A Critical Analysis of Different Forms of Employee Ownership

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"Those who cannot remember the past are condemned to repeat it."
Santayana

Abstract

From the 1970's, there has been almost a half-century of development of employee-owned firms. There has been a wide variety of legal/capital structures that have been tried but too little analysis of which legal forms work or don't work over the longer term, e.g., the transition from one generation to the next generation of employee-owners. This paper provides a critical analysis of the major forms. These include the forms based on common ownership (Yugoslav self-managed firms and the UK EOTs), the older plywood cooperatives in the US Northwest along with the Spanish Sociedades Laborales, and the American Employee Stock Ownership Plans (US ESOPs). Finally, we advocate a variation on the ESOP model that seems to avoid some pitfalls and combines the best aspects of the past forms of employee ownership.

Keywords: Common ownership, Yugoslav self-managed firms, Janus shares, mule firms, ESOPs.

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Introduction

During the 20th century, there were many different experiments in employee ownership. Much could be learned about positive and negative aspects of the different ownership structures. Yet this paper is premised on the relative lack of institutional learning. There are several reasons for the lack of learning:

- Ideological biases (which we will analyze);
- Lawyers and legislators who think it is "obvious" how to structure employee ownership;
- Institutional inertia by second-tier organizations "committed" to an existing legal form;
- Successful entrepreneurs and owners who apply their 'entrepreneurial genius' to developing their own *ad hoc* schemes (and any alternative is "Not invented here"), and
- Simple inattention to the lessons of the past.

Common Ownership

Probable origin of bias against recoupable claims on retained earnings

In an employee-owned firm, the employee-members have a choice about what to do with the value-added (= revenue – non-labor costs). Of course, much of the value-added will be paid out during the year as the wages and salaries but there may be after-tax income left at the end of the year. The members have the choice to pay it out as bonuses or to retain that income to directly fund new investments or pay down the loans that funded past investments. If they pay out that income as bonuses, then it is their individual property. But with the common or social ownership structure, they lose any recoupable claim on retained income. This creates various distortions discussed below, but why the bias against recoupable claims in the first place?

An explanation of the probable origin of that bias seems to go back to the characterization of the system called "capitalism" and thus to the view that such recoupable claims would be "capitalist." The name and characterization of "capitalism" was historically due to Karl Marx. Marx based his analysis on the medieval notion of land ownership where the landlord was the Lord of the land. The medieval notion of land ownership as "dominion" rolled together the governance rights of the people living on the land as well as the appropriation of the fruits of their labor. As Otto von Gierke put it, "Rulership and Ownership were blent." (Gierke 1958, p. 88) Or as Frederic Maitland echoed: "ownership blends with lordship, rulership, sovereignty in the vague medieval *dominium*...." (Maitland 1960, p. 174). In Marx's analysis of the so-called "capitalist" system, he substituted capital (i.e., the "means of production") for land.

> It is not because he is a leader of industry that a man is a capitalist; on the contrary, he is a leader of industry because he is a capitalist. The leadership of industry is an attribute of capital, just as in feudal times the functions of general and judge were attributes of landed property. (Marx 1977, pp. 450-1)

This analysis of the "capitalist" system as being based on private property delighted and was readily adopted by the defenders of the system. And even progressives and leftists who were not doctrinaire Marxists still absorbed that characterization; it was one thing that both defenders and critics of the system agreed on. Boiled down to the essentials, the idea was that the rights to appropriate the product of production and to govern the people working in the production process was part and parcel of the "ownership of the means of production." As one English Liberal put it:

> The owner of capital resources, or the agent who acts on behalf of the owner or a number of associated owners, controls and determines, *in virtue of such ownership*, the process of production and *the action of the workers* who are engaged in the process. (Barker 1967, pp. 105-6 [emphasis added])

Yet, that characterization, which might be called the "fundamental myth," is easily seen to be factually false for the simple reason that, unlike land in the medieval times, there are well-developed rental markets for capital goods such as machinery, buildings, and even land. When the owner of such means of production rents them out to a firm, then that owner does not appropriate the product or profits from the production and does not control the employees carrying out the production process. This is even true when an entire factory is leased out to an operating firm.

