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Article

Fallacies about Corporations: Comments on "Democratizing the Corporation"*

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Abstract

This article comments on Isabelle Ferreras's "Democratizing the Corporation." The focus is on the conceptual framing, which arguably contains a number of problems that are quite common on the left and are thus doubly deserving of commentary and explanation.

Keywords

bicameral firm, rights of capital, fundamental myth, so-called capitalism, personal rights, Co-op–ESOP model

*This special issue of *Politics & Society* is the latest installment of the Real Utopias Project begun by the late Erik Olin Wright and now directed by Tom Malleson. The issue contains an anchor essay by Isabelle Ferreras, an introduction by Tom Malleson, and comments on the anchor essay by David Ellerman, Marc Fleurbaey, Robert Freeland, Simon Pek, and Sanjay Pinto.

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I fully support Isabelle Ferreras's program of finding intermediate joint-governance models, for example, true-parity versions of codetermination or democratic employee stock ownership plans (ESOPs), between the current human rental firm and the "regulative ideal" of the democratic firm.[1]

My comments on Ferreras's "Democratizing the Corporation" will focus the conceptual framing that I believe contains a number of problems that are quite common on the left and are thus doubly deserving of commentary and explanation. Her conclusions do not depend on this framing, but it is so common and conventional that it needs to be discussed anyway.

What Is the Fundamental Defining Institution in So-Called Capitalism?

The problematic assumption is that the legal basis for the conventional firm is the rights attached to the ownership of land, buildings, machines, and other capital assets. This is a version of the very widespread idea, on both the left and right, that the legal basis for the current system is the "private ownership of the means of production," which is interpreted to mean that the ownership of capital assets includes

- the rights to the product produced using that capital, and
- the rights to the managerial control over the people carrying out the production process.

Yet this is descriptively *incorrect* in the so-called capitalist system.

The "Ownership of the Means of Production"

Karl Marx popularized the capital-based phraseology of "capitalist" and "capitalism." To understand Marx's concept of the "rights of capital" embodied in the "ownership of the means of production," one must go back to the medieval notion of dominion based on the ownership of land. What today we might call the "landlord" was then the lord of the land, exercising both political/juridical control over the people living on the land and the rights to the fruits of their labor. As the legal historian Frederic Maitland (1850–1906) put it, "Ownership blends with lordship, rulership, sovereignty in the vague medieval *dominium*."[2] Or as the German legal scholar Otto von Gierke (1841–1921) put it simply, "Rulership and Ownership were blent."[3]

By substituting "capital" for "land," it is this medieval notion of dominion associated with the ownership of land that Marx carried over to the ownership of capital in his conception of "capitalism."

> 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.[4]

Marx's blunder has been a staple of socialist thought ever since as was pointed out by Bo Rothstein:

> 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.[5]

The defenders of "capitalism" were more than happy to accept the view that management rights and the rights to the product are all "an attribute of capital" or part of the "ownership of the means of production." Hence any change in the management or product rights would be a violation of their supposed property rights. But the usual notion of the "rights to the private ownership of productive property" involves a misconception of property rights that I will call the *fundamental myth.*

The Fundamental Myth

The *fundamental myth* is that management rights over the people using the capital assets and the rights to the product produced using the capital assets are part and parcel of ownership of those assets. This hegemonic belief is asserted by thinkers, left, right, and center, as seen in the following quote from an English Liberal.

> 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. In its unqualified form, capitalistic organization is a form of autocracy or absolutism.[6]

It is not a question about "the management of capital" but the legal basis for the management of the people using the capital assets.

Suppose capital assets are rented out to another legal party who buys, hires, or already owns the other inputs and who undertakes a productive process. Then that renter by virtue of being the hiring party (not the owner of the capital assets) exercises the discretionary management rights within the limits of the input contracts (i.e., the management rights) over the people working in that process and has ownership of whatever product is produced. In addition to banks and other financial firms in the business of loaning out financial capital, real estate companies, equipment rental companies, and computer hardware companies are also in the business of hiring, renting, or leasing out physical capital assets.

The ownership of capital gives the owner the *negative* or *indirect control rights* over the use of the capital by other parties as in "No, you may not use this machine, building, or land." This right is sufficient to make those who nevertheless use the machine, building, or land into trespassers—but it does not automatically make them into employees.

