



Insolvency, Employee Rights & Employee Buyouts

A Strategy for Restructuring

by
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the common cause foundation

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The Common Cause Foundation works for social justice in employment and enterprise

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The cover photograph by CONFESAL – the Spanish association of employee-owned businesses - shows **Fundiciones Sinc SAL**, an employee-owned company located in Alcoy, Alicante, Spain.

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The key points on one page

1. The International Association of Insolvency Practitioners sees the position of employees in insolvency as intractable and unjust.
2. Insolvent businesses that could be saved are closing unnecessarily.
3. The Employee Buyout (EBO) is seen as a breakthrough in dealing with both the issue of employee entitlements, and, when appropriately used, is a successful strategy for corporate rescue, with a lower failure rate than management buyouts.
4. The EBO can also address a key problem of globalisation, by helping to anchor capital and jobs locally and preserve communities and skills.
5. However, there is a lack of knowledge and information about employee buyouts and their potential in business rescue, and employees are unable to act quickly to purchase a company due to the lack of access to appropriate finance and support.
6. A specialist investment fund needs to be established. A leading insolvency practitioner in the Association of Business Recovery Professionals, **R3**, in partnership with a thoughtful venture capitalist, have proposed an *Employee Buyout Foundation* with a starting capital of £50million to fund employee buyouts.
7. Many businesses are not being sold as going concerns due to the Transfer of Undertakings Protection of Employment Regulations (TUPE), and as a result the employees, using the employee buyout, are in a strong position to become the preferred bidders for the business if the lack of information and finance can be overcome.
8. In the majority of corporate distress cases (77%), by the time the insolvency practitioner is called in the business is beyond saving. A corporate distress early warning system is required.
9. Many business failures (almost 50%) are due to management problems. The key people who can rescue the business - the employees - are not included in creditors' meetings or other negotiations. Legislative change is required to give the employees and their representatives a voice.
10. Developing employee buyouts as part of a cluster of employee-owned companies networked with trade unions has proven to be the best method of maximising company survival, as demonstrated in Italy.

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Key recommendations on one page

Insolvency

1. The Enterprise Act 2002 be amended to formalise a voice for employees and their representatives in the insolvency and recovery process.¹
2. Further research and development with the European Federation of Employee Shareholders (EFES) on the potential of the EBO in Europe, the harmonisation of regulatory and support frameworks, and in particular how the European Globalisation Adjustment Fund can be used in a way that doesn't infringe EU Competition Law.
3. Liaison with the European group that are promoting the Unemployment Lump Sum as an EU policy.
4. The Australian Council of Trade Unions should share with the TUC and TGWU in the UK the results of their research on insolvency early warning arrangements, with a view to developing a bargaining tool.
5. The TUC also needs to be involved in developing a range of learning tools for both insolvency practitioners and trade unionists, on predicting insolvency, the range of alternatives to closure in insolvency, and in particular the employee buyout option.
6. A programme of seminars and conferences should be designed to bring together key sympathetic people in the European Commission, government departments and trade unions, together with insolvency practitioners, employee buyout practitioners, lawyers and academics.

New infrastructure for employee buyouts

7. Discussions need to take place with all relevant bodies on the establishment of an Employee Buyout Foundation (EBOF) - and in particular with Tom Powdrill, the TUC specialist on pensions, R3, key trade unions and financial institutions, with a view to developing a financial infrastructure for the EBOF.
8. A pilot project be developed with the DTI and RDAs to seek out, with the assistance of the trade unions, a number of distressed companies where an EBO could be proposed. Business and legal advice, networking, training, cultural change programmes and access to finance would be arranged. This action research will inform the establishment of the EBOF.
9. An EBO Insolvency Working Party is established to progress the other recommendations in this report.

¹ Specifically that Schedule 16 – Schedule B1 to Insolvency Act 1986 Paragraph 52 (2) - be amended so that when creditors are notified and sent proposals, employees participate in the process, receive information and have the right to participate in the creditors committee.

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1. Introduction

Insolvency is an intractable issue. Laws are written in terms of financial restructuring, leaving social issues to be dealt with by the state and the community. This report points to a way that social and economic values can be fused into an innovative strategy to protect employee entitlements and jobs, and enhance corporate recovery by creating a level playing field for employees in the insolvency process.

The Enterprise Act 2002 placed rescue at the heart of the UK insolvency regime, with the brief that where businesses can be saved they should be saved. This report argues that there are barriers to the achievement of this objective; however, an employee buyouts programme would both help achieve the UK Government's objective of increasing the number of corporate rescues and also address some of the intractable legal and practical issues of insolvency.

The Worker Takeover or Employee Buyout (EBO) phenomenon emerged across Europe in the 1970s and 1980s as a reactive strategy by working people to save their jobs when faced with the collapse of their employer, due to the economic crises and industrial restructuring of the period. Faced with few alternatives in finding employment, workers became entrepreneurs not by choice but by necessity, and took over businesses usually when no one else was prepared to do so. Hundreds of companies and thousands of jobs were preserved, moribund organisations were transformed, and industrial capacity was preserved and reconstructed. New ways of working and new roles for trade unionists have developed, established social and political ideas have been re-evaluated, new networks and economic formations have emerged, and men and women have surprised themselves by what they have become and achieved.²

With the improved conditions of the 1990s, long economic boom and governments developing greater welfare and labour market programmes, this reactive strategy became less used.

2 Paton, Reluctant Entrepreneurs, Open University Press, Milton Keynes, 1989.

However, businesses continue to fail unexpectedly and spectacularly, creating hardship for workers and communities and generating sympathetic and often strident public and press reaction. In the UK over 16,000 companies are declared insolvent annually – many unnecessarily. It is regarded as inevitable that workers will accept the dislocation and hardship, retrain, relocate and find another job.

The Labour Government in the UK has set out to address this situation with a reform of the insolvency regime, by introducing the Enterprise Act 2002 with its emphasis on corporate recovery; but this does not go far enough to prevent insolvency occurring, or protect worker entitlements, pensions and jobs, or the dislocation to communities and the knock-on effect to suppliers of the failed company.

This report proposes that employers become preferred creditors, and also draws on international evidence to position the EBO within the context of a broader range of policy options which are firstly designed to prevent companies sliding into insolvency and secondly to give employees and their representatives, the trade unions, a say in the recovery process – because they know what is going on and have the firm-specific knowledge to contribute and enhance the recovery process.

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2. Insolvency law and practices

2.1 International experience

INSOL (the International Association of Restructuring, Insolvency and Bankruptcy Professionals) made the following comments on the inability of insolvency regimes to resolve the problems employees experience when their company becomes insolvent:

For employees of a financially distressed company, there is seldom a more emotionally wrenching issue than the treatment of their wage and benefit claims in a restructuring process. Employees, who are the lifeblood of the enterprise, too often find that they are treated as expendable and their pension or retirement savings may have evaporated. Stories about the loss of employee benefits and resulting hardships abound in the newspapers throughout the world. The legacy costs associated with employee wages, benefits and pension claims can be enormous and are often among the most intractable issues confronted in a restructuring company.³

There are however countries where there have been initiatives to ensure that employees rights and entitlements are protected. In Hong Kong a company must pay out all employee entitlements before it files for bankruptcy. In Venezuela a bill currently before Parliament will give employees a role in the management and control of an insolvent company under certain conditions.

3 International Association of Restructuring, Insolvency & Bankruptcy Professionals, 2005

In a liberal free market economy such reforms are more difficult. In Australia in response to the collapse of Ansett Airlines and the loss of 16,000 jobs in 1999, the country's Prime Minister John Howard announced, at a press conference on the 14 September 2001, that statutory entitlements of employees in liquidation would rank ahead of secured creditors. In November 2001, in the party election manifesto, this was restated with the caveat that there was a need to balance the impact on the business against employers' legal and moral responsibility to pay entitlements to employees. This was called the *Maximum Priority Proposal*, reflecting that employee entitlements were not just a legal issue, but also a moral one. However, this proposal was rejected by the Parliamentary Joint Committee on Corporations and Financial Services in May 2003. The Committee recommended the continuation of the current government scheme - the General Employee Entitlements & Redundancy Scheme (GEERS) – stating:

*Whilst not able to provide a perfect solution to what is an imperfect situation it is the best of the immediately available policy options given the broader negative consequences of the other alternatives.*⁴

Kevin Davis, director of the Melbourne Centre for Financial Studies, has however recently cast doubt on the reality of such 'negative consequences'. Using credit modelling techniques he concludes that there would be little significant disruption of credit markets, there would be improved credit market discipline over employers, and the cost to the taxpayer would be reduced.⁵

In Germany, the 'codetermination' or 'mitbestimmung' system, which is still regarded by many as partly responsible for the strong business performance in Germany after the war, entrenches a strong participative tradition, some aspects of which have been incorporated into the default arrangements for the new European company form, *the Societas Europaea*. Under such arrangements, companies with more than 20 employees must have a Works Council, and disclose proposals for any substantial restructure. This is one aspect of the emphasis in many continental European states and European Union institutions on the *European Social Model*, which has also led to some interesting experiments with state initiatives to preserve jobs by supporting employees to buy distressed businesses.

In Italy the progressive Marcora Law in the 1970s and 80s set up a legal framework, bank and technical support organisation to help workers purchase insolvent companies.⁶

A similar initiative, *Sociedades Laborales*, occurred in Spain in the 1980s. At the time the Spanish economy was undergoing radical restructuring, resulting in the

4 Proposal to the ACTU by ACIRRT and Ithaca Consultancy 2005.

5 Davis & Lee, *Employee Entitlements and Secured Creditors: Assessing the Effects of the Maximum Priority Proposal*, mimeo, Department of Finance, The University of Melbourne, 2005.

6 See Appendix 1

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highest unemployment in Europe - 21.4% by 1985. EBOs were used in a significant state sponsored strategy to save jobs – indeed they became 'the standard way of dealing with insolvency in Spain'.⁷

However, both these job saving initiatives were discontinued around 1995 as potential infringements of EU competition law.

2.2 The UK

Key Marcora Law provisions

- Established FONCOOPER, a fund for the general promotion of co-operatives and CFI, a revolving fund investing in phoenix co-operatives
- employees' investment matched threefold
- maximum of 3 years' unemployment benefit can be capitalised
- corporate investors permitted up to 25%, providing networking support
- specialist monitoring and advisory body established
- £30 million invested
- 89 businesses and 3,100 jobs saved
- 10% failure rate of co-ops
- 5% of capital and jobs lost through failures

In the UK the Labour Government has made important reforms with the Enterprise Act 2002, aiming to put rescue at the heart of the administration process with the fundamental principal that "where companies can be saved they should be saved".

This was a development in the continuing process of protecting unsecured creditors - and therefore indirectly the employees - that began in 1982 when the Cork Committee reviewed UK insolvency law and practice and defined a set of principles for an insolvency regime that would be worthy of international respect. This led to the Insolvency Act 1986. The Cork Committee's principles represented a move, which was internationally recognized, away from a framework only for liquidation towards one for reconstruction/administration. The principles included

- recognising employees as unsecured creditors
- seeing insolvency as no longer a purely financial concern but involving other stakeholders and the community
- prioritising a recovery process based on efficiency, accountability, fairness and use of expertise.

An employee buyout, as a strategy to protect the position of employees in insolvency, is a vehicle to implement these principles.

⁷ European Federation of Employee Shareholders visit of Spanish Trade Unions to Belgium, 2002.

The Enterprise Act 2002 continued the process of enacting the recommendations of the Cork Committee on insolvency reform: modifying a regime based on the creditor model, elevating the status of employees, and changing the incentive structure for the main players. This was done by reconfiguring procedures and rights so that the administrator is required to consider the interests of the creditors as a whole. Overall, there was an attempt to move away from the bank-driven receivership model to a more inclusive collective model premised on the theory that this would improve the prospects for corporate rescue and, in particular, the outcomes for unsecured creditors and hence indirectly the employees.

Previously the receiver was an undertaker, too ready to bury companies in the interests of the banks.⁸

Receivers had a perverse incentive to close down the business in circumstances where the bank would get repaid on the basis of break-up value. The employees remained in an ambivalent position as unsecured creditors: they had a preferential status for wages and entitlements capped at £800; but also had super priority status when the administrator adopted their employment contracts in the recovery stage.⁹

The UK insolvency regime is based on a voluntarist approach in a pluralist liberal free market context. In this context it is difficult to legislate in the interests of employees, as it would be regarded as undermining the basis of financing capitalism.

In order to understand the issue of employee interests, it is useful to examine Finch's voluntarist model of insolvency to explore how an insolvency regime operates. Finch, an insolvency lawyer at the London School of Economics, developed a model based on the position that the UK insolvency regime can be influenced by giving the key actors incentives backed by government leadership to overcome vested interests and initiate a change in the rescue culture.

The Enterprise Act 2002 has introduced a superior *insolvency game*, says Finch, but for it to work it is important that the players adhere to the script, which requires them to feel that they have the incentive, and are motivated to do so. The key is to develop appropriate incentives but also specific legislation aimed at the key players to encourage them to support the government's corporate rescue process – to adhere to the script.