In the early 1950's, the Packard auto bodies were produced for the Studebaker-Packard Inc. by Briggs Manufacturing in their Conner Avenue plant in Detroit. When the founder of Briggs died, all of their 12 plants in United States were sold to Chrysler. "The Conner Ave. plant that had been building all of Packard's bodies was leased to Packard to avoid any conflict of interest." (Theobald 2004) In this case, an entire factory was leased by Chrysler to Studebaker-Packard. The shareholders of Chrysler still owned the Chrysler corporation whose property included the Conner Avenue plant, but Chrysler was not the *operating firm* in the operation of that plant since it was leased out to Studebaker-Packard. And Studebaker-Packard had the management rights and the product rights over the operation of the Conner Avenue plant since Studebaker-Packard had made the necessary market contracts (leasing the physical assets, hiring the workers, etc.). But Studebaker-Packard did not own the "means of production."

In spite of Marx's false characterization of the "capitalist" system being quite congenial to its defenders, perhaps the most philosophically sophisticated defender and founder of the "Chicago School of Economics," Frank H. Knight (1885-1972), did not call it by that name.

> Karl Marx, who in so many respects is more classical than the classicals themselves, had abundant historical justification for calling, i.e., miscalling—the modern economic order "capitalism." Ricardo and his followers certainly thought of the system as centering around the employment and control of labor by the capitalist. In theory, this is of course diametrically wrong. The entrepreneur employs and directs both labor and capital (the latter including land), and laborer and capitalist play the same passive role, over against the active one of the entrepreneur. It is true that entrepreneurship is not completely separable from the function of the capitalist, but neither is it completely separable from that of labor. The superficial observer is typically confused by the ambiguity of the concept of ownership. The owner of an enterprise may not own any of the property employed in it; and further reflection will show that the same item of property may in different senses be owned entirely, or in widely overlapping degrees, by a considerable number of proprietors. (Knight 1956, p. 68, fn. 40)

This intersection between Marx and Knight is further developed in Ellerman (2024).

But the easy factual refutation of Marx's characterization of the system has had little effect in left-wing, not to mention, socialist circles.

> It is astonishing that a hundred years of socialist thought have not confronted the basic capitalist idea—that owners of capital have the right of command in the relations of production. The idea behind nationalization, wage earner funds, and the like is in fact fundamentally the same idea as that on which capitalism is based, namely, that ownership of capital should give owners the right to command in the production process (be they democratically elected politicians, state bureaucrats/planners, workers' representatives, or union officials). Indeed, this is a nice example of what Antonio Gramsci called bourgeois ideological hegemony. (Rothstein 1992, p. 118)

And it is this “ideological hegemony,” on the part of socialists, leftists, progressives, and even Gandhian thinkers (Nuttall 2022), that seems to be basis for much of the bias in favor of common or social ownership instead of any individualized recoupable claim on retained earnings.

Yugoslav self-managed firms

The horizon problem

In the mid to late 20th century, there was a challenge to the dichotomy between private-enterprise “capitalism” and the Soviet-style state socialism (or state capitalism) made by the Yugoslav system of self-managed firms. Since they were sponsored by the Marxist government, they of course had “social ownership.” The professional defenders of the (private) “capitalist” system, i.e., the conventional economists, needed to find flaws in the self-management system.

One of the widely discussed flaws was the horizon problem (Furubotn and Pejovich 1970). Since the workers had no recoupable claim on retained earnings to buy a machine, they would rationally consider their time horizon in the firm. If the machine would be fully depreciated in, say, 15 years, and a worker would be in the firm for that time, then it would be more like an individual buying an asset and enjoying the benefits of the asset for its lifetime. But if the worker had a shorter time horizon, say 5 years, then it would be like an individual buying a 15 year asset but not being able to use it after 5 years. This would distort the investment decisions of the firm.

The bias in favor of debt finance

Since the workers had no recoupable claim on retained earnings, there was a straightforward bias in favor of taking out current net income as bonuses and financing new investments with debt. The debt finance would postpone the problem of the usage of net income (pay out or retain) over a longer period of time—whereas the alternative of paying out current net income as bonuses was an immediate benefit.