> Central to ownership is the right to exclude others from contact with an item. Ownership thus gives the owner of an item the right to control the uses to which others put it in the sense that

> he may veto any use of it proposed by someone else. But it does not give him any right to tell anyone to put that property to the use that he wants. *It is not a right to command labor*.[7]

The conceptual point is that in capitalist societies, the *positive* or *direct discretionary control* or management rights over employees come from the employer-employee contract, *not* the ownership of the capital the employees are using. This is a conceptual point about the structure of property rights in the current system. *The conceptual point is not about the bargaining power* (obviously almost always in the hands of capital owners) or transaction costs involved in renting capital out of a corporation.

The Conner Avenue Plant Example

Does the "ownership of the firm" determine who owns the product? If by "firm" one means a corporation, then there is currently the ownership of a corporation (more on this below), but it is the pattern of contracts (who hires what or whom) that actually determines who owns the product produced using some of the corporation's assets (ownership is not necessary as shown by cases where the capital assets are rented).

In addition to the fundamental myth being involved in a common misunderstanding of the "ownership of a corporation," it is also expressed in the usual notion of "owning a factory." But the simple logic of the rentability of capital does not stop at the ownership of a whole factory. In the early 1950s, an automobile manufacturer, the Studebaker-Packard Corporation, had the Packard auto bodies produced in the Conner Avenue plant of the Briggs Manufacturing Company. After the Briggs founder died, all twelve of the US Briggs plants were sold to the Chrysler Corporation in 1953. "The Conner Ave. plant that had been building all of Packard's bodies was leased to Packard to avoid any conflict of interest."[8]

This actual example illustrates the vacuity of the usual idea that "being the firm" or firmhood is determined by "the ownership of the firm." Where was the "ownership of the firm" that included the ownership of the auto bodies coming off the assembly line or the management rights over the production process? Of course, the shareholders in Studebaker-Packard owned that company and similarly for the shareholders in Chrysler, but that did not answer the question of "who is the firm" in that going-concern operation of producing auto bodies for Studebaker-Packard. That was determined by the pattern of the new market contracts—by who hires, rents, or leases what or whom. Since Studebaker-Packard leased the factory from Chrysler, then Chrysler would not hold the discretionary management rights and product rights for the operation of the factory owned by the Chrysler Corporation.

The Misnomer of "Capitalism"

In the Middle Ages, there was no developed market for renting out land, so those governance and product rights were rolled into the medieval notion of ownership as dominion. But capital assets, including land for that matter, are today *routinely* rented out in our so-called capitalist system. Given the central role of the Marxist notion of the "ownership of the means of production," it may be understandable

why Marxists cling to the fundamental myth as a matter of quasi-religious dogma. Many defenders of the "capitalist" system seem equally dogmatic in failing to think through the consequences of capital being rentable in a private property market economy. Yet the whole capital-based narrative emanating from the left, right, or center is mistaken.

Since the management and product rights are not part of the ownership of capital or the means of production in the first place, the whole "Great Debate" between "capitalism" and socialism or communism (as to whether there should be private or public ownership of the means of production) has been ill-formed from the very beginning. It is wrong in the same sense that two centuries ago it would have been wrong to frame the basic social question as to whether slave plantations should be privately owned, government owned, or socially owned.

Even the most prominent liberal philosopher could not get beyond the conceptual framing in terms of the ownership of the means of production or of productive assets (as opposed to personal assets):

- "Under socialism the means of production are owned by society."
- "The first principle of justice includes a right to private personal property, but this is different from the right of private property in productive assets."
- "Welfare-state capitalism permits a small class to have a near monopoly of the means of production."
- "Property-owning democracy avoids this . . . by ensuring the widespread ownership of productive assets."[9]

There is, however, one economist who stands out as the most philosophically and economically sophisticated defender of the so-called capitalist system—and he did not call it by that name because he was able to trace out the consequences of capital being rentable and understood that the product/management rights were thus not part of capital ownership. He is Frank H. Knight, one of the founders of the Chicago School of Economics. Knight was perfectly clear on "capitalism" being a misnomer and on Marx's role in propagating that myth about capital ownership:

> 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. . . . The superficial observer is typically confused by the ambiguity of the concept of ownership.[10]

If an established economic, political, or legal theorist is such a "superficial observer" as to not think through the consequences of capital being rentable, then there is little hope to get beyond erroneous tropes and libertarian talking points—or Marxist/ Post-Modernist slogans ("It's all about congealed power relations").