In Finch's model, insolvency involves five key actors and the relationships between them:

- secured creditors (legal charge holders)

8 Finch, V, Corporate Insolvency Law: Perspectives and Principles, Cambridge University Press, 2002, p.542.

9 See Appendix 2.

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- unsecured creditors
- administrators
- directors
- the courts

Importantly Finch leaves out employees as a specific group including them with unsecured creditors. This reflects the reality of the decision making process – namely that power rests with the banks, the administrator and the key creditor(s). Finch states:

Employees are in some ways the lost souls of insolvency law. Their working contributions are the lifeblood of companies, yet the law does remarkably little to involve them in insolvency procedures.¹⁰

Employees and their representatives, the trades unions, should be considered key actors in the process, and require a voice if their interests are to be taken into account. The fate of employees cannot be remedied while they are not represented at the bargaining table. Some questions therefore need to be asked of the actors if the government's aims around improved corporate recovery are to be achieved:

- Will they play by the rules?
- Is there an alignment of interests?
- Do the actors share attitudes, values, conceptions and assumptions about the way the processes are and should be operated?

Despite the difficulties of directly addressing employee interests within the current system a number of features of The Enterprise Act elevated the status of employees in insolvency indirectly through their status as unsecured creditors:

- the use of administrations was promoted;
- Crown Preference was abolished and employee preference was retained;
- the cause of employees in their capacity as unsecured creditors was advanced by ring fencing 10% of insolvent companies' net floating charge proceeds for the company's unsecured creditors (to the extent that employees have wage arrears over and above the £800 they receive from the redundancy fund);
- employees in their capacity as unsecured creditors were given greater powers, as preferential and unsecured creditors, to challenge the decisions of administrators.

¹⁰ Finch, 2002, p.570.

Pinsents, one of the UK's largest law firms, commented on these features of the Enterprise Act days after it had been ratified in 2003:

Consideration of the interests of employees of distressed companies has therefore never been of greater importance to practitioners.¹¹

However Pinsents concluded in the same report that a regime change was unlikely to occur:

The likely practical effect of the paramount regard to what is in the best interests of the company's creditors as a whole is that there will be few instances where the administrator performs his functions with the objective of rescuing the company as a going concern. Those primarily interested in a rescue are likely to be employees, guarantors of any debts of the company and shareholders, interests to which the administrator is not expressly to have regard.¹²

2.3 Critiques of UK insolvency law

2.3.1 Academic lawyers

Current UK insolvency laws are

not adequate to prevent employers placing employees' accrued entitlements at risk.¹³

Employees deserve the law's sympathy.¹⁴

As far as employees are concerned the law is worthy of little praise.¹⁵

The law has reached a dead end.¹⁶

Insolvency law fails employees for a number of reasons. It shows a lack of coherence as they find themselves at different points in the ranking of preferences:

11 Pinsents, Corporate Recovery Conference, September 2003, Manchester, p.116.

12 Pinsents, 2003, p.9.

13 Darvis, *Employees' Rights and Entitlements and Insolvency: Regulatory Rationale, Legal Issues & Proposed Solutions*, *Company and Securities Law Journal*, Volume 17, 1999, p.122.

14 O'Donovan, *Corporate Insolvency: Policies, Perspectives and Reform*

15 Villiers, *Employees as creditors: a challenge for justice in insolvency law*, *The Company Lawyer*, Sweet & Maxwell, 20:7, 1999, p.232.

16 Symes, Flinders University Interview, December 2004.

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- preferential with limited contractual claims when asked to rescue the business
- first priority creditors, albeit capped to a certain amount
- unsecured for the remainder of their claims.

Thus the employees are faced with a confusing set of rules, which leave them stranded between different levels of the creditors hierarchy. Firstly when the business has failed employees are regarded as unsecured creditors; however, they are then elevated to a super creditor status when asked to assist in saving the business in administration, in circumstances where the administrator trades the business and adopts the employment contracts. This elevation of employees is an implication or side effect of other factors rather than one determined by policy.¹⁷

Secondly the 'contractual bargain model' defends the status quo on the basis of the rights of all parties to freely enter a contract with the company. However, employees' employment contracts were not negotiated on the basis of risk, and the contractual bargain model ignores the economic and practical realities faced by different groups - and employees do not have bargaining rights. They are powerless to deal with both risk transfer and management malfeasance.

To deal with this issue, which is a complex mixture of company, insolvency and employment law, it is necessary to take the radical position that it is not appropriate that employees are treated as unsecured creditors (alongside trade creditors). This comes down to a matter of business ethics:

*But when the demands of doing business conflict with the morality or well being of society, it is business that has to yield, and this, perhaps, is the ultimate point of business ethics.*¹⁸

2.3.2 Trades unions

*The Transport and General Workers Union concludes from first hand experience that companies have been closed unnecessarily in circumstances where they could have been saved.*¹⁹

Insolvency is a difficult situation for trades unions in liberal market economies as they are predominately in a reactive position and endeavour to salvage an agreement for the workers from the financial wreckage when the company has collapsed. However, the collapse of Ansett Airlines, with 16,000 employees in

17 Villiers, 1999, p.226.

18 Solomon, *Business Ethics*, in *A Companion to Ethics*, ed. Singer, Blackwell, Oxford, 199, p.364.

19 Peter Booth, National Industrial Officer, T&GWU.

Australia demonstrated their ability to influence events:

Employees when united and organised have a very significant influence on the course of insolvency administration.²⁰

To deal with this the Transport and General Workers Union in the UK have taken the position that employees should be treated as priority creditors at the beginning of the administration process rather than at the end (when they are elevated to secured creditor status) and should be included in the initial creditor's meetings.²¹

In the long term the T&G would prefer comprehensive legislation in the whole area of insolvency, redundancies and closures so that the UK reflects best practice in Europe in terms of workforce consultation. Another objective would be to have the UK trade unions and workers provided with independent experts, as in the Information and Consultation procedures in France.

Trades unions are currently in discussions with Department of Trade and Industry officials about possible amendments to redundancy and insolvency law, arising from the Warwick Agreement and the *DTI Success at Work* document. Unions have made it clear that, at the very least, the Enterprise Act should be amended to require insolvency practitioners to treat employees representatives as priority creditors at the beginning of the insolvency process, rather than just at the end when the company is wound up.

This would mean that trade union representatives would have the same information and consultation rights as those creditors who are invited to the initial creditors meeting, and within the same timescales. The trades unions are also clear that the current Information and Consultation regulations, even if they have been triggered, do not provide the opportunity for unions to be involved in the rescue process.

The trades unions are not satisfied with the operation of the Enterprise Act 2002 and this was reflected in the 2005 *Warwick Agreement* with the Labour Government. This addressed possible legislation to prevent an Administrator taking premature action to remove plant and company assets. The DTI followed this in March 2006 with a commitment to investigate the actions of unscrupulous employers seeking to deny workers their entitlements by the premature removal of plant.

The government will work with stakeholders to protect vulnerable workers and support good employers.²²

20 Whelan & Zwier, *Employee Entitlements and Corporate Insolvency Reconstruction* (undated) p.42.

21 Peter Booth.

22 DTI Report.

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The trade unions have made it clear that protecting employees is more complex than the Enterprise Act 2000 allows. The key to understanding the employees' position in fact lies in the Insolvency Act 1986 and the Employment Rights Act 1996:

Businesses are broken up into smaller units separating the assets and liabilities, including employees, into different companies before the latter is placed in administration and employees made redundant. The law allows this to happen.²³

Administrators should be made to follow Employment Law. The Administrator is an employer with legal responsibility and is obliged to inform and consult with employees. Often they do not consult or give adequate notice of redundancy and are in breach of employees' rights. Unions apply for the protective award, win at the tribunal but the administrator acts with legal impunity.²¹

The T&GWU, following the Rover fiasco, would like to see the state involved in the rescue of key companies by taking a financial stake, as in France (though this would probably end up in the European Court). 'Intervention is needed to prevent the loss of what remains of the manufacturing sector' - which loses 7,000 jobs a month.²⁴

A senior trade unionist commented on insolvency: 'The management have failed, why not let the workers have a go?'. However there is debate amongst trade unionists over employee buyouts, with some local and senior trade unionists in favour at elected officer level but peak body opposition. This may be influenced by the linkage of employee share ownership with privatisation, which is opposed by the trade unions.

This reflects wider debate amongst the key actors on how to deal with insolvency and industrial restructuring. The Insolvency Service has advised that seeking new legislation is not appropriate; that existing legislation, if used properly, will have the desired result - yet the unions argue legislation is not being enforced. Insolvency practitioners are against further legislation, as it would make corporate recovery more unwieldy and expensive. Academics advise that it is unlikely that further legislation in such close proximity to the Enterprise Act 2000 would be considered.

A further complication is that due to the division of responsibility for insolvency issues between government departments especially relating to the DTI/Insolvency Service and the Department of Work and Pensions it is unlikely that progress can be made without a joined up government initiative. New thinking is needed to align the interests of the key players to overcome the problems identified.

23 Peter Booth.

24 Tony Woodley, TGWU General Secretary, *An end to passivity*, *The Guardian*, 3/5/05.

'Let them stack shelves at Tesco'

- a Minister's response to the closure of MG Rover.

Business collapses create public outrage and debate in the press. The MG Rover collapse was a major news media event, and was seen as demonstrating the inadequacy of the current UK insolvency regime.

The 'Phoenix Four' purchased MG Rover for £10 from BMW in 2000. It was declared insolvent in April 2005 with a loss of 6,000 jobs, with £1.7 billion in debts and a £67 million deficit in the pension fund. MG Rover was sold to Nanjing, the Chinese carmaker, for £53 million. 4,000 workers received around £50 million in redundancy payments. The Phoenix Four found themselves with £31 million in their bank account.

The total cost to the state exceeded £250 million, including a £150 million package to assist 20,000 workers at MG Rover and its suppliers in the West Midlands to find new jobs.

Simon Caukin argued at the time that this case demonstrated how the UK insolvency model 'comprehensively fails the tests of justice and common sense, stacking up neither in theory or practice' and how 'in every substantive sense, it is the employees who bear the greater risks not the shareholders' (*The Observer*, 1/5/05).

The demise of MG Rover was not blamed on the Phoenix Four but 'on an ageing range of models and no resources to develop new ones. Without a strong partner, a slow death was inevitable' (*Who Killed Rover? Cambridge MIT Institute for Competitiveness and Innovation*, 2005).

Another view places the blame on incompetent management - 'botched mergers, failed integration and a persistent inability to develop attractive models' - but even so, there were 2 scenarios in which part of the company could have been rescued and the jobs kept in the UK.

- Sir Digby Jones of the CBI described MG Rover as a flawed business model that was never going to work - but could support 1,000 workers manufacturing 80,000 MG sports cars a year for the US market. (*The Guardian*, 27/4/05)
- Tony Woodly, Secretary General of the T&GWU, criticised the government for allowing further decline of British manufacturing. Woodly believed that if the government had invested in the MG Rover there would not have been a problem persuading the Shanghai Automotive Industrial Corporation to invest as well. (*The Guardian*, 3/5/05)

The employees, the local communities, the state and the tax payer would have been better off if an employee buyout of viable aspects of the business - using the same funds eventually used in retraining - or an alternative state investment strategy had been pursued.

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2.3.4 Employee rights – the stakeholder model

Workers have often acted independently when faced with loss of jobs. Worker Take Overs, Employee Buyouts, and Sit-Ins, have been important strategies in a number of countries, especially in the 1980s, to challenge the arbitrary decision of management to close a company or plant, and also to provide a useful breathing space during which alternatives to plant closure can be arranged.²⁵ Unfortunately these are always reactive and under-resourced strategies.

A more recent example is the *Workers without Managers* movement in Argentina, a response to the crises in the Argentine economy in the late 1990s. In over 200 companies workers refused closure and have continued to run the companies without significant support structures.

A conference on *Retraining, Redeployment and Retrenchment Practices* held at the University of Sydney in 1992 concluded that:

*more attention must be given to preventing the redundancy situation arising and secondly using the situation to restructure the organisation.*²⁶

*Employees are often in a good position - much better than public shareholders - to evaluate the exercise of managerial authority within the firm: whether managers appear to be capable and well motivated, whether production moves smoothly, whether resources of capital and labour are efficiently used.*²⁷

Many good companies become insolvent due to incompetent and reckless management, and could be saved by appropriate intervention.²⁸ The failure of management emphasises the need for a change in management in the turnaround process. There is an emerging recognition of employees' key knowledge and understanding of the business and being able to see potential in situations that the venture capitalist does not - resulting in rescues that would not otherwise occur.

This is based on the notion that workers' *firm specific human capital*, is greatly under-appreciated and under-used. It validates the need for employee and trade union involvement in the management and control of the company in both the pre-insolvency and the Administration phases, where an input can be made in developing the turnaround and recovery plan.

25 Buchanan, ed. *Retraining, Redeployment & Retrenchment Practices*, University of Sydney, 1992, p.29.

26 Peter Booth.

27 Blair & Roe, *Employees & Corporate Governance*, Massachusetts Institution, Washington, 1999, p.335.

28 44 % of insolvencies in the UK are due to management inefficiencies (Finch, 2004).

Finally there is also an important line of argument around the stakeholder view of capitalism, where the employee is a key stakeholder possessing rights revolving around work, the need to work, and work as a place for fulfilment and a sanctuary for community. Insolvency results in loss of employment, skills and destruction of community.²⁹

2.3.5 The DTI - evaluation of the Enterprise Act 2002

Detailed research projects by a number of universities into the effects of the Enterprise Act 2002 on corporate recovery following entry into administration are being conducted for the DTI, but as yet there are no results available. The Corporate Policy Development Team has indicated that the final report will be available in early 2007. However, the author noted a statement from an officer within the Insolvency Service to the effect that 'Administration is quasi liquidation' and 'the majority of administrations do not result in rescues as an entity'.³⁰

Rescues are still common using the method of setting up a new company, transferring the employees across using TUPE as a 'rescue' and selling the company as a going concern above break-up valuation. Business rescues of this type are still common, keeping the business intact, despite buyer reluctance to take on TUPE liabilities. However, there is evidence that administration is being used as a business cessation and liquidation model by some Insolvency Practitioners – this is an unintended consequence of giving the administrator power to distribute the assets and then move straight to a dissolution without there first being a liquidation.