The solution of individual capital accounts

The solution to these problems of common or social ownership is the system of individual capital accounts (ICAs), a system that is one of the major and yet little appreciated social inventions pioneered by the Mondragon worker cooperatives (Ellerman 1986). In addition to the almost unconscious absorption of the fundamental myth on the left, there is the idea that ICAs are equity capital and thus “capitalist.” But this is clearly wrong if one bothers to analyze the question. If one has more equity in a conventional firm then one has more votes and a bigger share of the net income (e.g., as dividends). But neither of these are attached to the larger ICAs that older or higher paid members might have. The votes and the share of net income are independent of the size of one’s ICA so the ICAs are clearly not equity capital. The balances in the ICAs are a form of debt of the cooperative to the members representing the earnings that could have been paid out but were instead retained in the cooperative.

But accountants will ask, “If the ICAs are subordinate debts, then what is the equity capital on the balance sheet in a worker cooperative?” The answer is that there is no “equity capital” in a Mondragon-style worker cooperative since labor is the “equity” factor, not capital. That is, one qualifies for membership by working in the cooperative, not by buying equity shares. Technically, the Liabilities side of the balance sheet in a Mondragon-type worker cooperative is divided between ordinary (external) debts and the subordinate internal debts to the members represented by the ICAs.

In some American agricultural or producer cooperatives, there was a system that amounted to ICAs. The after-tax net income was declared as a "patronage dividend" to the members but not all of it was paid out. The part that was not paid out was evidenced by "written notices of allocation of patronage dividends" that were clearly a subordinate debt to be paid by the cooperative to the members in the future. This was a:

> revolving capital plan of financing—a financing plan in which capital funds are obtained from member patrons through capital retains or retention of patronage refunds, are used for a time by the cooperative and later repaid to member patrons… . (Zeuli and Cropp 2004, p. 87)

The accumulation of a member's written notices was the equivalent of their individual capital account.

There may also be a collective account which is not individuated (i.e., has no owner or beneficiary) and which represents a type of self-insurance. If the co-op could take out an insurance policy to guarantee the repayment of the ICAs, then it would have a cost, say, 20% of the insured amount. However, that sort of a risk is not insurable so the best a co-op can do is the self-insurance of only promising to pay back 80% of the retained earnings by crediting only 80% to the ICAs and 20% to the collective account. The Mondragon cooperatives have a collective account in addition to the system of ICAs.

Backward bending supply curves

The criticism of the Yugoslav self-managed firms in the conventional economics literature usually took the form of criticism of an 'idealized' model called the "labor-managed firm" (LMF) (Vanek 1970). In the mathematical model, the LMF was assumed to maximize net income *per member* while the capitalist firm was assumed to maximize total net income or, equivalently, total firm value. This was interpreted to mean that if there was an increase in demand for the product of the LMF, then the response would include kicking out some members to "thicken the soup" for the remaining members. This would reduce the supply of the product so the supply curve of the LMF would be backward bending—contrary to the capitalist firm which was assumed to maximize total income.

One response of advocates of LMFs was to ridicule the assumption that the supply response of a LMF would include kicking out some members to give a greater slice of the pie for the surviving members. But a more interesting response was to point out the falsity of the assumption of maximizing total net income or total value of the capitalist firm. As two Economics Nobel laureates put it:

> Thus the market value rule for current decisions within a firm applies to the market value of the equity *of the current owners* and not to the total market value of the firm. (Fama and Miller 1972, p. 84 [italics added]).

Hence if one makes the analogous assumption about the capitalist firm, i.e., that one can kick out some shareholders (by calling back their shares at yesterday's price), then one can get the same backward bending supply curve (since the capital expended to repurchase the shares would reduce the level of output) (Ellerman 2020). This example is mentioned only to illustrate the desperate lengths of conventional criticism of the Yugoslav firm or the LMF, but it is not relevant to our topic of the problems with common ownership.

Employee Ownership Trusts

Same old problems of common ownership

Let us look at some of the other ownership structures to see how this problem of having a recoupable claim on retained earnings is addressed.