In actual fact, the current system is not characterized by capital being unrentable, but by *both* persons and capital goods being legally rentable. As the leading neoclassical economist Paul A. Samuelson put it, "Since slavery was abolished, human earning power is forbidden by law to be capitalized. A man is not even free to sell himself: he must *rent* himself at a wage."[11] Similar remarks are made by other economists:

> The commodity that is traded in the labor market is labor services, or hours of labor. The corresponding price is the wage per hour. We can think of the wage per hour as the price at which the firm rents the services of a worker, or the rental rate for labor. We do not have asset prices in the labor market because workers cannot be bought or sold in modern societies; they can only be rented. (In a society with slavery, the asset price would be the price of a slave.)[12]

And Frank Knight makes a similar point: "In a free society the larger part of the productive capacity employed (as matters stand today in a typical Western nation) consists of the services of human beings themselves, who are not bought and sold but only, as it were, leased."[13]

Do the Shareholders "Own" a Corporation?

In the apparent attempt to weaken the claim of shareholder primacy, a number of legal and political thinkers have recently emphasized that the shareholders only own their shares, not the corporate assets, as their private property.[14] The fact that the shareholders do not *own* the corporate assets as their personal property is only the other side of the balance sheet from the fact that the shareholders do not *owe* the corporate liabilities as their personal liabilities.

Stout, Ciepley, and Robé try to argue that *since* the shareholders do not own the corporate assets as their personal assets, *therefore*, the shareholders (contrary to existing conventional corporate law) do not "own" the corporation. But the ownership of property would usually include the right to buy and sell the property, and the shareholders indeed have the right to buy and sell a corporation by buying and selling a majority of the shares. And the shareholders have the right to throw out the board of directors and the management. Since the shareholders' ownership of the shares gives them these rights over the corporation, their argument can at best be interpreted as the quixotic linguistic suggestion to not say the shareholders "own" the corporation—in spite of conventional corporate law all being written in those terms and corporations being routinely bought and sold by their shareholders or their agents, for instance, on a daily basis by the private equity firms.

There is a similar narrative that the particular legal aspects of a corporation (e.g., limited liability and separate juridical personality) are enabled or chartered by the government, and thus a corporation should have a "social" function (e.g., stakeholder primacy) sanctioned by the government. It is certainly true that the legal aspects of a corporation are created by the government, but that is true of *all* legal rights (e.g., the private property rights to houses and cars) and *all* legal institutions; they do not

exist as part of the natural world. That is hardly an argument that all private property must bend to some governmental purpose.[15]

On Personal Rights and Property Rights

Perhaps a few words are necessary about the terms “membership” and “ownership.” People have many membership rights that are personal rights while other rights are property rights. For instance, one’s voting rights in a city (or municipal corporation) are based on having the functional role of residing in the city, but those rights may not be bought or sold so they are personal rights, not property rights. Ferreras makes the point that states are not “owned”[16] and that is because the rights of the member/citizens are personal rights, not property rights.

In a cooperative corporation, the membership rights are based on the functional role of “patronage” in the cooperative (e.g., working in a worker cooperative or shopping in a consumer cooperative). When membership rights are supposed to be based on having a certain functional or patronage role, then it makes no sense to treat them as alienable property rights. A “buyer” may not have the functional role, and if the person did have the functional role, there would be no need to “buy” the rights.

It is easy to distinguish personal from property rights in terms of inheritability (or “bequeathability”). When a person dies, personal rights like one’s vote in municipal elections are extinguished while property rights like the votes of one’s corporate shares are passed on to one’s estate and heirs. In a conventional corporation, the shareholders are legally the “members” of the corporation: “In general, the shareholders are the members of the company and the terms ‘shareholders’ and ‘members’ may be used interchangeably.”[17] When membership rights, as in a conventional corporation, may be inherited or, in general, may be bought and sold, then they are property rights, so then the members are referred to as “owners.” Whether the shareholders’ ownership of the membership rights is to be called the “ownership of the corporation” is a question of only rhetorical interest.

Further Comments on the “Corporation”

Our purpose has been to analyze a miscellany of fallacies blaming the corporate form for a litany of problems. But the corporate form itself, at least in its original conception, is not the problem. Blaming “corporations” for the ills of the current system of renting human beings is like blaming glass bottles for alcoholism—or the legal form of antebellum cotton farms for the institution of slavery.

After all, a worker cooperative is also a corporation with the attribute of so-called limited liability (actually members have zero personal liability for corporate debts just like they have zero personal ownership of corporate assets). Do left-wing critics of “The Corporation” really think worker cooperatives should be reorganized as unincorporated partnerships with each member potentially having full personal liability for the cooperative’s debts? To reiterate, the basic problem in the current system is not private property per se (which should be based on people getting the full fruits of their labor) or the corporate form of “limited liability,” but the institution of hiring,

employing, renting, or leasing persons (as opposed to people always being the members of the companies where they work).