2.3.6 The way forward

This report emerged from the experience of practitioners in the UK who have worked on employee buyouts of distressed companies from a reactive position, and have seen the potential for a proactive strategy supported by appropriate policy and infrastructure.

29 Section 309 of the UK 1985 Companies Act famously required directors to 'have regard to' the interests of employees. This has long been subject to controversy – and often derision - because like all of the fiduciary duties of directors it is a duty owed to *the company* (ie. to the members or shareholders) and enforced by them alone – rendering it notoriously meaningless if the interests of employees and shareholders happen not to coincide. The new 2006 Companies Act consolidates previous company law (and is intended to simplify it, though it is the largest single piece of legislation ever passed in the UK). It contains some nods towards 'stakeholder' views – it mentions the interests of employees, suppliers, consumers and the environment - which were welcomed by the TUC - but few expect it to substantially improve the position of employees in practice.

30 Unstructured discussion with DTI officer. March 2005.

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Based on research in Europe on worker buyouts in the 1980s, Paton drew the following conclusions:

- restructuring that arises within a declining enterprise is very much preferable to restructuring that results from the closure of one enterprise and the opening of another;
- EBOs can succeed where others have failed or are unwilling to try; and even if EBOs are marginal to begin with (as they often are) they can consolidate and develop.³¹

There are however at least 4 key components that need to be put in place to prevent companies in crises entering administration.

Firstly a proactive strategy would begin with the development of an early warning system to predict corporate failure and distress and where possible avoid administration and insolvency. The UK Association of Insolvency Practitioners' Survey of Business Recovery in 2001 found that in 77% of cases, rescue professionals were appointed too late to avert failure. Developing a tool to predict business failure and preventing the distressed company entering into administration is therefore a key objective for the trade unions. An effective distress prediction diagnostic should assist employees at a workplace, enabling a better understanding of the employer's commercial viability or possibly perilous financial state – and its trajectory towards that state. The tool envisaged would provide more timely reporting to employees of an employer's drift into financial difficulties, enabling them to bargain more effectively regarding their wages, conditions and other employee entitlements. It would also enable decisions to be made as to whether the company was suitable for an employee buyout.

Developing an early warning system is in the spirit of the EC Information and Consultative Directive, but it goes beyond this directive as it is based on the ability to access accurate financial information from the company concerned. However, according to at least one expert research has indicated that up to 60% of audit work may be falsified.³² Accounting standards generally do not and cannot provide data to enable an accurate diagnosis of the company's position.³³ It is therefore unlikely that the European Information and Consultation

31 Paton, 1989, p.60.

32 Professor Sikka, BBC Radio 4 'File on Four', 31/5/05, Transcript p.16.

The auditors are hired to give an opinion on the accounts which directors have prepared. If we could all trust what the directors were telling us, we wouldn't want an audit anyway. The auditors have more rights than the police. Without a specific court warrant, they can go into a company, they can look at any record, any set of accounts, any file, any document, they can interview directors, they can interview employees, but that is not what they appear to be doing. Auditors... often appear to be simply rubberstamping the accounts which the directors have prepared. Published academic research shows that probably as much as 60% of the audit work is falsified. In other words, this audit work has never really been done.

33 Dean, Clarke & Oliver, Corporate Collapse, Cambridge University Press, 2003, p.25.

Directive 2005, is able to provide all the accurate information an early warning system requires to predict company failure. Unions advise that in the UK the Directive has been less rigorously implemented than in Europe allowing companies to close down plants in preference to closing them in other countries.³⁴

It is recommended that the TUC follow the progress of the Australian Council of Trades Unions, which is investigating a Corporate Distress Predication tool:

*It is about early intervention. It's about looking at some of the early warning signs. It is about information sharing and employees having the opportunity to look at the state of play of a company and be provided with proper details of contingent and accrued liabilities and a company's steps to secure those, at least to ensure that they are in an informed position as potential creditors or creditors of the company.*³⁵

Secondly, the employee buyout proposal may well be an idea 'whose time has come' as it accords with legislative reforms in the corporate insolvency field. The success of voluntary administration shows the early detection of corporate insolvency and the ability to investigate the situation has had significant benefits. What has been a continuing problem is the inability of government to legislate to better protect employee entitlements. There is however an opportunity for government to move from a welfare model of protection, where the company has externalised employee costs onto the taxpayer, to a more market based buyout by employee interests.

Thirdly, for the employee buyout strategy to succeed appropriate and timely finance is required to enable the employees of the company to become credible potential purchasers. In America and Canada pension funds have been used in this way for some time. According to Lynn Williams, former President of United Steelworkers of America,

*The pension funds of American workers should not only guarantee good pensions. They should also guarantee American workers jobs to retire from.*³⁶

In America pension funds are the now the major source of capital formation:

Let me give you the American numbers. Total US pension funds assets today are about \$7.5 trillion. They've grown extraordinarily rapidly; from about \$500 billion in 1977 to \$1.1 trillion in 1981 to \$3.4 trillion in 1996 to \$6.8 trillion in 2001.

34 Peter Booth, T&GWU, Unstructured Interview, June 2006.

35 *Corporate Insolvency Laws – a Stocktake*, a submission by the Australian Council of Trade Unions to the Parliamentary Joint Committee on Corporations and Financial Services Report, June 2004, p.190, Para.10.88. Professors G. Dean and F. Partington of the University of Sydney Business School are developing an employee-oriented early warning tool, which tailors to employee needs the best features of existing easy to use distress prediction tools with successful track records.

36 Quoted in Ahlstrom, *The Peoples Capital*, Euresa Institute, 2005, p.29.

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By comparison, the total value of all publicly traded companies in the US is around \$10 trillion today. Employee pension funds own about 45% of all publicly traded equities in the United States, but you sure wouldn't know it by the way it is invested.³⁷

With pension funds worth \$2,000billion signing up to a global charter placing environmental, social and governance standards at the core of their investment strategies, there is a clear case and prospect for dialogue on mutual solutions to insolvency.³⁸

The consequence of American corporate behaviour is that the AFL-CIO established a Centre for Working Capital in 1997 to seek to impose some minimum standards of corporate responsibility on corporations in which co-determined, multi-employer funds had investments.

The idea behind the Centre for Working Capital is that of 'capital stewardship'. That's the basic idea that labor's pension funds for tomorrow ought to be managed so they don't harm working people's interests today. That doesn't sound very revolutionary, but if it were applied across the board in American pension funds, it would fundamentally change the way that our pension funds operate and that American corporations – 45% owned by pension funds – operate.

Individual pension funds have also undertaken policies of enforcing corporate responsibility. CALPERS, for example, have endorsed global Sullivan principles as a basis for its investments. These principles include corporate respect for human rights, especially in the company's workforce; equal opportunity; respect for workers' rights to form unions; principles of fair compensation to meet basic needs; the right to a safe & healthy workplace; and to work with the community and government to improve community life where the companies have plants. CALPERS votes its shares accordingly.

John Logue

Fourthly, legislative changes need to be made to the insolvency process to enable the workers and trade unions to have a voice and input into deliberations on the reconstruction of the company. There needs to be an obligation on the administrator to inform and consult workforce representatives or the workers themselves. This would enhance the emphasis of the Enterprise Act 2002 on corporate rescue, as it would ensure that those who had knowledge of the company operations and the skills, the firm specific human capital, would be at the heart of the recovery process.

³⁷ Logue Paper *Hur Tar Vi Ansvar for Lontagares Kapital*, Runoskolan, September 2004.

³⁸ *Pension funds sign pact to secure ethical investment*, Financial times, 27/4/06.

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3 The employee buyout as an option in insolvency

Over the last 30 years the EBO has been used as a reactive strategy by workers, trade unions and labour governments in a number of countries to rescue companies, save jobs and preserve communities in economic downturns. In most instances it has sprung from direct action by the workers (sit-ins, work-ins and takeovers) to prevent plant closure and save their jobs – and mostly with the assistance of the trade unions, especially in the 1970s and 1980s.

Insolvency offers the opportunity to restructure the company. The EBO is a democratic model that can break the mould of the insolvent uncompetitive company, generally with a command and control structure, and redesign structures based on co-operation and participation that overcome the inefficiencies and friction involved in the separation of ownership and control in the conventional corporate form. William Mercer believes 90% of British companies are of this type, and the EBO can therefore offer the potential of a significant performance breakthrough - and there have been many successes as well as failures.

3.1 Legal issues

The EBO importantly resolves two intractable issues in insolvency: on the one hand, how to address the legal issues concerning employees in the insolvency process; and on the other hand how to preserve jobs, the enterprise, and address the economic and social needs of the employees and the wider community. In so doing the EBO challenges some of the key assumptions on corporate governance and collective bargaining held by the main actors. The EBO is an alternative way forward, which will meet the objectives of, and offer incentives to key actors – administrators, banks, creditors and trade unions.

The EBO is a vehicle that empowers the employees to enter the contractual bargain model and negotiate with the vendor. The employees can then choose to trade off wage concessions and entitlements for their job, an equity stake and democratic control of the company. In this way they are no longer passive participants in the process of insolvency but industrial citizens with rights to decide on their future.

The EBO goes beyond the most fundamental principle of insolvency law – the inertia of the *pari passu* principle – which in its attempt to balance competing interests where all creditors are in a common pool in proportion to the size of their admitted claims, is unable to address the main intractable social issue of employee jobs and entitlements. In practice this does not work effectively as secured creditors and suppliers take charge-leaving employees at different points in the hierarchy. In an EBO employees purchasing the business can act to bring about a better result for all creditors.

3.2 Employee Buyout Foundation

A breakthrough in dealing with the problems identified has come from a member of the Association of Business Recovery Professionals, *R3*, which produced a key insight into the nature of corporate failure: by default the employees have potentially become the favoured bidders for a distressed company, opening up the way for the strategy of the employee buyout to save their jobs and entitlements. This is due to:

- Relatively tough employment legislation, including TUPE, which has been a disincentive to some standard bidders to purchase the business. This could potentially lever employees into the position of favoured bidders.
- The Pensions Act 2005. Pension schemes, with their quasi-secured rights and increasing deficiencies are becoming the bankers to insolvent companies. The schemes are influenced by employees, again enhancing the employees' position as potentially favoured bidders.
- Diminishing assets of the business mean that the insolvency practitioner has little or nothing to sell. Intangible human capital, the workforce, is becoming the core asset of many companies. Employees have the leverage to drive the value of what remains of the asset value of the business.

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However the reason employees don't buy businesses is due to the lack of readily available and timely finance, and appropriate advice. A potential breakthrough in this area is a proposal linking trade unions and a thoughtful venture capitalist – a proposed **Employee Buyout Foundation** (EBOF). This would be a body working with a financial institution and other partners to provide appropriate finance to employees to purchase the business. The venture capitalist proposing this, and willing to contribute to the £50million projected starting fund, is also a corporate turnaround specialist who will work closely with trade unions and the vendor to propose a restructuring programme. The Employee Buyout Group of UK practitioners would provide expertise to represent the employees, but funds would need to be acquired to carry out training and cultural change programmes for unions and employees. The DTI has funded this in the past.

This strategy, the proposers believe, would have a significant effect in addressing the break-up of British manufacturing and its sale to India, China, etc. This has yet to be ratified by the trades unions; it is for this reason that there is emphasis in this report on how the trade unions would address what is for them a new industrial strategy.

Another member of R3, a partner in Deloitte & Touche, supported the EBOF initiative:

The Employee Buyout is thought leadership. However two problems need to be resolved. Dealing with the need to cut back on employees and to have finance in place quickly. There is no ideological barrier. The employee's money is as good as anyone else's.³⁹

Both practitioners agree that there are fewer sales of companies as going concerns, as the traditional buyer is reluctant to purchase a company weighted with employee liabilities. This sometimes leaves the employees as the only realistic buyers.

The Transfer of Undertakings (Protection of Employment) Regulations (TUPE) were introduced in 1981 and provided some limited employee protection following a relevant transfer on change of employers, including a change in response to insolvency. Recent changes introduced in April 2006 have added specific provisions to promote the 'rescue culture' by increasing the opportunity of insolvency practitioners to agree contract variations with affected employees. However, such provisions have already attracted criticism because of uncertainty over when they should apply.

39 Partner, Deloitte & Touche, Interview with the Author, August, 2005.

3.3 Examples

There are many examples of employee buyouts, where employees bargaining equity stakes to avert company closure have ranged from large steel works and airlines to small manufacturing companies. Some examples of EBOs include:

- **Weirton Steel in the USA** was the first of the major successful EBOs – 8,500 employees faced with closure, and the local community with collapse, raised \$200million to purchase 100% of the company in 1984. Raising finance was made possible by taking a total labour cost reduction of 30% including a 20% wage cut. However, the local community remained intact due to the rescue and a \$¾ billion investment programme was undertaken. The buyout was supported by the Independent Steel Workers Union. Although retaining an ESOP, Weirton returned to the private sector in 1996 after a public share offering, with around 5,500 employees.⁴⁰
- **Tower Colliery in Wales** has been a flagship of the EBO movement in the UK. The management at Tower Colliery in South Wales had spent some time re-capitalising the loss-making pit in preparation for its closure, when the miners would be made redundant and management could purchase and restart the business. The 300 miners decided to challenge this, at which point management declined to be involved in the buy-out. The buyout was also initially opposed by the National Union of Mineworkers (NUM). The Conservative Government granted the miners preferred-bidder status and eventually 300 purchased the business investing £8,500 each. The mine now employs 300 workers. The NUM eventually approved the buyout.
- **Betsade in Spain** was formed in 1989, as a Sociudades Laborales (SAL), when 114 workers bought the insolvent business - reducing the workforce from 236. The company had lost money for 11 years and was abandoned by the



⁴⁰ Some years later, in May 2003, Weirton again hit problems. It was purchased by International Steel Group to form ISG Weirton, but in turn sold to Mittal steel in 2004, and is currently in the process of 'downsizing' again.