1. Partnerships: In any given year, the partnership may be making a big investment (e.g., buying a building or office space) so each partner's share in the earnings cannot be paid out in cash. What is done? Do the partners say "forget it"? Do they "Stay around long enough and you will reap the benefits of the retained income."? No, they typically just keep track of the shares in partner income that couldn't be paid out in cash in a each partner's "capital account". Is a partner's capital account "equity'? No, it is only a subordinate form of debt like an officer's loan to a company. Each partner's share in the net income or vote is not affected by the size of their capital account.
2. Cooperatives: The member's share in the net income is their patronage dividends which cannot always be paid out in cash so there is such a thing as certificates of retained patronage dividends. The member's accumulated certificates of retained patronage dividends is their internal capital account. The certificates are typically eventually paid out on a FIFO basis. The certificates of retained patronage dividends are not "capitalist equity" since they have zero effect on the member's vote or patronage. They are a form of subordinate debt to the members.
3. Mondragon coops: In the Mondragon coops, the retained patronage dividends are replaced by each member's internal capital account that records what would otherwise be the face value of the certificate of retained patronage dividends. Many in the common ownership circles in the UK and elsewhere somehow think the Mondragon ICAs are somehow "capitalist equity" rather than again a subordinate form of debt. For those who bother to think it out, a person with more "capitalist equity" would have more voting power and a larger share of net income, but the size of the Mondragon ICAs is perfectly independent of voting rights and net income rights. Some in the common ownership circles spend their careers never bothering to think through why ICAs are not "capitalist equity."
4. ESOPs: The net earnings that are retained rather than paid out would increase the value of the shares in the members' share accounts so those earnings are recouped when the shares are ultimately bought back (or rolled over) at their increased value.
5. Conventional companies: Usual increase in the value of the shares.

This failure of any mechanism to recoup the value of retained earnings under common or social ownership is not addressed by just saying "they can get bonuses in the future" since there is no accounting connection between future bonuses and the value of the retained net income. The bonuses may or may not recoup the retained earnings--so that is just a form of hand-waving rather than structural thinking.

The old common ownership firms like John Lewis Partnership and the more recent employee ownership trusts (EOTs) in the UK are clear examples of not learning from the problems of social ownership in the past or from the Mondragon solution of individual capital accounts. The primary motivation seems to be the idea that any recoupable claim on retained earnings is somehow “capitalistic” and thus to be avoided in structuring an alternative to the conventional

firm. There seems to be "no learning" that the Mondragon-style ICAs represent subordinate debt, not equity capital as in conventional firms.

The private 'socialistic' vision of 'responsible,' trusteeship, or stakeholder governance

Another source of common ownership seems to be a high-minded notion of a "responsible company" or "trustee ownership," the presumption that any particular set of owners would tend to follow their self-interests. In contrast is the "responsible company" where

> an enterprise, before it can be termed responsible, must be so organized and administered that it, too, can respond fully to the claims made upon it by the workers, the community, the consumers, and the State. (Goyder 1961, p. 112)

The responsible enterprise is analogized to a democratic commonwealth but in contrast to nationalization in a political democracy:

> What was needed was to separate the functions of the workers, consumers, community and shareholders and to provide for their separate representation. (Ibid. p. 117)

This concept is today represented in the notion of stakeholder governance (Harrison et al. 2019) and it suffers from the same flaws.

- There is the question of practicality, e.g., how are the owners of iPhones worldwide going to choose their representatives on the board of Apple?
- Moreover, this sort of private socialism ignores the function of markets (like other notions of "socialism") between buyers and sellers without either having any "representation" or "say" in the governance of the other party. It is the purpose of anti-trust and competition policy to maintain competitive markets so that buyers and sellers can always "vote" with their feet. And it is the function of market regulations to protect legitimate interests even outside of market relationships.
- The analogy with democracy (in the sense that the government is elected by those who are governed) is false since the only people actually governed by the management of the enterprise are the people working in the enterprise (by virtue of their employment contracts). Management of an enterprise does not govern consumers, suppliers, or citizens of the "community."
- The net income of an enterprise is the net economic value of the new liabilities (from used-up inputs) and new assets (produced outputs) created by the people working in the enterprise, so why should those assets or liabilities be treated as being owned or owed by others?
- And with common, social, or communal ownership, the enterprise avoids the "complexities" of actually keeping track of the property rights of the members.

> There are no complexities from buying and selling individual employee shareholdings with an EOT. The collective holding of shares by a trustee company works whatever the size and type of the employed workforce. (Nuttall 2022, p. 132)

And EOTs as "trusteeship" companies is a similar vision would consider social interests locally and globally.