It is important to preserve the original and ancient idea of a corporation per se as a group of natural persons engaged in certain joint activities "that possessed a juridical personality distinct from that of its particular members."[18] This original conception of the corporation is well described in the legal literature,[19] and particularly by Abram Chayes:

> We can here perhaps note a final irony, at least. The concept of the corporation began for us with groups of men related to each other by the place they lived in and the things they did. The monastery, the town, the gild, the university, all described by Davis, were only peripherally concerned with what its members owned in common as members. The subsequent history of the corporate concept can be seen as a process by which it became progressively more formal and abstract. In particular the associative elements were refined out of it. In law it became a rubric for expressing a complicated network of relations of people to things rather than among persons. The aggregated material resources rather than the grouping of persons became the feature of the corporation.[20]

The point that is little, if at all, mentioned in the corporate law literature is that the original joint activity of the members could only be "refined out" since it was replaced by the joint activity of the employees (including managers) of the corporation. In conceptual terms, the *absentee-owned* corporation is a "wholly owned subsidiary" of the human rental relation, the employment contract. The characteristic feature of the current system, misnamed as "capitalism," is not the imagined rights of capital (fundamental myth) but the institution for the renting, hiring, employing, or leasing of persons.

The corruption of the notion of membership in the corporation was carried to its logical conclusion in the modern corporation of the joint stock or limited liability variety. The partaking in the human activities of the corporation (e.g., "patronage" in a cooperative) was reduced to zero by the human rental system, thus turning the membership rights into untethered free-floating (i.e., no personal functional role requirement for the members) property rights that could be arbitrarily bought and sold on the market like any other piece of property. And this reduction of the members' personal functional roles to zero was enabled by the above-mentioned human rental institution where the "employees" carry out the corporation's human activities.

Thus, the original conception of the corporate embodiment for people associated together in a joint human activity was turned into a piece of property like a piece of real estate or "a large, composite machine"[21] to be bought and sold in the marketplace. When a recent occupant of the American White House suggested "buying Greenland," the leading thinkers in political science, economics, and the law as well as various pundits and thought-leaders ridiculed the suggestion. They rightly did not accept "it's just a real estate deal" as a justification. Yet, the same thinkers find no problem in the purchase and sale of corporations (whose workforce is many times the population of Greenland); after all, it is supposedly just the purchase and sale of a bundle of assets since the "aggregated material resources rather than the grouping of persons became the feature of the corporation."[22]

What about the appeal to democratic ideals in the notion of "shareholders' democracy"?

> The analogy between state and corporation has been congenial to American lawmakers, legislative and judicial. The shareholders were the electorate, the directors the legislature, enacting general policies and committing them to the officers for execution. . . . Shareholder democracy, so-called, is misconceived because the shareholders are not the governed of the corporation whose consent must be sought.[23]

The concept of "shareholder democracy" is analogous to the people of Russia going through the motions of running multiparty "democratic" elections of the government of Poland or Ukraine. The democratic ideal applied to corporations should be based on "the people who are governed by the corporate management."

What about the effectiveness argument for corporate governance? "The only cohesive, workable, and effective constituency within view is the corporation's work force."[24] In spite of Robert Dahl's earlier use of the affected interests principle,[25] which points toward stakeholders' governance (whatever that might be), when it came to later specifying the "alternative," he made *no* use of that principle or the stakeholders theory. He advocated instead "a system of economic enterprises collectively owned and democratically governed by all the people who work in them."[26]

It is only because of the professionally prudent forgetting of democratic ideals in the workplace that the whole question of corporate governance and purpose is "up for debate" in the first place.

The Property Argument for the Democratic Firm

Isabelle Ferreras is in the distinguished company of political theorists such as Robert Dahl and Carole Pateman in applying democratic principles to the workplace.[27] But her argument is one-sided and thus leads to such one-sided hybrids such as codetermination (true-parity or not) where the workers have some democratic rights, but no net income rights. They are not the residual claimants to the retained net income that builds up the net asset value of the company. The true members of a democratic firm, for example, a Mondragon-type worker cooperative, have *both* the governance rights *and* the net income and asset rights in the firm—regardless of whether the net income is paid out in cash or retained and thus added to the members' internal capital accounts representing the net asset rights. As only a governance model, the bicameral firm may be able to affect the income paid out as labor bonuses (i.e., which are not *net* income), but it is silent on the claim to retained net income and asset rights—as if the only problem in the human rental firm was the lack of governance rights. The case for the bicameral firm as a stepping-stone toward the democratic firm needs to use both sides of the full argument: on the one side, there is the democratic self-governance argument (which Ferreras makes), but on the other side, there is the important fruits-of-the-labor argument, which states that workers not shareholders morally deserve the fruits of corporate labor (this argument Ferreras and other political theorists fail to make).