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owners. It is now a successful producer of cast iron parts for the automotive industry and one of the top 5 companies in its market sector in Europe, employing 280 employees and supplying VW, MAN, Ford and Evaco. The company recently invested €150million in a new automated warehouse. There is a two tier board consisting of a blue-collar Assembly Board of 8 members plus an outside consultant, plus the management board of 8 consisting of representatives of all departments. The trade union takes a traditional collective bargaining role. The company also has Works Council.

The rise of the EBO in the USA

Every year hundreds of subsidiaries, divisions, product lines, and entire corporations are sold. These sales are typically arranged through privately negotiations or private auctions conducted by investment banks. They range from healthy to distressed businesses. Buyers are typically companies in the same line of business, companies with complementary product lines, or leveraged buyout firms. However, selling a company to all its employees through an employee stock ownership plan (ESOP) has been a growing trend.

The National Center for Employee Ownership (NCEO) estimates that from 1985 through 1993, over 750 employee-owned companies were established through selling a company or through corporate divestitures to newly created companies that are at least 25% ESOP-owned. A few examples of these transactions follow.

- In 1987, the employees of *Avis* borrowed \$1.7 billion to buy their company from *Wesray Capital Corporation*.
- In 1989, *American Maize Products*, a publicly traded conglomerate, sold 100% of a chain of home and building supply centres to the chain's employees. Spread over rural Pennsylvania, the chain has \$27 million in annual sales.
- In 1990, *PPG Industries* sold 100% of a paint and wire brush manufacturing division with \$14 million in annual sales to the division's employees.
- In 1990, *GenCorp* sold 100% of an automobile vinyl plant, which had \$43 million in annual revenues and the largest market share in its industry, to the plant's employees.
- In 1990, the employees of *Erie Forge and Steel* teamed up with *ACS* to buy a majority of their company from *National Forge*. *Erie*, which markets high alloy steel and forges ship propeller shafts, has \$65 million in annual sales.
- In 1992, *Union Carbide* sold 55% of its *Midwest industrial* bottled gas business to the employees. The business had \$50 million in annual sales and is a leading supplier in its market.

- In 1992, an ESOP at *National Underwriter* borrowed \$32 million to buy the company from its existing owners.
- In 1993, *Northwest Airlines* agreed to establish an ESOP with \$886 million of convertible preferred stock for all its employees in return for working practice concessions.
- In 1994, the employees of *Good Stuff Food Company* in Los Angeles, a bakery with \$30 million in sales, teamed up with ACS to purchase their company out of bankruptcy.
- In 1995, the 450 employees of *Mobile Tool International* in Denver, Colorado, an aerial lift trucks subsidiary of *Penn Central* with \$70 million in sales, teamed up with ACS to purchase the company with majority employee ownership.
- In 1995, after previously selling one of his companies to its employees, the owner of *National Forge* sold 78% of his remaining company, a rural Pennsylvania forger with \$70 million in sales, to his employees in a \$45 million transaction.
- In 1996, the US Office of Personnel Management sold its background investigative unit to its employees in the first ever majority ESOP privatization in the US. *US Investigations Services* is now a 100% employee-owned independent company with \$65 million in sales.

Employee buyouts have become an attractive alternative to the standard leveraged buyout in the USA for several reasons.

- First, there is the hard-to-measure but very real motivational effects of ownership. For the same reasons that managers who become owners in a management buyout are motivated to improve their performance, the workers as a whole are motivated to strive for the success and growth of an enterprise when they are equitably included in a transaction, and their ownership shares are accompanied by participation and communication.
- Second, ESOP transactions offer significant financial benefits unavailable under any other ownership structure. The substantial tax benefits of ESOP transactions, which are discussed more fully below, make an ESOP a strong bidder in a buyout by increasing cash flow available for debt service.
- Finally, where employee concessions are needed for survival, such as at *Northwest Airlines* and particularly in unionised settings, employee ownership may be the only effective way of giving workers something of value in return for their sacrifices. Without sharing the 'upside', employees may not be willing to make the sacrifices necessary for success.

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3.4 Research on EBOs

Research on the EBO in the US found employee ownership, when combined with employee participation, results in a substantial productivity enhancement. There are approximately 11,000 companies with Employee Stock Ownership Plans (ESOPs) in the USA with greater than 25% employee equity. The seminal study of Winther and Marens of employee buyouts demonstrates the complementary impact of ownership and participation. The research showed that after the employees purchased a majority interest in a business and a 'high' level of employee participation was introduced, the EBO outperformed conventional companies which also have high participation: in sales growth by 19.7% and in jobs growth at a rate of 25.9%.⁴¹

The Employee Ownership Centre based at the Kent State University in Ohio, where 5% of buyouts are from insolvencies, has researched the use of the EBO in distressed situations. A study was conducted into firms with high trade union involvement. These firms, had more participatory processes, more communication channels, more training, and had the presence of an employee/trade unionist on the board more frequently than other companies.

Importantly, 43% of the rescued companies had a strong economic performance, doing better than the market. However there were also 43% that experienced a situation less profitable compared to their industry. This was however seen by the researchers as a good performance, overcoming adversity and providing jobs. Distressed companies are often subject to asset stripping, have dated equipment and have lost important markets, helping to explain below average performance.⁴²

The EBO can well be a one off stable transaction or it may be the beginning of a series of transactions that restructure the company and take on outside investors to raise capital. It may return the company to the private sector after achieving corporate recovery or seek listing on the stock market to raise investment capital when eventually the employees lose control. Weirton Steel, the first major EBO to rescue a company in the US in 1984, returned to public ownership in 1994 – but with 5000 jobs and a community still intact.⁴³

41 Winter & Marens, *Participatory Democracy May Go a Long Way: Comparative Growth Performance of Employee Ownership Firms in New York and Washington States*, Economic and Industrial Democracy, SAGE, London, 1997, p.18.

42 Logue, 2004, p.113.

43 Oakeshott, *Jobs and Fairness*, Michael Russell, Norwich, 2000, p.365-391.

In a European study of worker takeovers in the 1980s, Paton describes how people became entrepreneurs 'not by choice but by necessity' and how many hundreds of companies and many thousands of jobs have been preserved by groups of workers who had the initiative and determination to take over failing and bankrupt enterprises, usually when no one else was prepared to do so. Paton described three outcomes of this first phase of worker takeovers:

- Consolidation - those companies that outperform the market – 25%
- Marginal - those that survive in the shadow of the market – 50%
- Failure – 25%³⁷

Importantly for this study Paton noted that in Italy collapse is less frequent, due to the support from the co-operative and trade union movements on the lines of the Co-operative Consortia model.⁴⁴

3.5 The potential EBO market for distressed companies

The corporate turnaround business of failing companies is a major industry – it is an important sector for management buyouts and a very profitable sector for private investment funds. It could be an important area for pension fund investment to secure local industrial restructuring and retain jobs and investment by meeting the challenge of globalisation and the competition of low wage cost countries.

There is no reason why this should not be the case for employee buyouts, provided a strategic and selective approach is taken. Below are some interesting examples of a very structured and well-resourced approach to rescuing failing companies in the commercial sector.

3.5.1 Private equity capital

Aurigo Management, in the UK, was set up by Archie Norman in 2006 to turn around failing companies, and is supported by hedge funds which will provide £500 million per year to purchase struggling businesses and nurse them back to health. This is a capital backed management team rather than a private equity fund and will focus on four to five businesses over a three-year period. The focus

⁴⁴ Paton, 1989, p.108. See also point 3.5.2 below.

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will be on the retail and marketing sector. Norman made his reputation by turning around the near bankrupt 60,000 employee ASDA supermarket chain with a combination of all employee stock options, participative decision-making and strategic management.

Wilbur Ross & Co, in the US, set up by the billionaire investor, specialises in purchasing distressed companies in the manufacturing and automotive sectors. A key feature of some of the rescue strategies is the setting up of subsidiary factories in low wage countries. Ross claims his role is to clean up the mess made by capitalism.

An Employee Buyout Foundation (EBOF) has been proposed for the UK by a leading insolvency practitioner as a partnership between Unity Trust Bank and a venture capitalist, who is also a leading turnaround specialist, and can raise £50million.

3.5.2 Social capital

Mondragon Corporation Co-operativa (MCC) has been involved in saving jobs in Spain by assisting workers save their companies. The finance is provided by their own bank, *Casa Laboral Popular*. A recent corporate rescue was the strategic purchase and turnaround of the car components company MAPSA. Mondragon was able to bring to bear its management expertise and financial support to dramatically improve the performance of this company in a sector in which they have a big stake. MCC also has a global network of subsidiaries in 57 countries, which will be co-operatively owned and managed by 2008.

The Employee Ownership Centre in Ohio is a best practice enterprise hub for employee buyouts and works with distressed companies. They have worked with 14 successful buyouts out of a total of 79 successful buyouts since 1987. Of these 14, 7 are still in business as employee-owned companies. The employees in distress sold 3; 3 were sold as successes; and one was shut. John Logue, director of the EOC comments:

Of course, conventional business practice would have shut them all. One of them, Producers Services, which was rescued in 1994 from an announced shutdown, now ranks No 4 in Ohio in the wealth per ESOP participant list, with an average of \$259,000 per employee owner. Not bad for a bunch of oil field roughnecks who otherwise would have been on the employment line.⁴⁵

The Wales Co-operative Centre has been operating since 1984 and has conducted 30 employee buyouts –10 of distressed companies. All have survived. The UK has well-developed sources of finance for the SME, and Finance Wales has played an important role. The employees are also expected to invest £2-3,000

45 Logue in Correspondence with the Author, June 2006.

each. Nevertheless, the programme is constrained by lack of access to appropriate loan finance. Infrastructure support is well developed through the provision of advice and training by the Wales Co-operative Centre.

3.5.3 State sponsored programmes

The Marcora Law experience in Italy was a successful experiment in financing worker buyouts with state funds. It also dealt with the key factors of addressing managerial competence and providing infrastructure support. The key features were:

- FONCOOPER, a fund for the general promotion of co-operatives;
- CFI, a revolving fund investing in phoenix co-operatives where employees' investment was matched threefold;
- a maximum of 3 years' unemployment benefit could be capitalised;
- corporate investors were permitted up to 25% equity holding;
- networking support;
- a specialist monitoring and advisory body was established; and
- £30 million was invested.

A review of the programme by CFI concluded that overall the Marcora Law had worked very well.

By 30th June 1992 it had invested 40 MECU (£30m) in saving 89 co-operatives. It was disbanded due to possible infringement of EU Competition Law, at which time these co-operatives employed more than 3,100 workers, 80% of whom were members. Their turnover exceeded 230 MECU (£180m).

There were failures, and 9 co-operatives, 10% of the total, were in liquidation in 1992. However these were the smaller co-operatives, and represented only about 5% of the capital and 5% of the jobs. Furthermore, this loss has been compensated by asset and employment growth within the successful co-operatives.

This experience shows that the availability of capital is a necessary condition for setting up new co-operatives, but is not sufficient on its own – other types of support are also necessary.

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Mondragon Case Study

The EBOF would draw on the best experiences from organisations around the world that support worker ownership and employee buyouts: Sociedades Laborales and Mondragon Corporation Cooperativa in Spain; the Ohio Employee Buyout Centre in the USA; Le Lega in Italy; the Baxi Partnership, ICOF and the Wales Co-operative Development Centre in the UK.

However the structure of the Mondragon Corporation Co-operativa (MCC) provides the most important insights into a process that provides a stream of new jobs, business start-ups, takeovers and innovation. Moreover, it provides a buffer against market pressures and the degeneration and failure of individual businesses. Preserving jobs is paramount.

MCC now has 80,000 employees – 40,000 out of the country in subsidiaries in 57 countries. There are 30,000 members. The business model is based on the values of co-operation, participation, social responsibility and innovation. They have met the challenges of globalisation and EU competition. Importantly it has taken the step to elevate the customer ahead of the worker. They believe it is 'Up to us to decide our destiny. We are decision makers of our own fate - strategic and financial - as long as the market and world allows.'

Some of the features that might assist in developing the EBOF in the UK are:

- Finance: Casa Laboral Popular provides start up equity, loans for expansion plus loans for consultancy fees;
- Impresorial Division – research and development into new products and services – there are 11 innovation centres at Mondragon;
- Management mentoring – between the co-operatives assisting new enterprises;
- Networks of businesses – clusters provide a buffer for redistributing labour and trading extension;
- Corporate Governance – multiple boards provide stability and enhanced performance;
- Mondragon University – education and management training in co-operative principles and self- management.

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4. Saving companies worth saving

The EBO has been a reactive strategy by workers. It hasn't been used as a specific well constructed proactive policy initiative in the UK, as it has in some other countries, and therefore any judgement of the results must be tempered with the fact that UK examples are usually very experimental. There was a pattern to the worker buyout movement in Europe in the 1980's which correlated to the countries' industrial relations traditions – in the Mediterranean capitalist countries such as Italy, Spain and France, with a syndicalist tradition, the buyout was most common; in the free market capitalism of the UK EBOs occurred, but the management buyout was preferred as it preserves the collective bargaining structure; and in countries with Rhineland capitalism such as Germany, and Holland it was least common as co-determination, the stakeholder model, was preferred. In fact all these traditions can be reflected in employee buyout models.

