Subcommittee on Financial Institutions and Consumer Credit
Hearing on " Financing Employee Ownership Programs: An Overview"
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WRITTEN TESTIMONY OF JAMES D. MEGSON

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Thank you for giving me the opportunity to testify today at this hearing on expanding employee ownership and providing financial incentives to employees in order to create Employee Stock Ownership Plans and Worker Owned Cooperatives.

My name is James Megson. I have worked in the field of employee-ownership for the last 16 years. For fifteen years I served as Executive Director of the ICA Group, a non-profit organization dedicated to creating employee-owned companies to save and create quality jobs. For the last year I have served as the Executive Director of ICA's sister organization, the Local Enterprise Assistance Fund (LEAF), a US Treasury Certified Community Development Financial Institution that provides debt and equity financing to employee-owned companies.

LEAF and ICA have been involved in the creation of more than 50 employee-owned enterprises employing over 7,000 people. We work with community groups in inner city areas to create worker cooperatives. We work with unions and employees who are about to lose their jobs due to a business closing, to buy their companies. And we work with the owners and employees of small and medium sized businesses to share some or all of the ownership with the employees.

Employee-ownership is a powerful tool. It enables ordinary men and women to share in the benefits of capitalism and links very directly the rewards they receive with their own efforts. However, in addition to being good for our society and, I believe, the health of our democracy, employee-ownership is sound economic policy.

Over the past 15 years a number of academic studies have demonstrated that employee owned companies outperform their conventionally structured counterparts. A recent publication by Blasi and Kruse of Rutgers University, and Bernstein, a writer for Business Week summarizes these findings. Looking at every significant study of broad based employee ownership over the last two decades they found that broad based employee ownership boosts company productivity by 4%, shareholder return by 2% and profits by 14% over what otherwise would have been the case.

Employee ownership also makes a significant contribution to our economy by reducing job loss in two significant areas – small closely held firms that close due to inadequate succession planning and viable divisions of larger corporations that are closed for strategic reasons.

Small business owners who wish to retire frequently find a limited market for their enterprise. Studies show that a significant proportion of these businesses are lost either by being rundown slowly before the owner retires or by being liquidated. The result is that a significant proportion of small, successful businesses are closed and jobs are lost while a potentially interested buyer – the employees – is close at hand. While some businesses are preserved through a sale to the employees many are lost simply because the business owners and employees are not fully aware of this option. Many of these businesses and jobs could be saved if more information on sales to employees were available to small business owners and employees.

When a large corporation closes a major facility, or division, hundreds of well paying jobs are often lost. If the enterprise is no longer economically viable this is inevitable. Frequently however, other factors including the intent of the parent to focus on certain core competencies, relocation of the factory overseas, or the failure of the enterprise to meet target levels of return, drive the decision. Often in these situations the employees could, with just a little support, use an ESOP or Worker Cooperative to buy the enterprise and save their jobs.

Widening employee ownership through the creation of more Employee Stock Ownership Plans and Worker Cooperatives will create significant benefits for our economy and our society, both by saving jobs that would otherwise have been lost and by making existing companies more productive and profitable.

Given their proven benefits why aren't there more employee-owned companies in the US today?

I believe that this is due to a number of factors.

1) Despite the best efforts of its promoters, the employee ownership option is not widely known or understood by small business owners, employees, unions, state and local economic development organizations and community groups. To my knowledge only two states – Ohio and Vermont - currently have organizations that have pro-active outreach programs and provide resources and assistance on employee ownership to local companies. The Vermont Employee Ownership Center just held its first annual conference on employee ownership. They attracted more than 90 businesses of which about 80 say they are now considering this option.

2) A second barrier that employees face is the cost of putting together an employee buyout. Employees in troubled companies, who wish to explore the option of buying their company, division or factory, face a formidable task. They need to know if a buyout is a feasible option and, if it is feasible, how to go about raising the money and putting together a team to buy and run the enterprise. With few resources and little knowledge of the tasks involved most give up. In a few rare cases trade unions or states provide money to fund the necessary feasibility studies, business planning and financial packaging. As no funds are readily available to meet this need these efforts take time to arrange and precious time is wasted, ultimately making an employee buyout much more difficult.