Over a period of time, the production operations (not exchange operations) of the firm create a set of assets (the products or outputs produced by the firm) and a set of liabilities (the liabilities for the inputs used up by the firm). The firm directly (and the members of the firm indirectly) legally *own* those new assets (the products typically sold) and *owe* those new liabilities (typically paid for prior to or at the end of the production time period in question). The normative question of who should be the members of the firm is not *only* the question of who should have the governance rights (a question answered by democratic self-governing principles) but who should be the people who (in their corporate body) jointly own those output-assets and jointly owe those input-liabilities through their corporate body. That normative property question is answered by the old *labor* or *natural-rights theory of property*—people's rights to the (positive and negative) fruits of their own labor.[28]

That is the property-theoretic answer to the question of who ought to be the members of the firm, not the question of the "ownership of the means of production," which does not decide the question since capital goods, indeed, whole factories as in the Conner Ave. example, may be rented.

The answer to that question is the people (legally employees or employers) who work in the firm; they are the ones who use up the inputs in the process of producing the outputs—not the absentee shareholders who do neither. In a statement of remarkable clarity in 1944, the Tory scholar, member of Parliament, and public servant Lord Eustace Percy (1887–1958) made precisely this point:

> Here is the most urgent challenge to political invention ever offered to the jurist and the statesman. The human association which in fact produces and distributes wealth, the association of workmen, managers, technicians and directors, is not an association recognised by the law. The association which the law does recognise—the association of shareholders, creditors and directors—is incapable of production and is not expected by the law to perform these functions. We have to give law to the real association, and to withdraw meaningless privilege from the imaginary one.[29]

When that is done, then the "human association which in fact produces and distributes wealth" will become the firm, and the suppliers of the nonhuman inputs will become the parties to whom the input-liabilities are paid.[30] Or as Justice Brandeis put it,

> The civilized world today believes that in the industrial world self-government is impossible; that we must adhere to the system which we have known as the monarchical system, the system of master and servant, or, as now more politely called, employer and employee.[31]

An Alternative "Bicameral" Transitional Firm: The Co-Op–ESOP Model

The point of the bicameral discussion presumably is to suggest transitional forms from the conventional human rental firm to the regulative ideal of a democratic firm. How would "the bicameral firm" transition to a democratic firm? A democratic firm such

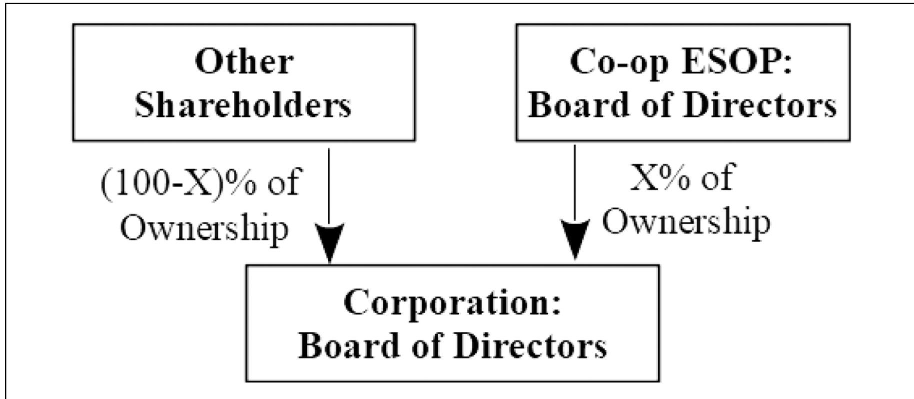

Figure 1. Two "boards" in the Co-op–ESOP model.

as the existing examples of democratic firms (e.g., the Mondragon worker cooperatives) are monocameral.

We do have existing models of firms designed to transition to a democratic firm. One such model of importance is based on the idea of the US ESOP, but reformed in order to democratize it. I call this the Co-op–ESOP model.[32] In this model, the ESOP trust is replaced by a democratic worker cooperative whose members are all the employees in the underlying corporation. The Co-op–ESOP model increases its share of the ownership over a period of years, and when it reaches 100 percent, then the company can be consolidated and collapsed into the cooperative, which would then function as a Mondragon-style worker cooperative.