In the UK it may well be that the potential for employee buyouts will arise from two areas

- Firstly the larger unionised workplaces where a small number of sometimes high profile cases will occur and key decisions will be made by the insolvency practitioner, trade unions and workers as to the most appropriate strategy - be it restructuring, a management buyout or employee buyout.
- Secondly there is a potentially large pool of non-unionised family SME businesses of under 50 employees. These are often the most difficult for the insolvency practitioner to deal with and are liquidated 'en mass' when many have potential for an EBO, as has been demonstrated by the work of the Wales Co-operative Centre.

Importantly, the EBO is not recommended as a saviour for all distressed companies, but many that failed, both large and small, have had the potential to be successful as an EBO. It is important to note that employee buyouts may be completed in one transaction, when the total equity is transferred to the employees, or it may occur over a period, when equity is transferred to the employees as debt incurred in purchasing the business is repaid.

4.1 The policy context

Globalisation is the major economic issue of the 21st Century and is a prime factor in the decline of labour intensive companies and industries, and also the context for aggressive private equity firms taking over companies and bankrupting them. It is here that the EBO has an important contribution to make. Ben Bernanke, chairman of the US Federal Reserve, has pointed out that globalisation will have an effect on equality as policy makers struggle to deal with retraining workers left jobless by the rapidly changing trade environment. He also called on governments 'to do more to ensure that the benefits were widely spread within rich countries, helping workers displaced by shifts in production to retrain for other careers'.⁴⁶

The EBO importantly enters this debate offering an alternative to a strictly financial perspective in enabling workers to make the decision on whether they want to be displaced by global restructuring and retrained, or anchor jobs and capital locally by taking action to purchase and preserve their company against low wage completion, and offering added value and proximity to their customers. Ahlstrom in The Peoples Capital says this gives workers

*The opportunity to invest in modernisation of the regional economy they live in, an opportunity that did not exist before and which is of immense importance to their future employment, wage levels and future yields on their investments in real estate.*⁴⁷

The driving force of globalisation is the market, not the multinational. In this context the EBO challenges the view that the Anglo-American model of corporate governance will predominate in the context of increasing globalisation. This model is characterised by an ownership structure dominated by highly liquid capital markets, dispersed share ownership, and vulnerability to hostile takeover bids in the presence of large institutional investors who are seeking increasing quarterly returns in a short term perspective.

⁴⁶ Bernanke speech sounds a warning, and A share of the spoils: why policy makers fear 'lumpy growth' may not benefit all, Financial Times, 28/8/2006.

⁴⁷ Ahlstrom, The People's Capitalism, Euresa Institute, 2005, p.53.

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The EBO with both economic and social goals aims to develop sustainable enterprises based on local and regional networks. This model is characterised by a relatively concentrated pattern of shareholding, with a dominant stakeholder group, the employees, holding a majority or near majority stake with the ability to more easily establish and sustain co-operative arrangements between all stakeholders.

The re-launch of the Lisbon Strategy, aimed at making Europe the most competitive economy in the world by 2010, advocates a socially responsible industrial restructuring policy. This resonates with one of the key principles established by the Cork Committee, namely that insolvency is more than a financial exercise but involves wider stakeholders including employees and the community. The author was advised that informal discussions accompanying the strategy indicated that the worker buyout strategy, important in Spain and Italy in the 1980s, was now being reconsidered. Proposals for overcoming the problems around state supported buyout programmes infringing EU competition law include the use of equity funds based on workers pensions or the new EU Globalisation Adjustment Fund.

The EBO offers the trade unions and employee ownership movements the opportunity to combine in an organisational transformation strategy which

Socially Responsible Economic Restructuring – The Lisbon Strategy

In 2005 the European Commission relaunched the Lisbon Strategy, which was agreed in 2000, focusing on stronger and lasting growth and the creation of more and better jobs. The Communiqué stated that:

In order to achieve these objectives, it is necessary to mobilise all national and Community resources through an enhanced partnership between the Union and the Member States, but also with the social partners, civil society and all players concerned.

The prosperity and well-being of European citizens depend on economic players and workers adapting rapidly to the current far-reaching socio-economic changes, which are translating into the creation and development of new economic activities, but also into the contraction, or even disappearance, of existing activities and the related jobs.

At the same time, the restructuring of enterprises often entails costs that can be very high, not only for the workers concerned but also for the local or regional economy. The preservation of social cohesion, which is a distinctive characteristic of the European social model, requires the introduction of accompanying policies designed to reduce the social costs to a minimum and to promote the search for alternative sources of jobs and income.

It is therefore essential to ensure that restructuring is well managed so as to meet a two-fold economic and social requirement. It is vital for enterprises to adapt to change: if enterprises conduct these operations rapidly, their competitiveness can be preserved and enhanced.

Moreover, the intention to preserve the employability of workers and to facilitate their transition to another job of equivalent quality has an economic impact by taking advantage of one of the main competitive assets of the European Union, namely the quality of its workforce, which is the guarantee of future growth.

would address the above issues, especially inequality and industrial democracy. Most UK trade unions still have a commitment to industrial democracy in their constitutions. In the UK the EBO could fit with current trade union policy development – UK trade unions have, through the Warwick Agreement, engaged with the Labour Government to develop an industrial strategy.

In recent years two strategies have emerged for the involvement of trade unions in corporate decision making and bargaining - a partnership approach emphasising co-operation with management for mutual gains, and an organising approach strengthening the collective organisation and a willingness to act by workers.⁴⁸ The first approach is not widely accepted now following some discredited arrangements.

The organising model has the intention, over the longer term, that the workplace organisation becomes more self sufficient as a result of membership participation and takes an active part in the union. This would be an ideal culture in which to introduce the early warning distress prediction tool, which would result in workers identifying a drift into crises and the ability to discuss an appropriate response including preparation for an EBO. The organising approach is being actively pursued by some unions and 'in a suitable administration or pre-administration it could lead to an EBO or worker ownership'.⁴⁹

This report notes that '*Partnership Working*' promoted by the UK Labour Government, the Department of Trade and Industry and the TUC a few years ago needs to be looked at again as it provides a policy context in which to introduce the EBO.⁵⁰ *Partnership Working* is supposed to be characterised by co-operative employment systems and participative forms of governance and ownership structures which give rise to high performance partnership-style relations at work and a collegiate culture. These are all features of an EBO.

48 Heery, *Partnership versus organising: alternative futures for British trade unionism*, Industrial Relations Journal, 2002, p.20.

49 A UK Trade Union's Correspondence with the Author, June 2006.

50 The Partnerships at Work Project, Centre for Corporate Law and Securities Regulation and the Centre for Employment and Labour Relations Law, University of Melbourne.

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4.2 The employee buyout versus the management buyout

Increasingly, it is suggested that the corporation should be accountable to a wider set of interests than simply shareholders. However, it is to be noted that directors of corporations legally owe their allegiance to the shareholders' interests. Legally, employees are virtually on their own.⁵¹

Despite the legalities, however, employees are in fact increasingly seen as stakeholders, and in the context of *stakeholder capitalism* it is increasingly hard to legitimise an uneven playing field:

The finance provided by employees by way of entitlements involves risk, return and governance considerations.⁵²

The EBO in the US has been shown to outperform the leveraged MBO by Wilkus:

- it secures lower interest rates;
- it enhances earnings, company net worth and enterprise value;
- employee returns are greater;
- investor returns, in the short term, are less - but there is reduced risk.⁵³

In this context this report argues that there are three key reasons why the EBO should be preferred to the MBO in the UK:

- The Corporation is increasingly seen as vehicle that undermines democracy and environmental sustainability. Corporate Governance has become a major issue over the last 15 years with legislation to make directors more accountable to shareholders. Finch states this strategy has failed as it is undemocratic and concludes that dealing with insolvency and reconstructing companies is flawed: 'the law's quest to legitimate the power of corporate management failed' as 'accountability to shareholders through internal company controls' and 'the requirement of directors to act in the best interests of shareholders' are both flawed in acting as restraints

51 Dean, Professor of Accounting, University of Sydney Business School.

52 Davis, *Employees as Creditors: Protecting Entitlements*, unpublished paper, 2006, p4. Draws on material in Davis & Lee, 2005.

53 Wilkus, in *Expanding the Role of ESOPs in Public Companies*, Young (ed) Quorum Books.

on managerial powers. Finch goes on to call for a new strategy by building on a stakeholder model of the company

Managerial power would be legitimated by giving expression to the common purposes of shareholders, creditors, employees and the community.

Finch concludes:

A democratic ideal might be introduced into corporate life in order to legitimate corporate power. This ideal would demand that all those substantively affected by decisions should be involved in making those decisions.⁵⁴

An EBO would meet this ideal. This is in preference to an MBO, which does not meet the standards of the Cork Committee in corporate rescue: efficiency, accountability, fairness and use of expertise.

- Financial restructuring using the EBOF with an emphasis on 'patient capital' would bring about a transformation of the company moving from the short term focus of an MBO with its needs for aggressive returns on capital to a long term focus which will deliver greater economic stability and anchor capital at the local and regional level. Saving one job in a key enterprise is claimed to affect another 13 jobs in the community in a study by Yildirim.⁵⁵
- Partnership workplace relationships and high performance workplaces will be more easily delivered by an EBO based on the *Le Lega Cooperativa Corportiva* model where long term employment prospects encourage workers to engage in ongoing economic restructuring and co-operative work practices. This is in contrast to the MBO 'churning model' where workers are offered a role as 'a highly trained and flexible workforce where they are prepared to change their careers seven times in the course of their working lives'.⁵⁶

54 Finch, 2004, p.45.

55 Yildirim, *Employee Buyouts and Industrial Relations under Employee Ownership, Economic and Industrial Democracy*, Sage, London, 1999, p.565.

56 Gordon Brown, Budget Speech 2006.

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4.3 The Spanish solution

The evolution of Spanish policy to deal with industrial restructuring and insolvency post Franco was a mix of the European Social Model and free market approach, and has developed an innovative form of finance: capitalising worker unemployment benefits.

The policy began with support for worker takeovers in the 1980s and was followed in the 1990s by the encouragement of displaced workers to start their own business based on worker participation. In 2006 there were 12,000 of these business start-ups employing around 120,000 workers.

In the period 1980-1985 there were at least 1,300 state funded worker takeovers involving a minimum 50,000 workers (could be 70,000 to 80,000) in the metal working, construction, timber, textiles and printing industries. The number of takeovers per annum depended on the amount of finance the government was prepared to allocate. It is no longer a State strategy to deal with insolvency as it was controversially deemed to contravene EU directives on state assistance; however in certain provinces the strategy still continues. It is estimated that approximately 2,500 firms exist that started from a worker buyout of a distressed company.

The objective of the Sociadades Laborales legislation in 1985 was to create an enterprise that is flexible and participative and one which allows for human and entrepreneurial development. Ongoing research on these firms indicates that they are at the leading edge of organisational development of the small and medium sized firm. A new type of firm has been created with a collegiate culture and a new worker has emerged that has the ability to engage in co-operative and entrepreneurial activity, resolve conflict and balance the tension between the social and economic objectives.

The Spanish insolvency regime had a number of unique features to protect workers in an insolvency situation. It did not legislate to grant super priority status to employees but they acquired this position indirectly through the following mechanism.

- Firstly, workers assumed a *Credito Refaccionario*, or quasi 'floating charge' similar to that held by the banks. This gave them prior ownership over the goods they had produced and in an insolvent situation they could use this right and their rights to employee entitlements, negotiated separately to the insolvency process, to seize plant and equipment and negotiate with the vendor.

- Secondly, having access to finance supported workers actions. In the first instance this was provided by the Ministry of Labour, which would grant 'soft' loans up to 1985. After that there was an innovative solution in the form of the Unemployment Lump Sum (the capitalisation of two years unemployment benefits) that could be drawn down by the workers to purchase the insolvent business. This latter was initiated in 1985 and now is mainly used for redundant workers to start their own business.
- Thirdly, the legal model used for this financial transaction as defined by the 1985 Act was to promote worker ownership and worker democracy. It could be either a co-operative or a *Sociedades Laborales* (SAL). The latter was a legal form based on worker participation with 51% of shares belonging to the workers. The workers elected an Assembly Board, which appointed management – forming a two-tier board structure. For over 50 employees there was a requirement for a works council in Spain.

The 10 SALs listed in **Table 1** were takeovers out of insolvencies between 1982 and 2000. Seven were in the metal manufacturing sector and 3 in the service sector.

The metal companies were SMEs ranging in size from 22 employees to 380, and a number were leaders in their particular market. They demonstrated the vibrancy of worker self management, with a collegiate culture between workers and management. Impressive democratic and well-managed companies were created through the employee buy-out. These were examples of companies in crisis, where there was a failure of management and the market, resulting in high levels of over-staffing, and the recovery plan depended on shedding up to 50% of staff. The trade unions in the negotiations assisted this: workers were prepared to take a reduction in pay and conditions to rescue the company and engage in capital bargaining, but this 'hurt money' was recovered as the resulting SALs became successful. Trade unions engaged with the formation of SALs because 'it is important to make room in the economy for worker self-management'.⁵⁷ CONFESAL, the national organisation of SALs, has on-going agreements with the main trade unions.