> What Gandhi's theory of trusteeship encourages is to get to the position that a company is not employee owned unless it also serves society and the environment, locally and globally, as well as its shareholders, its employees (call this EO with added Gandhian purpose or "EO Version 3"). (Nuttall 2022, p. 138)

"Employee Ownership Trust" as linguistic legerdemain

Aside from the above-mentioned problems with common ownership, the EOTs evoke the language of "employee ownership." In general, employees might *directly* own shares individually (with or without various restrictions) or they might *indirectly* own shares held in an individual capital or share account as in the American ESOP. But the common ownership structure of an EOT embodies neither direct nor indirect ownership of shares by the employees so even the name "Employee Ownership Trust" is a bit of linguistic legerdemain. Although the details will depend on the trusteeship agreement, the basic idea is that the trustees need to serve society and the environment in addition to the employees as the "beneficiaries" of the trust—like the children who are not old enough to own inherited property—except that the employee status as 'minors' is permanent.

The first cohort problem

The EOTs have another problem that was not relevant for the Yugoslav self-managed firms. That is, the EOTs are mechanisms for the ownership trust to gradually acquire the shares by payments out of future income (as in the ESOP mechanism). But the difference is that the ESOP has ICAs in the form of individualized share accounts in the trust so when net income is used to buy back shares through the trust from previous owners, then that value accrues to the members' ICAs which are eventually recouped when the member exits the ESOP.

In the case of the EOTs, the economic benefit comes in the form of profit-sharing or bonuses when funds are available for that purpose. But as the acquisition debt is being paid off, the first cohort of workers of the EOT will have little or no bonuses.

> While these [bonus] payments are still subject to NICs [National Insurance Contributions], they provide a real, material benefit to the employees of an EOT company. The company must still generate sufficient cash flow to pay the bonuses and they may not be paid up to the full level, if at all, for the first several years of EOT ownership, as the company may need to dedicate its excess cash flow to repaying the debt used to finance the transaction. (Karch 2018, p. 10)

By foregoing the ownership bonuses during the years of paying off the acquisition debt, the first cohort will in effect be financing the acquisition, but the common ownership structure prevents them recouping any of that value. Just like the employees that come later, they "go out naked," i.e., have no ICA to be paid off after exit or retirement.

However, in the case of the UK EOT, if a sellout of the EOT shares is made, then the proceeds are distributed among the employees. This creates pressure for a sellout as that first cohort nears the exit or retirement and can thus capitalize their 'implicit equity.' The later cohorts will get bonuses *and* the proceeds from a sellout. Hence the EOTs as currently structured have the

potential to be what Jaroslav Vanek called "mule firms," i.e., employee-owned firms that will not reproduce themselves as employee-owned firms.[1]

The problem of managers, unlike workers, having individual equity stakes

The UK EOTs also allow managers to have their own private equity plans (stock options, share appreciation rights, and virtual equity) outside the EOT; common ownership for workers, individual equity accounts for managers. Apparently, the "complexities" are not too great for managers to keep track of their own equity stakes outside the EOT. That will create an additional pressure for a sellout so the managers can reap the gains of their outside equity plans.

Janus Shares

Plywood cooperatives

After World War II, there was a huge housing boom in the US that used plywood produced largely in the Pacific Northwest. A significant segment of the plywood was produced by worker cooperatives inspired by the heritage of Scandinavian immigrants (Berman 1967). The plywood cooperatives had shares that served two quite different functions—and hence the name "Janus shares." To be a member of the cooperative, an employee needed to own at least one share but the shares also carried the pro-rated value of the company. As the shares rose in value due to the economic success of the cooperative, the value for a retiring member meant a considerable boost to their retirement wealth if they could sell it at its "market value." But the new workers typically could not afford to take out a loan to pay out the retirement package of a retiring worker in order to become a member. Hence, there were two obvious consequences, the new workers were hired as non-members and the retiring members would advertise their shares to the general public as an unusual "investment opportunity." Eventually, time and again, the retiring members banded together to sell out the cooperative to one of the large conventional plywood producers. Thus, the plywood cooperatives with the Janus shares were one of the early examples of mule firms.