This model is "somewhat bicameral" since there are, in effect, two boards of directors (see Figure 1). The board in the worker cooperative is pure labor representation but it only accounts for a certain X percentage of the underlying conventional corporation. The other board is the conventional shareholder-representing board—where one of the shareholders is the worker cooperative. The board of the corporation is jointly determined by the other shareholders and the Co-op–ESOP.

The Co-op–ESOP model is designed to correct for two artifacts of the way the American ESOP was implemented. First, the worker-ownership vehicle is a worker cooperative (with democratic one-member/one-vote governance of its board) rather than a trust with the trustee usually a member of some bank's trust department selected by management. Second, the Co-op–ESOP is an ownership acquisition vehicle rather than a special type of retirement plan so there is no need for workers to retire or otherwise exit to receive some cash payouts.

Moreover, the underlying agreement or "social contract" between the other shareholders (e.g., a retiring founder), the underlying Company, and the Co-op–ESOP means that the ownership may over a period of years transition to 100 percent in the Co-op–ESOP, at which point it could be consolidated into one democratic worker cooperative firm.

The Co-op–ESOP model is a generic model designed to work in any country with conventional company law and worker cooperative law. Examples could be

established without any special legislation but also without any special tax breaks. Later legislation could then standardize the model, apply some suitable tax incentives, and help spread the model around the economy.

A Brief Description of the Co-op–ESOP Model

The American Employee Stock Ownership Plan (US ESOP) was introduced in the late 1970s, and now there are about seven thousand ESOPs in the United States covering 10 percent of the private workforce. Our purpose is to describe a generic model of an ESOP for any country that captures the unique features of the US ESOP and makes some improvements over aspects that were only artifacts of how ESOPs were legislated in the United States.

The Co-op–ESOP would be a separate legal entity associated with a company (hereafter "Company"). That separate legal entity could be a new type of Employee Ownership Cooperative where each Company employee has membership and an individual account holds their share of the Company ownership.

The Co-op–ESOP is a vehicle for the employees in the associated Company to acquire, over a period of time, some percentage (up to 100 percent) of the ownership of the Company. The shares owned by each employee are kept in the ESOP in an individual share account so the employees will enjoy the rights to the income and capital appreciation rights of the shares, but they may not individually sell, mortgage, or bequeath the shares. The shares will eventually be bought back by the ESOP and redistributed to the current employees.

The US ESOP is *not* based on employees individually making share purchases out of salary or other income. The Company makes periodic ESOP contributions, much like a form of tax-favored profit-sharing, in cash to the ESOP that then passes the money through to buy out the shares of an exiting owner (and eventually to buy back employee shares). In other words, part of the Company's income is repeatedly contributed to the ESOP to purchase shares from the owner in order to slowly transition ownership and control from the owner to the workers.

Most of the US ESOPs arose out of the succession of family firms or small- and medium-sized enterprises (SMEs) where the founders wanted to retire or exit to pursue other opportunities. The problem with selling to a competitor is that it usually means the slow death of the enterprise because the competitor typically moves the customer list, some key employees, and eventually all the business to their other facilities. Since family firms can be benefactors to the local community by providing jobs, income, and taxes to support the community—selling out to a competitor may be seen as a betrayal of the community and the local employees who, for the most part, will lose their jobs. Hence, an ESOP provides an alternative of rewarding the employees who helped build up the Company and keeping the jobs, incomes, and taxes in the local community.

One way to understand the Co-op–ESOP structure is to follow the steps in all the transactions (see Figures 2–4).