   However when these difficulties can be overcome and a company is saved the return on investment is spectacular. Some years ago ICA assisted the employees of Market Forge, a manufacturer of kitchen cooking equipment in Everett, Massachusetts buy their company when the parent decided to close it. The state, the United Steelworkers of America, and the parent company each contributed $10,000 to fund a feasibility study and the employee buyout effort. 150 well paying jobs that provide generous health and pension benefits were saved. Since that time employees have built up significant equity in the company and the company is currently returning about $500,000 a year to the state in individual and state taxes. The initial money the state invested in supporting the employee buyout has been returned many, many times over.

3) A third and critical hurdle employee groups face is assembling financing. When a business owner is prepared to sell the company to the employees over a period of several years the current ESOP and Worker Cooperative structures can be used very effectively to achieve this end. However when the employees are faced with the purchase of a majority of an enterprise either because the seller wants to do this or because the enterprise will otherwise close, it is extremely difficult.

   In a typical transaction a bank will provide acquisition financing in the form of senior debt, but will limit that financing to the liquidation value of the available collateral. This leaves the employee group to find the balance of the necessary financing in the form of subordinated debt and equity. While some employees often do make an equity investment, the employee group as a whole rarely has the resources to meet more than a very small part of the need. A few equity funds now exist that are prepared to invest in employee-owned companies. However in order to meet their return objectives they are never, in my experience, able to provide the balance of the financing necessary to complete the transaction. The employee group must seek subordinated debt to fill the gap and this is extremely difficult to find. Community development financial institutions like the Local Enterprise Assistance Fund fill this gap for some smaller transactions but our resources are miniscule relative to the need.

   Subordinated debt is often the critical piece in closing the financing gap for a buyout. In 1992 LEAF and ICA worked with the employees of a mold-making factory in Pittsfield, Massachusetts to buy the company after the owner, Tredegar Industries decided to close it. At that time Pittsfield had an unemployment rate of more than 20%. In a relatively short time we were able to develop a strong business plan, get commitments from potential customers, and assemble a management team and board for the new employee-owned company. Assembling the necessary financing was extremely difficult. The eventual financing package included the local bank as the senior lender, two equity investors and no fewer than four subordinated debt lenders, all stretched to their maximum limits. However the time it took nearly sank the deal. The employee owned company opened as Marland Mold in 1993 with 35 employees and had grown to 88 employees by 2001. During this time it paid off all its initial debt, bought out the equity investors, moved into a new custom build factory, increased its share price by an average of 20% per annum and returned almost $2 million to the state in company and individual taxes.

The employees of Marland Mold were fortunate. Other employee buyout attempts often fail due to the difficulty in filling the gap between the need and what a senior lender and equity investor are prepared to invest. For example: In the spring of 2002 we worked with the employees of a machine tool manufacturer in Vermont. The company had a strong brand name and customers who wanted to continue to order from the new company. The employee group had identified an outside equity investor and a bank prepared to provide the senior debt. However no financing institution could be found to provide subordinated debt financing. As a result the employees were unable to buy the company and 350 well paying jobs were lost in a struggling area of Vermont.

An Employee Ownership Bank that provided loan guarantees and subordinated debt financing would significantly help employee groups wishing to buy their companies using Employee Stock Ownership Plans or through Eligible Worker Owned Cooperatives. The provision of the loan guarantees to senior lenders would enable them to increase the amount they could lend to the employee group without unduly increasing their risk. There would still be a need for subordinated debt financing from the Bank but it would be less than would be the case if there were no guarantees on the senior debt.

In summary I believe that a Federal Government program to encourage the expansion of employee owned businesses in the United States through the provision of loan guarantees, subordinated loans, technical assistance and outreach programs will yield a very high rate of return. Some of this return will come from the jobs saved at factories that would otherwise have closed or small closely held businesses that were in danger of closing due to inadequate succession planning. The majority will come from expanding the number of companies that, because they are owned by their employees, will experience a 4% increase in productivity, a 2% increase in shareholder return and a 14% increase in profitability.