57 Interview with Spanish trade unionist by the Author, August 2005.

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Table 1: Example employee buyouts in Spain

	<i>Company</i>	<i>Industry</i>	<i>Formed</i>	<i>Jobs before insolvency</i>	<i>Jobs at re-start</i>	<i>Jobs in 2005</i>
Phase 1	<i>Minifor</i>	Metals	1982	70	23	23
Phase 2	<i>FMDCarbide</i>	Metals	1985	150	35	58
	<i>Aircon</i>	Metals	1986	45	8	22
	<i>Betsaide</i>	Metals	1989	236	116	280
	<i>Izar</i>	Metals	1991	317	124	188
	<i>TIP</i>	Metals	1993	80	34	47
Phase 3	<i>MD</i>	IT	1995	37	13	9
	<i>Sisteven</i>	Metals	1997	40	40	57
	<i>3D</i>	Data	1997	60	11	70
	<i>Collegio</i>	Education	1997	40	13	38
Total Jobs				1075	421	816

Table 1 tracks the creation of jobs when the insolvent companies were restructured and recovered as SALs. An average 60% drop in jobs occurred when the companies were restructured; however this was subsequently compensated for by a near-doubling of the jobs across the 10 companies. This insight may be a pointer to a strategy for an industrial reconstruction policy in Europe based on local economic regeneration and worker participation – at least it should be a stimulus to more in-depth study.

Minifor is the oldest SAL going back to the first period, having formed in 1982, with 23 employees. It still has 23. In 1982 the business lost the Citron account, which was 91% of sales, and went bankrupt. It now makes central heating radiators and exports to Cuba. The company is confined to a small factory and owns the land, which is valuable due to rezoning. Although it has not grown, it has survived for 24 years and made good profits to the satisfaction of its worker owners.

FMD Carbide makes high quality precision tools from wolfram carbide. It went through two bankruptcy and SAL formations in 1985 and 1994, dropping from 150 to 35 workers before turning around. It is now expanding at 6% per annum with a corporate plan to increase this to 11% based on improved productivity, due to teamwork work practices.

Air Con manufactures commercial automotive paint spraying equipment and is a market leader in Spain. It went into bankruptcy in 1996 dropping from 45 employees to 8. It now employees 22. When they began trading they were leasing their factory - now they own it.

Betsaide is the largest SAL in Spain and produces castings for the automotive industry. Clients include VW, MAN and Ford. It has recently built an €150million fully automated warehouse. It went bankrupt in 1989 after 11 years of losses due to loss of direction and poor management.



Izar is the number one maker of drills in the Spanish market and is in the top 5 in Europe, marketing to 66 countries. At the peak it had 1,130 employees before going into bankruptcy in 1991, and in 1996 dropping to 124 employees. **Izar** now has 188 employees and is embarking on building a new factory.

TIP produces screws for the automotive industry and went into bankruptcy in 1993 due to a recession in the car industry. The workers were given the company, as there was not a cash redundancy payout. Clients include Citron, Peugeot and Renault.

Sisteven manufactures fans and ventilation equipment, and went into bankruptcy in 1997 when the company closed for 9 months, primarily due to a succession problem. The products were good but the owning family was old and had lost interest in the company, which it couldn't sell. It has expanded from a 2,500m² factory to 6,000m². It started with 40 employees, now has 58, and is a market leader.



In these case studies about 45% of the buyouts outperformed the market. It would be unrealistic to expect for every employee-owned company to outperform the market, as each carries multiple objectives for the workers concerned: job security, job satisfaction, democratic participation and a desire to be in charge of their own destiny. The Spanish experience was a model designed to give workers the edge in insolvency through legal and institutional mechanisms supporting their decision to rescue the company.

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4.4 Conditions for success

Paton and Holmstron outline key issues for the success of a worker buyout programme.⁵⁸

- Firstly, the successful EBO needs a cohesive and homogenous group of skilled workers. This reduces the number of disagreements that arise and contains those that do. It also seems to encourage employees with the latent ability and confidence to take on managerial roles.
- Secondly, leadership is needed which is totally committed and able to balance the short and long term social and economic goals of the enterprise. An individual or a group as in the elected assembly board of experienced workers can provide leadership.
- Thirdly, the presence of effective and consistent advisory support mechanisms is needed. This included the trade unions, which were at the forefront of these buyouts in Spain, spotting suitable opportunities, assisting in negotiating the purchase and take over of the business and adding the social dimension after the takeover.

The SAL experience, supported by other research such as that into ESOPs in the USA, point to the success of the EBO under the right conditions and with appropriate support structures. Equally clearly, they indicate the difficulty of isolated and under-resourced employee buyouts of companies that in many cases are the most damaged and difficult to rescue. The key design features suggested for an ideal EBO are:

- Equity Participation – collective and individual equity holdings for all employees ensures individual motivation and the long-term stability of the organisation
- Corporate Governance – a two-tier board is recommended involving key stakeholders, enabling the legitimisation of management and the ability to deal with complexity more effectively than the Anglo-Saxon unitary board.
- Employee Participation – the emergence of worker self-management and a team-based model, restructuring the insolvent enterprise from command

⁵⁸ Paton, 1989, p.125; and Holmstron, *Spain's New Social Economy*, Berg Publishers Limited, Oxford, 1993.

and control to maximise employee engagement and performance improvement.

- Trade Union involvement – enabling collective bargaining over social and remuneration issues and acting as a catalyst for improved communication and training practices, resulting in high performance workplaces.
- Networked Companies – companies working in a cluster to leverage resources and tendering opportunities, also as a buffer against the market offering greater employment security and hence a willingness of employees to engage in workplace change and the improvement of corporate performance.
- A financial institution providing a range of financial packages, financial and management advice, training and technical support.

The process and methodology of an employee buyout are illustrated in the following case study of UBH International.

UBH International

1. Fact file:

Name of enterprise:	UBH International Limited
Location:	Burscough, Lancashire
Legal structure:	Company Limited by shares
Type of activity:	Liquid and gas tank container manufacturer
Date of establishment:	August 1999
Type of members:	Employee owned
Number of members:	120 employees
Latest annual turnover:	£8million

2. Key features:

- World class company put into receivership in February 1998, putting 300 people out of work;
- Strong support from the trade unions for a buyout – GMB and AEEU combined with a steering committee made up from different divisions of the business;
- 90 employees agreed to invest £5,000 in the new venture (either their own money or borrowed). A free-phone number at the Co-operative Bank was set up to enable employees to obtain the funds;

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- Advice team from Lancashire CDA, Malcolm Lynch (Wrigleys) solicitor, Casson Beckman corporate finance
- Determination of the steering committee to fight on in the face of fierce competition from other bidders, antagonism from the receiver and a long period between ceasing to and recommencing trade.

3. History:

The old Universal Bulk Handling (UBH) was a company which had built a world-class reputation manufacturing lightweight tank containers. Although there were larger producers, UBH had gained a reputation for design and engineering quality. It was put into receivership in February 1999 and 300 people lost their jobs in an area of Lancashire that could ill afford it. Burscough is a small town located in a mainly agricultural area.

The two key Trade Unions involved (GMB and AEEU) were keen not to see potential competitors strip out the assets and leave no employment in the area. Following an initial feasibility study supported by Lancashire CDA and Moore & Smalley (Accountants), a bid of £1.1 million was put to the receiver. The receiver accepted a significantly larger bid from an Irish competitor in March 1999.

The employee led steering group was not convinced about the seriousness or the viability of the opposition and continued to prepare. In Mid April, the competition withdrew and the management/employees sought exclusivity. This was not granted. Regular mass meetings with the potential workforce were held to feedback information and gain commitment for actions taken by the steering group.

Corporate financiers (Casson Beckman) and Malcolm Lynch, solicitor, were engaged to advise the employees in the submission of the revised bid, the raising of the finance package, and commercial and constitutional aspects of the buyout. Although funds were sourced from the County and District Councils and LAWTEC for the initial work, most of the corporate finance and legal work was undertaken at risk.

The buyout was completed on 26 July 1999 some 5 months after the company had gone into receivership.



4. Structure and governance:

A board comprising executive and non-executive directors, the majority of who were involved in the buyout process, manages the new company. Three employees also sit as directors.

The fact that 90 former employees were willing to invest £5,000 each in the company proved to be a very strong factor in attracting external investment. It was thought at one point that venture capital would be required (thereby diluting the employee shareholding) but the reward required was felt to be too great. In the end sufficient debt capital was raised to affect the buyout. Over £2 million was raised through:

1. Employee equity
2. ING (Dutch leasing company) – asset finance
3. Riggs (American bank) – working capital finance
4. Regional Selective Assistance – grant

A remuneration committee has been established to set the terms and conditions of employment in negotiation with the trade unions. It also sets company policy on benefits. The employee directors have a seat on this committee.

An employee benefit trust (EBT) has been established:

1. To create an internal market for the purpose of buying and selling shares in the company and;
2. To provide a mechanism for consultation between employees and the directors of the company.

Provisions regarding this have been inserted in the Articles of Association of the company and also in the trust deed governing the employee benefit trust. The trustees of the EBT are representatives of the trade unions active in UBHI, an employee representing administrative staff and an employee who is part of the management structure.

5. Current Activities and Business Strategy

The original company was a manufacturer of specialist road tankers and began to diversify from the early 1970s onwards using the skills of its engineers and workforce to develop a range of inter-modal tank containers for the carriage of bulk liquids. The old UBH became one of the world's leading suppliers of tank containers (1998 – 15% of the world market).

Following the management and employee buyout in August 1999, UBHI began to refocus its activities moving away from standard tank containers to concentrate on building the more specialised custom-built units increasingly demanded by end users.

Despite an unprecedented slump in the world market for tank containers, UBHI has re-invented itself, carving out a new position in this fiercely competitive international marketplace. Soon after the relaunch of the company UBHI manufactured the world's lightest full-frame tank, a 31,000-litre swap tank for a German tank container operator weighing in at 3,250 kg (against a target weight of 3,400 kg). UBHI's swap tanks permit

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the carriage of up to 35,000 litres while ISO tanks are used in deep seas. Products carried range from orange juice to Scotch whisky for the food and beverage industries, and from latex to sulphuric acid in the sphere of bulk chemicals.

The slump and strong competition have affected UBHI particularly in cash flow. A substantial refinancing was completed by UBHI representing an investment of over £1 million together with further funding facilities which were made available to the Company by Baxi Partnership Limited Trust (Baxi) established in 1983 and confirmed by Act of Parliament in 2000 with the specific purpose of promoting business success in employee ownership and professional management within a partnership culture. Baxi has acquired a 50% shareholding in UBHI enabling the employees of UBHI to become beneficiaries of Baxi itself thereby adding further benefit and protection.

6. Member Benefits

The 95 founder members were able to save and maintain their own jobs. Since then 25 new jobs have been created. The manufacture of tanks is highly skilled engineering work and there are few other employers offering comparable work in the area.

The business is 100% employee owned. The employees elect three members of the Board and mechanisms have been set up to ensure genuine employee involvement and sharing of information. There is therefore a sense of ownership by the employees of their place of work. UBH is committed to providing training to its employees.

The employees, as the owners of the business, are entitled to a share of any profits made by the business.

UBH did have some difficult years when the market collapsed resulting in cash flow crises, which made the workers question the prudence of their buyout. This period was weathered and the company is now on a sound footing due to assistance from the Baxi Partnership.



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5 Conclusions and recommendations for the UK

Gordon Brown, UK Chancellor, has outlined a vision for employee ownership:

Employee ownership is world changing. It is the way ahead for the UK in the global economy. It reflects that human capital is becoming more important than physical assets. A company is more and more defined by its skills. It relies more on its creative energies... The global economy will succeed when employees feel a stake in the business.⁵⁹

The employee owned company sector in the UK is already robust and growing, with a turnover estimated at £20-£25 billion. This includes the John Lewis Partnership, Ove Arrup and Partners, the Scott Bader Commonwealth, Loch Fine Oysters, hundreds of co-operatives and a growing co-owned sector. Since the 1990s a successful model has been developed in the UK based on a succession strategy where the retiring owner sells the business to the employees. This is a top down process usually initiated by management, which is modelled on the successful John Lewis Partnership retail chain. Employee ownership is a growing sector of independent businesses, which are autonomous self-governing enterprises.

In corporate rescue from an insolvent situation, where reconstruction is more difficult, a different model is proposed, one that will also accommodate the bottom up process of a worker buyout. Here the process of concessional bargaining over job cuts and possible cuts in the remuneration package becomes an issue to be resolved with union assistance.

This report proposes the EBO as a model, which offers the trade unions and the co-operative movement the opportunity to engage in a transformational strategy. This proposal is based on the network or clustering model of economic integration, of which the Italian *Corporation Co-operativa* closely linked with the Italian trade union *La Lega* provides a good example. It is the preferred model as

⁵⁹ Gordon Brown at the launch of the Job Ownership report *Shared Company* in 2005.

it gives increased support to the individual enterprise and has been shown to increase the survival rate.

In Wales there have been a number of successful small employee buyouts – and the larger example of Tower Colliery - of businesses in crises, which have reflected this approach.

This La Lega model delivers viable enterprises in economic terms as well as the social aspirations and values of the labour movement: solidarity amongst workers, wage parity, right to a job, dignity at work and democratic rights as a worker rather than a shareholder. In practical terms this network offers opportunity for joint tendering, the takeover or rescue of other businesses and merging with another for greater stability. The network provides greater employment stability, job satisfaction and a buffer against the worst effects of the market.

This report argues that the employee buyout needs to be considered as a strategy to deal with globalisation by the UK trade union movement. The EBO can offer the union a new role and strategy in protecting jobs as well as wages, overtime, hours, holidays, redundancy and a defence against arbitrary management decisions.