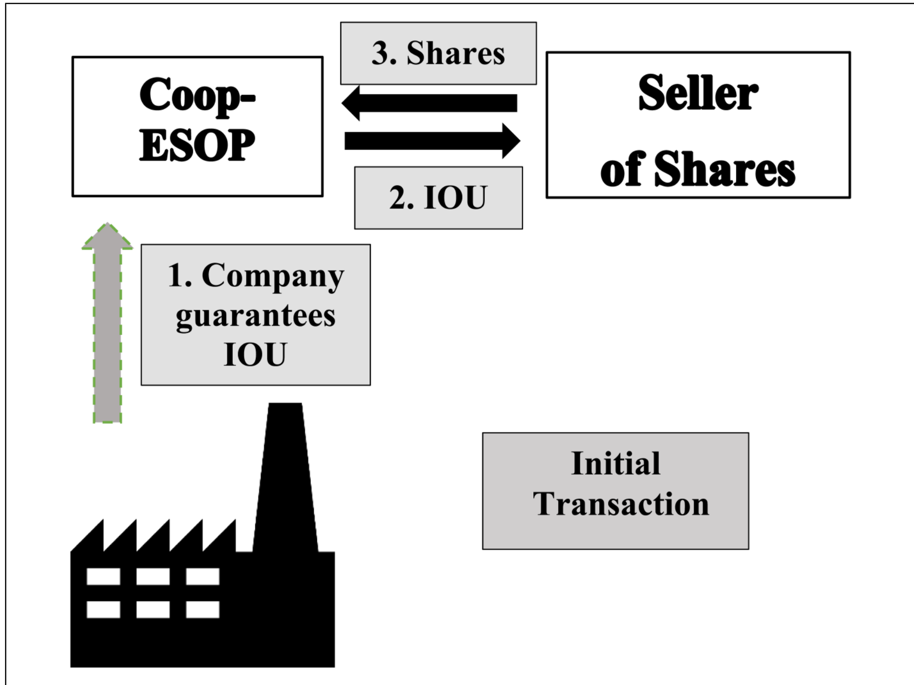

Figure 2. Initial transactions in the Co-op–ESOP model.

Initial Transactions

Step 1: The seller of shares (i.e., the exiting or retiring owner) gets a guarantee from the Company that contributions will be made to the ESOP to eventually pay off the IOU or note in return for a certain percentage of the shares going to the ESOP.

Step 2: The ESOP issues the Company guaranteed debt note to the seller.

Step 3: The shares pass to the ESOP. The shares are not individuated to the employees at this stage but are held in an unindividuated "suspense" account.

Future Transactions with Seller

Step 4: The Company makes regular (e.g., annually or semiannually) cash contributions to the ESOP.

Step 5: The cash contributions are passed through the ESOP to pay down the note from the seller.

Step 6: Shares equal in value to the principal portion of each note payment are taken out of the suspense account and divided between the individual employee share accounts usually according to salary.

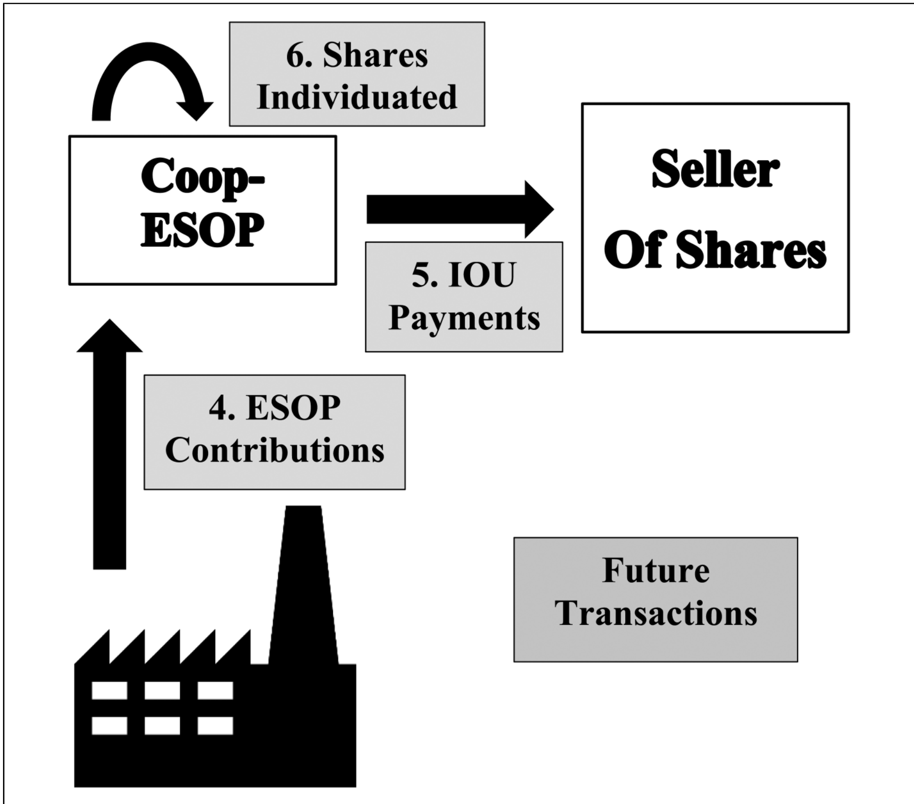

Figure 3. Future transactions with seller in the Co-op–ESOP model.