It is a general law of engineering that one instrument cannot track two quite separate functions. The solution is to create two instruments to track the two different functions of serving as a membership share and carrying the value eventually due back to the members as they exit or retire. The membership share could have a fixed (e.g., two months' salary) and perhaps even nominal value and the function of carrying the capital value eventually due back to a member is the natural role of individual capital accounts. The Mondragon cooperatives with their ICAs were not known then, but some agricultural cooperatives had the system of retained patronage dividends (discussed above) which served, in effect, as a system of individual capital accounts.

The Spanish Sociedades Laborales (SLs)

The SLs are not cooperatives. They are a special type of share company that has certain privileges as long as they are majority worker-owned. One innovative privilege of the SLs is that an unemployed worker can capitalized their unemployment insurance for a certain future time period if the lump sum is invested in shares of an SL (Lowitzsch et al. 2017)—a scheme that is also available in the Italian Marcora cooperatives (Vieta 2015; Gonza et al. 2021).

However, the SLs also have Janus shares (while the Italian cooperatives have the common ownership structure already analyzed). In the late 1980s, the first author had a discussion of the

[1] A mule is cross between a horse and a donkey, and mules cannot reproduce themselves.

problems in SLs with the director of the association of SLs for the Basque region of Spain. He explained the problem that the new workers could not afford to buy a membership share from a retiring member (or even other members who could own more than one share). They tried to get the retirees to lower the price of their shares to be affordable to entering workers but to no avail. In response, the first author described the same problem in the plywood co-ps in the mid-20th century and pointed out that the solution was almost literally 'across the street' in the individual capital accounts of the Mondragon co-ops. He exclaimed; "Co-ops are nineteenth century whereas SLs are twentieth century" and that was the end of considering that solution. Today, a third of a century later, the problem remains.

> In some cases, SLs either deliberately leave the regime of SLs or involuntarily disqualify and become a conventional corporation, that is a limited liability or a joint stock company. Among these cases, there is a significant number of SLs that convert into conventional firms when growing too fast to retain the legal restrictions on SLs. Thus, successful SLs may lose their SL status by disqualification when employee ownership goes below the 50% threshold as they grow and employees cannot keep up buying shares; these firms may still have substantial employee ownership but be forced to revert to conventional corporate status. (Lowitzsch et al. 2017. p. 97)

The SLs are another example of "no learning."

The American Employee Stock Ownership Plans (ESOPs)

An advance on other forms of employee ownership

ESOPs (the American model unless otherwise specified) have individual capital accounts so they don't have the common ownership problems. Retained earnings to finance investment or pay off loans are, in effect, recouped by the employee by the increase in value of the shares in their ICAs. When an employee exits or retires, the ESOP (in companies not publicly traded) is obliged to buy back the shares in the ICAs so new workers do not have to buy shares from retiring workers to become members of the ESOP. Indeed, aside from a probationary or vesting period, e.g., one year, all employees become members of the ESOP by statute.

Our focus is on the problems of learning in legal forms intended to develop and sustain majority employee ownership. Thus, we have ignored the old Employee Share Purchase Plans (ESPPs) where employees can voluntarily buy shares (perhaps at a reduced price and with a matching grant from the employer). The employee-purchased shares are paid for by payroll deductions or by taking the option to convert a profit-sharing bonus into company shares. ESPPs are not intended to develop and sustain majority employee ownership; they tend to create only a small percentage of employee ownership on behalf of the employees with discretionary disposable income, e.g., white-collar and managerial employees.

ESOPs represent a major advance on the ESPPs in that the employee shares are not paid for out of payroll or bonuses but out of the future net income of the company and ESOPs include all employees (after a probationary period). That is why in almost a half-century since ESOPs were legislated, there are now about 6,500 American ESOPs covering about 10% of the private workforce.

In spite of these significant advances, there are a number of "problems" in the American ESOPs due to artifacts of they way they were legislated and problems which have solutions.

ESOPs as pension plans

A non-problem with ESOPs

Normally a private pension plan sponsored by a company can only invest a small percent of its capital in the shares of the company. The ESOPs were created by a 'carveout' of American pension law to create the ESOP as a special tax-privileged pension plan that could invest 100% of its assets in the shares of the sponsoring company.