The purchase of the company by the workers is the first stage of a series of transitions to transform the company that will deliver on the issues of job security and, importantly from a labour process perspective, wide dissemination of job satisfaction throughout the organisation; the emancipation from alienation and the division of labour as a worker-owner; and the potential to minimise bureaucracy, hierarchy and managerial controls. Logue's research has outlined the importance of the trade union presence and the participatory and democratic mechanisms used to achieve these social goals.

New Unionism in the UK with its emphasis on the organising model of industrial relations and the establishment of the Organising Academy opens up a new avenue and opportunity for the trade unions to consider the EBO as a strategy to protect jobs and British industry. In the past the EBO could be seen as a diversion from the main goals of the trade unions but based on the organising approach this report argues this no longer applies.

Also the reservations that the trade unions have regarding the EBO - that the involvement of the union undermines its ability to protect the workers, that there is deterioration in pay and conditions below award rates, and that the workers may no longer feel a need for the union - are all dealt with by defining the new role of the union in assisting in the transformation of the organisation.

In the past the best strategy for the shop steward was to negotiate the best redundancy package for the workers, but under the new regime of 'where a company can be saved it should be saved' - and providing an EBOF can be put in place - workers would have the choice of saving their job, where they have firm-specific skills, against going to a lower paid less satisfying job.

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The high profile failures in the UK in the 1970s of Triumph Meriden, the Scottish Daily News and Kirkby Manufacturing, and the bad experience with employee ownership in the nationalising of the UK regional bus companies, has left a scar on union consciousness. Hindsight points to the first group as being ill conceived or poorly funded ventures, and the second as structured with poor governance structures to protect workers interests.

The investigations and consultations behind this report point to the need for a broad and integrated approach to address the problems created for employees in insolvency. The proposals seek to integrate the EBO in this approach. In the recommendations Finches voluntarist insolvency model is invoked but it is felt necessary to go beyond this in certain instances to incorporate a corporatist approach involving some legislation along European lines.

The main conclusion of this report is that the Enterprise Act 2002 in the UK is unlikely to achieve the government's objectives of maximising corporate recovery. The following is a list key conclusions from the research which point to ways this can be addressed:

1. The International Association of Insolvency Practitioners sees the position of employees in insolvency as intractable and unjust.
2. Insolvent businesses that could be saved are closing unnecessarily.
3. The Employee Buyout (EBO) is seen as a breakthrough in dealing with both the issue of employee entitlements, and, when appropriately used, is a successful strategy for corporate rescue, with a lower failure rate than management buyouts.
4. The EBO can also address a key problem of globalisation, by helping to anchor capital and jobs locally and preserve communities and skills.
5. However, there is a lack of knowledge and information about employee buyouts and their potential in corporate rescue, and employees are unable to act quickly to purchase a company due to the lack of access to appropriate finance and support.
6. A specialist investment fund needs to be established. A leading insolvency practitioner in the Association of Business Recovery Professionals, **R3**, in partnership with a thoughtful venture capitalist, have proposed an *Employee Buyout Foundation* with a starting capital of £50million to fund employee buyouts.
7. Many businesses are not being sold as going concerns due to TUPE, and as a result the employees, using the employee buyout, could become the preferred bidders for the company if the lack of information and finance can be overcome.

8. In the majority of corporate distress cases (77%), by the time the insolvency practitioner is called in the business is beyond saving. A corporate distress early warning system is required.
9. Many corporate failures (almost 50%) are due to management problems. The key people who can rescue the company - the employees - are not included in creditors' meetings or other negotiations. Legislative change is required to give the employees and their representatives a voice.
10. Developing employee buyouts as part of a cluster of employee-owned companies networked with trade unions has proven to be the best method of maximising company survival, as demonstrated in Italy.

The following recommendations are designed to address these issues. They fall into 2 areas:

- recommendations on insolvency law and practice (Point 5.1)
- developing new infrastructure for employee buy-outs (Point 5.2).

5.1 Recommendations on insolvency law and practice

5.1.1 Amendment to the Enterprise Act 2002

It is recommended that the Enterprise Act 2002 be amended to formalise a voice for employees and their representatives in the recovery process. This will oblige the administrator to consult with the employees and their representatives and that the employees and trade unions have information rights at the creditors meeting relating to the administrators proposals.

Specifically Schedule 16 – Schedule B1 to Insolvency Act 1986 Paragraph 52 (2) - be amended so that when creditors are notified and sent proposals, employees and their representatives participate in the process, receive information and have the right to participate in the creditors committee.

The practical implications of this change are that:

- The administrator should send a copy of the statement of proposals to the relevant trade unions;
- Workforce representatives and employees should have the same

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preferential status as those creditors invited to the initial creditors meeting and should be consulted within the same time frame;

- It should be stated that administrators should consider any proposals put forward by the workforce including a buyout proposal by the workers.

Recommendation 1.1: Discussion with the DTI on the best way of implementing this amendment; possibly a Private Members Bill to be developed with the support of Scottish Labour and Co-operative MP Mark Lazarowicz.

5.1.2 European harmonisation of insolvency and Marcora law

This report recommends a comprehensive review of legislation in the whole area of insolvency, redundancies and closures on a EU level, so that the UK reflects best practice in Europe in terms of workforce consultation. This would involve taking the best aspects of the 'Mediterranean Model' which proposes employee owned enterprise start-ups using the unemployment lump sum and the EBO of distressed businesses and combining this with corporatist regulations against business closure of the Rhineland model. Another objective would be to have the UK trade unions and workers provided with independent experts as in the Information and Consultation procedures in France, to ensure full disclosure of contingent and accrued liabilities.

Further, the Marcora Law in Italy was a very successful state intervention in unnecessary insolvency and company closure. The provisions of the Marcora Law were originally limited to an experimental period, but its success was such that parliament debated its extension for a further two years. However, together with the Sociudades Laborales initiative in Spain it was discontinued because it was found to conflict with EU competition law.

Developing a clear model of best practice across Europe should address both improvements to current UK insolvency law and practice and the possibilities of pan-European legislation to reintroduce provisions like those of the Marcora law without infringing EU competition law.

Recommendation 1.2: Further research and development with the European Federation of Employee Shareholders (EFES) on the potential of the EBO in Europe, the harmonisation of regulatory and support frameworks, and in particular how the European Globalisation Adjustment Fund can be used in a way that doesn't infringe EU Competition Law.

5.1.3 Industrial reconstruction - unemployment lump sum

In both Spain and Italy redundant employees have been enabled to engage in industrial restructuring by the provision of two or three years unemployment benefit in a lump sum to purchase the insolvent business or start up on their own.

In Spain, over 120,000 jobs have been created using this way for unemployed workers to access finance for start up businesses. CONFESAL, the Spanish Federation of Employee Owned Businesses, has a national collaborative agreement with the two major trade unions on job creation using this method. It is an area for growth in union membership in Spain.

Spain is advocating this as a model for Europe. It is important that links are established with the relevant Spanish and Italian bodies to examine the feasibility of this legislative approach in the UK.

Recommendation 1.3: Liaison with the European group that are promoting the Unemployment Lump Sum as a EU Policy.

5.1.4 Early warning arrangements

An early warning system might take two forms:

- A voluntary arrangement based on bargaining for information
- A legislative approach

Employees can bring together both qualitative and quantitative information within a clear and accessible diagnostic framework, much like a rapid internal audit. Many of the signals of distress are qualitative and identifiable from the shop floor; other financial and market information that would be bargained for by the trade unions.

An effective distress prediction diagnostic tool should assist employees at a workplace, enabling them to have a better understanding of the employer's commercial viability or possibly perilous financial state – and its trajectory towards that state. Such a diagnostic ought to indicate emerging problems early enough for employees to approach employers to offer assistance in formulating strategies to overcome the difficulties, and otherwise avoid an exacerbation of the financial and social fallout from failure.

The tool envisaged would provide more timely reporting to employees of an employer's drift into financial difficulties, enabling them to be better placed to bargain effectively regarding their wages, conditions and other employee entitlements. It would also enable decisions to be made as to whether the

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company was suitable for an employee buyout, and it would enable a company to be restructured before it was too late, so enhancing the quality of buyout available for employees.

Such a voluntary approach based on bargaining for information is preferable, but a more radical approach based on legislation is also under consideration in some countries. One of the most interesting and controversial submissions to the research for this report came from the Australian economist Shann Turnbull, who has proposed a controversial innovative legislative approach for an early warning system. This warrants further research to determine its impact on the legal/financial environment for business.

Turnbull argues that in private and public companies stakeholders have the right to a *present liquidation value* in contrast to the normal audit of 'going concern' value. This would benefit both employees and shareholders by addressing the current situation where contingent liabilities for employees are not carried in the company's books, but only crystallise when a company is wound up.

Turnbull further suggests that if the auditor determines that the liquidation value is not sufficient to cover all unsecured liabilities, then the directors might be held personally liable, and further that if the liquidation value doesn't cover employee entitlements then shareholders lose limited liability.⁶⁰

Radical legislative changes to amend company law along these lines would have to be very carefully researched, but might have to be considered if voluntary early warning arrangements fail to prevent unnecessary insolvencies.⁶¹

Recommendation 1.4: The Australian Council of Trade Unions share with the TUC and TGWU the results of their research on insolvency early warning arrangements with a view to developing a bargaining tool.

⁶⁰ Shann Turnbull, Interview with the Author, April, 2006.

⁶¹ The Australian *Maximum Priority Proposal* (see p.14 above) might also be considered a form of early warning system. By giving employees the status of preferred creditors above fixed creditors it would add a market discipline encouraging companies to think twice about taking the insolvency route. The economic modelling of Davis and Burrows (2003) and Davis and Lee (2005) might be examined to ascertain its relevance to the UK.

5.1.5 Trade unions

In Australia the need for the trade unions and companies to work together has been recognised, for example by the *Parliamentary Joint Committee on Corporations and Financial Services* (JCCFS):

*The Committee urges companies to review the issues raised by the trade unions during this inquiry and work with them in devising reporting mechanisms that would satisfy their concerns.*⁶²

An important first step in the UK is to develop thought leadership to resolve the issues identified in the Warwick Agreement between the Labour Government and the Trades Union Congress in 2004. A partnership is required between the trade unions, insolvency practitioners and employee buyout practitioners to develop a Good Practice Guide that will outline all the options available to the Administrator in the insolvency process, including an EBO.

As a first step, a symposium should be brokered involving trade unions and the seven key bodies representing insolvency practitioners. This would aim to develop guidelines on consulting with trade unions and banks in a corporate distress situation with the objective of canvassing a wider range of options than closing the business and selling off the assets.

At the same time, there is a need for the trade unions to disseminate better information on insolvency and the employee buy-out option among their own membership. The TUC should consider including Insolvency, early warning arrangements and the employee buyout option in the curriculum of the Organising Academy.

Further, the TUC with key partners might develop an information pack for trade unionists to guide them on employee buyouts – how to recognise the signs of corporate distress, action to take, and sources of information and contacts to assist with an EBO.

Recommendation 1.5: The TUC needs to be involved in developing a range of learning tools for both insolvency practitioners and trade unionists on predicting insolvency, the range of alternatives to closure in insolvency, and in particular the employee buyout option.

⁶² *Corporate Insolvency Laws: a Stocktake*. Parliamentary Joint Committee on Corporations and Financial Services (JCCFS), October 2004, p.193, para 10.100.

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5.1.6 Other seminars and conferences

The employee buyout solution to key problems of insolvency has been endorsed by a wide range of constituencies: employees, trade union members, insolvency practitioners, lawyers and academics, both in the UK and other countries. It is essential that opportunities are developed for these constituencies to share knowledge and experience.

- *R3* are interested in convening a conference on the employee buyout solution.
- Professor Adrian Walters, Law School, Nottingham Trent University has commended the prospect of a seminar. Professor Walters is conducting two research projects for the DTI on the effectiveness of the Enterprise Act and also sits on a committee organised by the DTI Insolvency service.
- Marc Mathieu, Secretary of the European Federation of Employee Shareholders, has offered to convene a conference in Brussels to discuss this report.
- Alejandro Barahona Riber, Director General of the Department of Economics and Work, Madrid, has suggested that this report be discussed at the bi-annual meeting between Spanish and UK public servants.
- Also in this context the proposed re-launch of the Lisbon Treaty on socially responsible economic restructuring in Europe is highly significant. The *Sociedades Laborales* and *Marcora* approaches to job retention and industrial restructuring needs to be researched further as a strategy for economic reconstruction in the EU.

Recommendation 1.6: A programme of seminars and conferences should be designed to bring together key sympathetic people in the European Commission, government departments and trade unions, together with insolvency practitioners, employee buyout practitioners, lawyers and academics.

5.2 New infrastructure for employee buyouts

5.2.1 – The Employee Buyout Foundation

*Money drives deals. Deals don't drive money.*⁶³

It is recommended that an Employee Buyout Foundation (EBOF) is established, as this would be the most effective way of reaching and motivating insolvency practitioners. It would help solve the insolvency practitioner's problem of selling the company as a going concern, by providing advice and access to finance for employees, and therefore a new market for distressed companies.

It is recommended that the EBOF would promote an equity transfer model that demonstrates corporate social responsibility values in the areas of networked stakeholder governance, patient financing and participative work place relations. The EBOF would aim to build an EBO sector of networked businesses which has been shown to maximise the survival rate of firms, provide a buffer against the worst effects of the market, enable exchange of expertise and ensure employment stability in return for high performance.

The Employee Ownership Centre in Ohio, USA, is currently developing in this way:

*The centre's role should be that of a catalyst in building this broader community (of EBOs) by supporting the development of an **Equity for ESOPs** Fund.*⁶⁴

This also has parallels in the charter established by the Mondragon Co-operativa Coporation (MCC) for the autonomous co-operatives linked to it, enabling them to draw on its research, finance and educational services.