Future Transactions with Members and Ex-members

Step 7: The ESOP contributions continue on a regular basis.

Step 8: After the seller note is paid off or when the ESOP has funds in excess of the note payments, then the ESOP starts to repurchase the oldest ESOP shares from the employees on a first-in–first-out basis.

Step 9: As the longest-held shares are repurchased from the member (whether still an employee or not), those shares are redistributed to the current employee accounts on the usual basis.

This Co-op–ESOP model is an improvement over the US ESOP in several respects.

- The US ESOP was implemented as a special type of retirement plan so the ESOP does not need to buy back the shares until the employee exits or retires, although there are some provisions that some shares can be repurchased after age fifty-five.

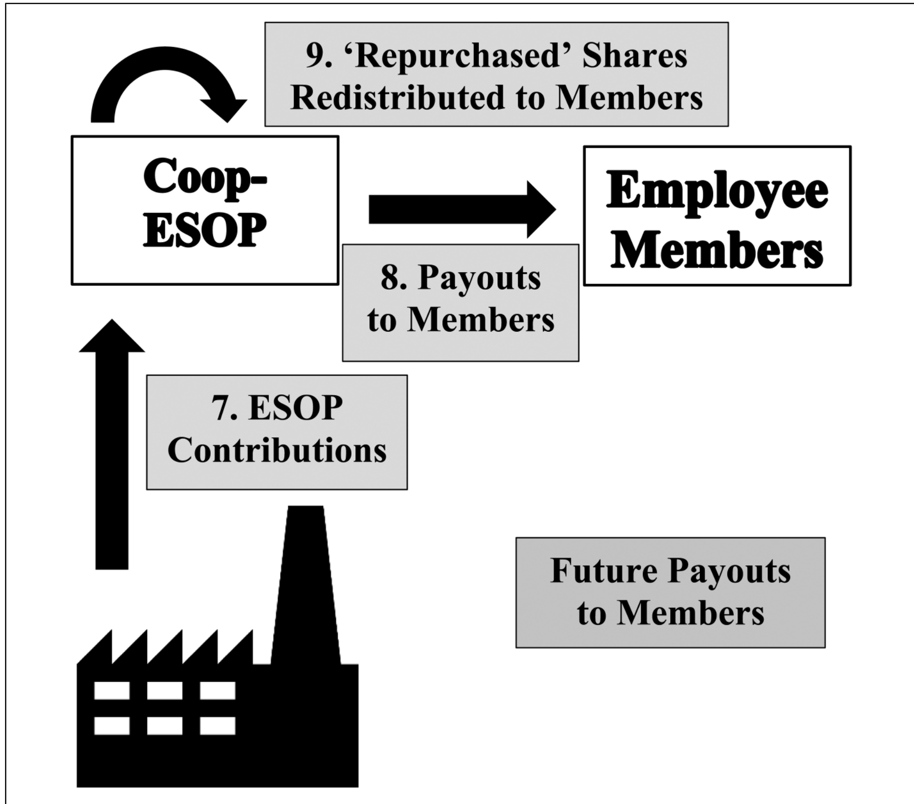

Figure 4. Future transactions with members and ex-members in the Co-op–ESOP model.

In the Co-op–ESOP model, the employees "see some ownership money" in step 8 where that "rollover" can start when the seller note is paid off or whenever funds are available.

- In the Co-op–ESOP, the ESOP is an ownership vehicle that is democratically governed by its members (i.e., the Company employees beyond some probationary period). In the US ESOP, the ESOP is a trust and the employees are only "beneficiaries" as if they were minors. The democratic governance of the Co-op–ESOP is the first step toward building an ownership culture in the Company since the employees are treated as partners.
- In the US ESOP, the ESOP contributions are only made when there is a loan to be paid off or shares to be repurchased. Hence new employees only *then* start to get shares, so they are not owners and do not capture any share appreciation until there are more ESOP contributions. In the Co-op–ESOP, the ESOP contributions are regularized to repay the loans/notes or to start the share rollover so this problem does not arise.

One final point is that the Co-op–ESOP model builds labor-based membership in the Co-op (since all and only the people working in the underlying corporation qualify as members) on top of a Company where the membership rights are still property rights. When the Co-op–ESOP nears 100 percent, then the operating Company can be folded into the Cooperative thus creating a Mondragon-style worker cooperative. In that manner, the institutions of the old society can be used to demonstrate how within a firm, the human rental relationship can be transformed into a worker cooperative with labor-based membership. Any chance of a new economy in the future needs to have concrete working models at the firm level in the present.

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Notes

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