There is a 'criticism' of ESOPs from the left and from trade unions that in the case of bankruptcy, the employees lose both their jobs and the ESOP pension income. But this so-called 'criticism' is ill-founded since the alternative to the ESOP is typically not a diversified company defined-benefit pension plan but no private pension plan at all. And where there is a private company pension plan, it is forbidden by law to convert it into an ESOP. Thus, an ESOP is an "add on" to the usual system of wages and benefits. The real comparison point or counterfactual to an employee with an ESOP is an employee without an ESOP.

In this context, we might mention the other flaws in the usual advice: "Don't put your eggs in one basket." That advice assumes that the owner of the basket has no control over the basket, i.e., that it is subject to uncontrollable random shocks. But where the owner has a good measure of control over the basket, then the better advice is: "Put your eggs in that basket and watch it very carefully." That is the position of the people in a majority or 100% employee-owned company who can adopt countermeasures to protect the basket against various shocks, e.g., changes in supply or demand conditions, recessions, or Covid-like events.

Moreover, this advice is borne out in the opposite solutions to the problem in the biological kingdom of reproducing the species (see r-selection versus K-selection in Wilson and Bossert 1971). If the species has little or no control over their offspring, e.g., insects or fish, not to mention weedy plants, then they adopt the strategy of having many offspring or seeds with little resources expended on each one. They put their eggs in many baskets. At the other end of the spectrum are the species like mammals with a large measure of control over their offspring so they invest their reproductive resources in only a few offspring—like putting their eggs in one or a few controllable baskets.

Accumulation and stochastic nature of repurchase liabilities

Since an ESOP is a pension plan, it is required to repurchase (within a limited time period) the shares in a member's ICA upon exit or retirement. These accounts can accumulate a very significant balance, particularly for the first cohort of employees in the ESOP. Moreover, exit or retirement is a stochastic factor and may even be vulnerable to herd behavior, e.g., like runs on a bank. The older employees will be bearing greater risks with the higher balances in their accounts and thus may be motivated to retire early and perhaps in a group.

One of the suggested "solutions" is to form a sinking fund of set-aside cash within the company to meet such contingencies. But the obvious point is why set aside cash in the company when paying out the cash to start continuously repurchasing the shares (independent of retirement) would address a number of problems.

The rollover or share-recycling scheme

This sort of scheme is called a "rollover" or "recycling" plan since the repurchased shares are reallocated to the accounts of the current members according to the distribution key such as current salary (Ellerman et al. 2022). This rollover scheme also removes the incentive to retire or exit early since the only effect of exit is no repurchased shares going into the ICA of that member, i.e., their ICAs are closed to new credits. The older balances are continuously paid out in the rollover scheme whether the worker has exited or not which removes the stochastic factor. Such a rollover or recycling scheme addresses a number of problems in the current cash-only-on-exit ESOP:

- *Lack of cash from ESOP ownership*. Young employee-owners, who may want to make personal investments (e.g., cars or apartments), do not see the cash from their ownership until they near retirement and they cannot use the shares in their ICAs as collateral for a loan.
- *Disproportionate risk on older workers*. Without the rollover, the balances in the older employee ICAs can grow to 'eye-popping' amounts which puts a disproportionate risk on their shoulders and may motivate early retirement by the people who have accumulated the most firm-specific knowledge. The rollover scheme solves that problem since the oldest-dated shares are the first to be repurchased (on a first-in-first-out or FIFO basis) and reallocated to the current employees.
- *Diversification with an ESOP*. The rollover scheme also allows employees to wisely invest their rollover cash, not in current expenditures that should be covered by wages, but in diversified assets that will appreciate in value over the years. With this scheme, the balances in retiring worker accounts will no longer be 'eye-popping' since most of their older balances will be paid out in the rollovers. The valid comparison amount is the value of their account at retirement *plus* the value of their diversified investments in appreciating assets funded by the rollover payouts.
- *The "two companies problem."* This problem arises in ESOPs when the allocation of shares into ICAs only occurs when the acquisition loan is being paid off or shares are being repurchased from retiring members. In the time period between paying off the acquisition loan and significant retirements, the new employees will not have any shares creating the "two companies problem" of owning and non-owning employees. The rollover scheme solves that problem since after the acquisition loan is paid off, the rollover repurchased shares will be allocated to all current employees.