It is recommended that the EBOF could take on a monitoring and networking role. This would involve detecting impending problems or crises, assisting with management mentoring from other EBOs, refinancing and facilitating the

⁶³ Ahlstrom, 2005, p.53.

⁶⁴ Ohio Employee Ownership Centre Annual Report, 2004.

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relocation of labour.

In this respect Mondragon and its Casa Laboral Popular (the bank) are almost flawless, as illustrated by the high cash flow percentage of Gross Value added and by the system of distribution of pure surplus.⁶⁵

In terms of finance, there are three different alternatives to consider.

1. Pension Funds

There are better alternatives for investing employees' pension funds... they are what we call 'economically targeted investing' or 'double bottom line investing'. That double bottom line is a market rate of return plus some additional good - like more local investment, good jobs, better housing, and health and safety at work.⁶⁶

It is not clear whether pension funds can or should be used in the UK, as they are in America, to invest directly in EBOs. However, even if direct investment is not appropriate experts believe there is a particular opportunity for intervention by the Pension Protection Fund. This has two statutory purposes: the preservation of pensions and the preservation of jobs. There is a possibility that the member nominated trustees who must agree on a plan to ensure pension funds in deficit return to surplus will see the option of an EBO is the best solution.

2. Private Equity Investment Fund

An EBOF has already been discussed as an ethical private equity investment fund, linked to venture capital funds. This would be a market leader in providing finance and expertise to employees in order for them to purchase suitable distressed businesses. The EBOF would give the insolvency practitioner confidence to consider the employees as a potential buyer.

R3 have agreed to a national conference for their members on the 'EBO and Insolvency' if such a fund can be put in place.

This line of thinking follows previous studies into the development of employee buyouts by EBO practitioners in the UK, which recommended the possibility of a holding company to buy distressed companies interested in converting to employee ownership and reconstruct them. This is in fact a form of private equity fund.

65 Thomas & Logan, *Mondragon: An Economic Analysis*, George Allen & Unwin, London, 1982, p.185.

66 Logue, 2004, p.8.

3. Social Bank

The UK has a vibrant social economy which is experienced in setting up funds to support social enterprises, and is well placed to set up a specialist fund for smaller employee buyouts. Current examples include Co-operative & Community Finance, the Co-operative Bank, Triodos and the Big Investor. Also many of the larger banks, such as Barclay's and the Royal Bank of Scotland, have a social enterprise commitment. There is also a possibility of a social bank is emerging from the Commission for Unclaimed Assets, managed by the Scarman Trust.

The Globalisation Readjustment Fund, proposed as a new measure to help Europe's economy absorb the effects of globalisation, will have half a billion euros capital. The fund will assist retraining and relocating workers whose jobs have been eliminated in ways demonstrably tied to global trade dynamics, such as outsourcing. The proposed fund reflects the alarm Europeans feel at the prospect of foreign economic influence, accompanied by massive job losses or even loss of domestic control over an economy. The European Commission is making an effort to demonstrate that 'it can stand up for free trade and open markets as well as care about the people'.

Recommendation 2.1: Discussions need to take place with all relevant bodies, and in particular with Tom Powdrill, the TUC specialist on pensions, R3, key trade unions and financial institutions, with a view to developing a financial infrastructure for the EBOF.

5.2.2 Employee buyout pilot project

Alongside the financial development of the EBOF there is a need for further action research on its *modus operandi*. Drawing on models outlined in this report, such as the experience of the Employee Ownership Centre in America and the operation of the Marcora Law in Italy, a two year action research pilot project could resolve the practical issues involved in employees purchasing distressed businesses. In the context of globalisation, this project would assess what sectors would be most suitable for EBOs, develop criteria for success, document a staged process for the buyout and study cultural change and performance issues.

The DTI have in the past part funded the professional fees involved in a feasibility study on behalf of employees interested in purchasing the distressed business.

Also, there is a model for Regional Development Agencies in the Wales Co-operative Centre's approach, which has already achieved 10 successful employee buyouts from distressed companies. There is active interest from other RDAs, such as One North East. The idea of an action research pilot project might

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be developed in conjunction with a number of RDAs interested in providing information and part funding feasibility studies to assess potential employee buyouts that would save jobs and companies in their region.

Recommendation 2.2: A pilot project be developed with the DTI and RDAs to seek out, with the assistance of the trade unions, a number of distressed companies where an EBO could be proposed. Business and legal advice, networking, training, cultural change programmes and access to finance would be arranged.

5.2.3 The EBO Insolvency Working Party

There is a need for a co-ordinating body to progress the recommendations in this report, and in particular to oversee the development of the EBOF and act as a steering committee for the pilot project.

This should include representatives of *R3*, the Association of Business Recovery Professionals, key trade union national officers, and leading employee buyout experts.⁶⁷ It should be convened by the DTI with the Common Cause Foundation.

Recommendation 2.3: An EBO Insolvency Working Party is established to progress the other recommendations in this report.

⁶⁷ Perhaps drawn from the members of the steering committee which assisted the research for this report: Miguel Millana, CONFESAL; Roger Spear, Open University; Graeme Nuttal, Equity Incentives; Patrick Burns, Job Ownership Limited; Marc Mathieu, European Federation of Employee Shareholders; Norman Watson, Wales Co-operative Centre.

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Appendices

Appendix 1:

The Marcora Law - a basis for European legislation

This appendix is based on the work of Alberto Zevi of the Compagnia Finanziaria Industriale (CFI) at the Conference Strategies for Democratic Employee Ownership, held in London in November 1992.

The Marcora Law was passed on 27th February 1985, and provided state backing for two funds to support co-operatives. The first, FONCOOPER, is a general fund for the promotion and development of all types of co-operatives. The second, the Compagnia Finanziaria Industriale, is a special fund to help save companies in crisis. It invests only in new co-operatives set up by employees who have been laid off when companies close or downsize. CFI was capitalised by the state, and is managed on an ad hoc basis by the co-operative federations.

CFI invested in the share capital of phoenix co-operatives, up to three times what the employees invest, up to a maximum limit of three years' unemployment benefit. In return for this capital input, the employees lost their right to unemployment benefit during that period, should the co-operative fail. At the end of the period, the employees could buy the shares at face value from the fund, or they could be sold externally. The law also introduced the innovation that other outside shareholders – co-operatives, private companies or public bodies – could also contribute up to 25% of the co-operative's share capital. Up to this point, private enterprises had not been able to invest in co-operatives in this way in Italy.

Encouraging risk-taking and adequate capitalisation

The effects of the Marcora Law were as follows:

- It helped workers save their jobs by taking the entrepreneurial risks themselves.
- It incentivised employees to contribute capital, because the amount of outside financing was directly related to the workers' own shareholdings. This was important because it created co-operatives which were adequately capitalised, and many co-operatives are undercapitalised. The average employee shareholding in co-operatives supported by CFI was 5,500 ECU (£4,400), and in cases is as high as 15,000 ECU (£12,000), which meant the co-operatives were strong, had a good relationship with their banks and could grow faster.
- Thirdly, the link between the external capitalisation and unemployment benefit meant that there was a powerful incentive to make sure the enterprise worked; it also meant that workers were unlikely to start a co-operative which was likely to fail.

About a quarter of CFI-financed co-operatives have some corporate shareholding. In some cases this is a public body or a local financial organisation, and this helps the local community get involved. In other cases, it is other co-operatives who see such a shareholding as offering the potential for synergy and ways of moving forward with greater solidarity. Or it may be a private company that is seeking the benefit of organisational or industrial synergy. In general the involvement of non-co-operative shareholders has been beneficial, as it has brought in useful experience, prevented mistakes being made, and has stopped the co-operatives from becoming isolated. On the other hand there have been cases where outside shareholders have tried to take advantage of the inexperience of the co-operative members, and have tried to divide them up.

CFI feels that overall the Marcora Law worked very well. By 30th June 1992 it had invested 40 MECU (£30m) in 89 co-operatives. These co-operatives employed more than 3,100 workers, 80% of whom were members. Their turnover exceeded 230 MECU (£180m). There were of course failures, and in 1992 9 co-operatives, 10% of the total, were in liquidation. However these were the smaller co-operatives, and represented only about 5% of the capital and 5% of the jobs. Furthermore, this loss was compensated by asset and employment growth within the successful co-operatives. This experience shows that the availability of capital is a necessary condition for setting up new co-operatives, but is not sufficient on its own – other types of support are also necessary.

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The benefits of a specialist institution

One decisive factor in this success was that the state aid was made available in the form of equity, not grant, and has been administered by a specialist institution. This meant firstly that the co-operatives had a partner who took an active interest in their performance, and who could bring its contacts and experience to assist the co-op. Secondly, the dividend paid on the investments (about 15%) was returned to the movement, to help promote the growth of new co-operatives. CFI's monitoring, training and support was very similar to that provided by the Caja Laboral Popular in Mondragon.

The provisions of the Marcora Law were originally limited to an experimental period, but its success was such that parliament extended it for a further two years. However CFI was aware of the danger of becoming reliant on public financing, and actually refused additional public funding of 30 MECU because the government wanted it to act too hastily; it preferred to forego the extra money rather than invest in unsound co-operatives and bring the mechanism into disrepute.

This experimental law was instituted to provide an option for people who were made redundant, but its value went beyond that. First, it is important that among the workers there is a nucleus that is prepared to become entrepreneurs. Secondly, the Marcora Law provided the means to surmount some of the traditional obstacles that new co-operatives face: it provides incentives that help co-ops succeed. The Marcora Law provides a very good example for pan-European legislation.

Appendix 2:

UK insolvency statistics and the Enterprise Act 2002

Employee entitlements in the event of insolvency:

- Wages arrears – basic pay, bonuses, commission and overtime. A back claim of a maximum of 8 weeks. Only the first £800 is considered as a preferential creditor.
- Holiday pay – last 12 months, but only 6 weeks are considered as a preferential creditor.
- Redundancy – if the employee has been employed for longer than 2 years there is a payment entitlement depending on length of service, age and wage. It is unsecured.
- Payment in lieu of notice – if employed greater than one month a payment of 1 week's notice per year. Claimed against the company. Unsecured.
- Protective award – claims brought by Trade Union. Combined with wages claims.
- Unfair dismissal – up to £55,000 can be awarded. Unsecured.
- Unpaid pensions – a claim against the company. Amounts paid the prior 12 months are preferential and the first 4 months deducted but not paid over by the company are preferential.

In the England and Wales in 2005 there were 16,500 insolvencies per annum. The majority end in liquidation. An insolvency practitioner stated: It is the small end of the market where there are mass liquidations, companies of 20–30 employees where it is difficult to find a solution. This is an ideal market for the employee buyout. It is also the unexpected collapse of major corporations such as Rover that highlight the challenges to the insolvency regime, which an EBO may well address.

In 2005 2,257 companies went into administration, 604 into company voluntary administration and 590 into receivership. Administrator appointments had virtually ceased – being 4 in number.

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Summary of the Enterprise Act 2002

The sponsoring ministry for the legislation was the Department of Trade and Industry. The main thrust of the reforms were as follows:

- effective abolition of administrative receivership in all but a handful of exceptional cases;
- abolition of the Crown's status as a preferential creditor ranking ahead of a floating charge holder
- reform of the administration procedure (including the statutory hierarchy of objectives of administration) and imposition of the duty on the Insolvency Practitioner to act in the interests of all creditors;
- establishment of the ring-fenced fund (the so-called prescribed part) for unsecured creditors out of floating charge assets.

Overall, there was an attempt to move away from the bank-driven receivership model to a more inclusive collective model premised on the theory that this would improve the prospects for corporate rescue and, in particular, the outcomes for unsecured creditors. There is nothing in the legislation, which is specifically directed at employees. Regarding wage arrears, up to the statutory cap of £800 per employee, the employees were preferential creditors before the Enterprise Act and remain so now.

In practice, the £800 is met by the Redundancy Fund (financed from NI contributions) and the State having paid out then subrogates to the employee claim in the insolvency. Any impact on employees is at best indirect in the sense that the Insolvency Practitioner owes a duty to all creditors including unsecured creditors, which would clearly include the employees to the extent that they are owed wage arrears above the £800 cap.

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He graduated from the University of Sydney with a Masters in Economics in 1988 and has been a researcher, policy consultant and strategist on employee ownership since then. He co-founded the *Australian Employee Ownership Association*, and is also a member of the *International Association for Financial Participation*.

As a senior research consultant with *WM Mercer* from 1998 to 2001 he jointly researched a paper with the City of London Business School on the productivity effects of employee share schemes in top UK companies, and presented this at the University of Trento in 2000.

He is currently engaged by the *Australian Council of Trade Unions* and the pension fund *Members Equity* in Australia to research the role of pension funds in financing corporate recovery from insolvency. He is also a part-time lecturer in the Business Ethics programme at the University of Wales on employee ownership.

He has been a visiting scholar at the University of Sydney Business School and the Australian Centre for Industrial Relations Research, where he plans to commence his Doctorate studies in 2007.

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The Common Cause Foundation

The Common Cause Foundation works for social justice in employment and enterprise

Common Cause invests in the development of enterprise that involves employees and other local stakeholders in ownership and control, that creates employment and extends participation in enterprise to disabled and disadvantaged people, and that helps end exploitation and injustice in enterprise and trade generally.

It works internationally, but does not believe in 'foreign aid' – instead it builds partnerships and makes investments in the potential of all people, however disadvantaged, to create future common wealth.



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