of blue collar America were no higher in the early 1990s than they had been in the early 1970s. Virtually all the gains of a twenty-year period had gone, either in the form of higher salaries or higher dividends, to the better off and the biggest gains to those at the top. The article, in short, offered a most serious critique of contemporary American capitalism but not one which started from socialist premises or that wished to abandon the free enterprise system.

But the article itself was perhaps less significant than the way its themes were taken up across the American political spectrum. Its themes were taken up by the luckless Robert Dole, then campaigning in the primaries for the Republican nomination.

Then, early in 1996, the consensus in America behind the Reagan and Thatcherite orthodoxy was again challenged – this time by a voice even, perhaps, more unexpected that of then leading candidate for the Republican Party's presidential nomination. This was the multi-billionaire Hungarian financier and philanthropist, George Soros. His uneasiness about what I may crudely call the 'excesses' of contemporary capitalism was voiced in an article published in *Atlantic Monthly* early in 1997 and reproduced around the world. This is not the place for even the briefest summary of his arguments. But I can't resist noting that they were immediately subjected to the most dismissive criticism in a short and maddeningly know-all piece in the *Economist*. Equally predictable was the editorial hostility of *Forbes Magazine* which ran an article headed 'Beware of Billionaires Bringing Gifts.' But Mr Soros stuck to his

guns and rapidly expanded his article into a book, *The Crisis of Global Capitalsim* (1998).

The ground swell of a similar non-socialist critique of the same Reagan and Thatcherite orthodoxy was also increasingly in evidence in Britain in the early 1990s. Here the running was brilliantly made by the economic journalist Will Hutton whose book, *The State We're In*, was an instant bestseller and who was appointed to be editor of the *Observer* in 1996.

It is true that Hutton's critique was widely condemned as 'populist' and or 'unhelpful' and 'simplistic' by commentators in the mainstream of Britain's economic orthodoxy. But at least some of his criticisms were later echoed, even if in modified form, by for example the widely respected business journalist who contributes frequently to the *Financial Times*, John Plender.

Two overlapping anxieties about the consequences of the Reagan and Thatcherite orthodoxy are perhaps common to all these critics. One is about the hugely inequitable redistribution of the fruits of economic success which has come in with them. The second is about how it is characteristic of the new-style capitalism to be exclusive rather than inclusive in its embrace, and to be so both inside and outside actual businesses themselves. These anxieties prompt the question whether a more human, and thus almost certainly more labour-orientated, capitalism needs to be sought if the system is not to become so unpopular as to call into question its own survival.

And that at last brings me to the possible qualification about the persuasiveness of my evidence for the advantages of employee ownership which I signalled earlier in this final chapter but deferred for discussion to this final stage. It seems to me that at the level of the individual firm, and at that of groups of firms, we are now entitled to be sure that if best practice is followed performance will be at least as good as under conventional capitalism and more often better. There is also I think a strong presumption – to be validated or otherwise by the research just getting under way in Imola – that these businesses when they become reasonably well established will produce quality of life benefits for those in their local communities.

But there is still perhaps an important unknown. What might be the consequences if a largely employee-owned capitalism was to replace the conventional variety not only in a firm or a group of firms but quite widely across a national economy. No doubt, if nothing else, we can predict that a dramatic move in that direction – as opposed to a slow incremental process – would precipitate a flight of mobile capital.

However it is not that, but the likely comparative performance of a substantially employee-owned economy which needs to be examined. Moreover I have a rejoinder to the obvious objection that no such substantially employee-owned economy exists and thus cannot be examined. There are possible proxies given that what we are really wanting to find out about is the comparative performance of a more human, more people-orientated and indeed more labour-orientated system always within a free enterprise framework.

It seems to me that the German economy offers one proxy for what we want to know more about. I would also argue that Japan offers another. In the case of Germany, and in comparison with both Britain on the one hand and Europe's three main Latin countries on the other, a Dutch economist, Dr de Jong, has already done some important preliminary work. For what it is worth, his research seems to suggest that the greater labour orientation of the German economy has stood it in good stead, at least for most of the last forty-odd years. On the other hand, there are important recent studies of the effective use of capital by German businesses on one side and by their US counterparts on the other. These apparently suggest that by this measure the less labour-orientated 'Anglo-Saxon' capitalism achieves hugely better results.

The starting point of this book was the widespread surviving discontents with conventional capitalism and my sympathies with them. Those who share those sympathies should also share my view that we need a better understanding of the comparative performance of capitalisms which are more or less orientated towards labour. That for me is the big unknown which now cries out to be examined. Employee ownership is only one form, if perhaps the most radical one, which a more labour-orientated capitalism can take. But we now know that it can work, and work well, at the level of individual firms or groups of firms. I think we can also be confident that it offers undoubted benefits to those at the middle and lower levels of enterprise wage scales. Surely the records over many years of the John Lewis Partnership and Equity Shoes tell us that. I hope that people so placed on those wage scales won't mind if I equate them with those in Adam Smith's 'middling and inferior

stations' and suggest a) that employee ownership could modestly increase their share in the returns to their work and b) that their local communities as well as themselves should benefit as a result.

Let me close by attempting to dispose of an obvious but ill-founded objection – that a more labour-orientated economy, like that of Germany, has been experiencing, by virtue of that orientation, much higher levels of unemployment in recent years than its Anglo-Saxon counterparts. I would argue that it is not the sort of labour orientation that goes with employee ownership which is responsible for Germany's high unemployment levels but something very different: a labour orientation which finds its expression in a whole tangle of unhelpful government restrictions – especially those relating to employee dismissals. As my case studies show, the kind of labour orientation embodied in employee ownership need not suffer from any such handicaps at all.

Postscript

Numbers are given in chapter 3 for the total of private and public companies which had introduced all-employee schemes in 1994:

With all-employee profit sharing/share schemes, 1,100

With all-employee SAYE schemes, 1,250

In December 1998 the Treasury published a pamphlet entitled *Consultation on Employee Share Ownership*. It included a table with the 1998 totals for those same two schemes:

With all-employee profit sharing/share schemes, 869

With all-employee SAYE Schemes, 1,201

In the case of the US, the latest data comes from an academic rather than an official source. Professor Richard Freeman of Harvard University chose employee ownership as the subject of his Lionel Robbins Memorial Lecture, with the title *The Road to Shared Capitalism and Economic Justice*. It will have been noticed that in the discussion of the numbers in the US in chapter 24 there is a superficially bewildering array of statistics. The main explanation is that different sources measure different aggregates. The following numbers are taken from Exhibit 3a in Professor Freeman's lecture:

Shared Capitalist Institutions in US and Multinationals

Millions in 401 K plans	23.1
With some employer stock	6.9
Largely in own firm	2.0
Millions in ESOPs	7.7
Millions in stock ownership	7.0
Millions with all-employee stock options (AESOPs)	5.0
Millions on employee improvement (EI) committees	22.0
Percentage of multinationals with AESOPS/share purchase	27%

In Exhibit 5b of the same lecture, Professor Robbins brings together the results, in relation to employee ownership, of:

Meta-Analyzes and Large Studies of Productivity Effects

ESOPs	
All studies	3.3%
Cross-section study	6.2%
Longitudinal study	4.4%
(Cash) Profit Sharing	
All studies	5.0%
Longitudinal study	7.4%
Worker Participation in Decisions	
All studies	6.0%

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