The valuation problem for ESOPs

The requirement of annual "professional" valuations of ESOPs is based on the idea that the working community of a productive company is just a big complex piece of property like an office building. A piece of real estate can generate future rentals that can be discounted back to get a valuation of the real estate. When the same valuation methodology is applied to an operating firm (unlike a 'dead' piece of real estate), then it is evaluating the present value of the future net income that is expected to be earned by furthering the present contracts like hiring the people working in the firm. Hence if that methodology is used to determine a value for the firm to be purchased by those same people, then they are, in effect, buying the future net income *that they will produce*. That is the basic problem in carrying over the valuation methods from inert pieces of property to a productive firm to become an employee-owned firm. Instead of having to buy the fruits of their future labor from someone else, it is more accurate to see them as buying

the assets of the firm and taking over its liabilities, which means that the benchmark valuation for the purposes of an ESOP should be the net asset value.

The ESOP sellout problem

Since ESOPs were legislated in the 1970s, there has been a steady growth until about the last decade when the net number of ESOPs has plateaued. There are still about 250 new ESOPs a year in America, but there is an equal or greater number of sellouts. The problem is to determine what is the main determinant of the sellouts.

The accumulation of repurchase liabilities

Since the US ESOPs don't have a rollover plan, the liabilities to repurchase the considerable accumulated shares in retiree account may force the company to consider a sellout of the ESOP shares and then distribute the proceeds to all the current or just retired employees. We have already outlined the solution to this problem, namely, the rollover or share recycling system so the account balances are paid out over a long period of time and no different payments are caused by stochastic retirements.

Short-sighted instructions to trustees

In the US ESOP, like the UK EOT, the special purpose vehicle to hold the employee shares is a trust with a trustee who is legally instructed to consider the interests of the 'beneficiaries', namely the *current* employees. Yet it is safe to say that the retiring owner or owners did not forgo the higher payouts they might receive from a competitor or private equity only to have the employees to do a sellout in a few years. Those retiring owners would probably prefer the trustees to be instructed to consider the current *and future* employees as their beneficiaries—which would tend to maintain the owners' legacy company operating in the local community.

Managers having equity plans outside the ESOP

In both the US ESOP and the UK EOT, the managers are allowed to set up their own private equity plans—virtual or phantom equity, stock options, and share appreciation rights—outside the ESOP. Hence as the top managers look forward to retirement or just to an extraordinary 'wealth event,' they will be pushing for a sellout of the ESOP shares at a value that will create a 'wealth event' for themselves with their outside equity plans. The solution is to have everyone in the same boat, i.e., not allow managers to create a separate equity plan for themselves that may have cross-purposes to the stability and sustainability of the ESOP.

The European Co-op ESOP Model

One important opportunity for learning about the problems structuring employee-owned firms in the past is the creation of and legislation for employee-owned firms in other countries. Hopefully there can be learning about the previous problems of common ownership, Janus shares, or ESOPs as pension funds.

The European Co-op ESOP model developed by the Slovene Institute for Economic Democracy (Ellerman et al. 2022) is one such attempt to learn the mistakes or problems with past employee ownership (Gonza 2024) and to implement the known solutions to those problems like individual capital accounts, nominal membership fees coupled with moral pressure for the inclusion of all employees, and the rollover plan to start recycling shares long before huge sums accumulate to threaten the viability of the ESOP.

One common aspect of the US ESOP and UK EOT is the use of a common law trust to hold the employee shares. A trust is often set up when a minor inherits money and it holds the money until the person grows up to become of age. The use of a trust as the shareholding vehicle treats the employees as permanent children or minors who never grow up. The Co-op ESOP model substitutes a special type of worker or employee cooperative for the trust—where membership in the cooperatives is based on employment in the underlying company (past a certain probationary period). The Co-op ESOP's function is to be the employee shareholding vehicle which runs the individual capital account system, the rollover scheme, and the organization of the one-person/one-vote election of the co-op's board of directors who will decide how to vote the co-op's shares in the shareholder decisions of the underlying company.

Final Remarks

The purpose of this paper has been to sketch the sorry history of legal forms for employee ownership over the last century. For a variety of reasons mentioned in the Introduction, there has been very little cumulative learning from experience. Ill-founded ideological prejudice seems to compete with simple ignorance to explain the lack of learning. The same problems seem to occur again and again—even when effective solutions are known. Hence, we have summarized that history of problems and solutions and sketched one attempt to put that learning into effect.

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