Employee Ownership: A Topic for the Entrepreneurship Curriculum

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> "*In 2007, 5 of the 15 winners of the Top Small Workplaces Award given out by the Wall Street Journal and Winning Workplaces were employee-owned, and a number of the others planned to move in that direction*."
>
> - The National Center for Employee Ownership

Entrepreneurship issues have roots in many disciplines, including finance, strategy, and human resource management. Employee ownership (EO) is similarly an issue that has implications for funding an enterprise, differentiating it, and motivating and retaining talented employees.

A third of the workers in the highly entrepreneurial computer services and software industry have employee ownership and broad-based stock options, according to the 2006 General Social Survey of the University of Chicago. Many entrepreneurs have chosen this approach in an innovative industry, often in a way that is integral to their strategy for financing their enterprise and motivating an engaged workforce.

This Teaching module shows four areas in the entrepreneurship curriculum where teaching about employee ownership can 1) put a needed spotlight on this widespread and useful practice and 2) add conceptual value and rich examples for the course topics being taught. See our Closer Look for ideas on where employee ownership is already being taught.

"Between one-third and one-half of employees participate directly in company performance through profit sharing, gain sharing, employee ownership, or stock options" (Rhokeun Park, Douglas Kruse, and Joseph Blasi, *Shared capitalism: Prevalence, characteristics, and employee views of financial participation in enterprises*, 2008).

Employee ownership is an under-appreciated means for funding new ventures and securing employee alignment with the enterprise. EO is found in start-ups and "built to last" corporations. It harnesses employee motivation at every stage of organizational growth.

➔ Please note that the CasePlace.org collection on employee ownership includes many more sources (over 150) in addition to the ones noted in this Teaching module.

For each topic, some relevant cases, articles, and books are suggested.

1. EO as a mechanism for new venture financing

2. EO as a vehicle for incentive alignment, motivation, retention, engagement

3. EO and the stability of growing firms – links to the economy-wide use of EO

4. EO and social entrepreneurship

1. <u>EO as a mechanism for new venture financing</u>

Most discussions of financing new ventures focus on traditional sources, such as venture capital. For example, a teaching note on new venture financing (by Howard Stevenson and Michael Roberts, Harvard Business School, 2006) "describes the spectrum of sources which an entrepreneur can tap both during the start-up phase and as a going concern." The note includes personal investing (bootstrapping), equity finance, personal investors and angels, venture capital (early and late stage, mixes of debt and equity), public equity markets (IPOs), and corporate partnerships. It does not mention employee ownership as an option. There is an opening to add a new approach to the spectrum.

Many courses in business schools are focused on start-up high technology companies. "The extent to which high-tech firms which are focused on the Internet have granted ownership to their employees has no precedent in modern American history….This ownership consisted of the future stock to which employees had a claim through stock options, plus the much smaller amount of stock they owned directly." (Joseph Blasi, Douglas Kruse, and Aaron Bernstein, *<u>In the company of owners: The truth about stock options (and why every employee should have them</u>*, 2003: 79-81.)

Case:

<u>The Signature Group</u>
The National Center for Employee Ownership, 2008.
Abstract: The Signature Group, Inc. (TSG) is an employee-owned network systems firm established in 1997. TSG has distinguished itself as a leader in delivering high-quality local, enterprise, and global network infrastructure design, project management, and implementation services. It has grown to over 50 employees with a headquarters office in Vienna, Va., and satellite offices in Baltimore; Charlotte, N.C.; Boston; Ft. Lauderdale, Fla.; and Mississippi. CEO Michael Perdue attributes the company's success to its innovative employee ownership structure.

Article:

<u>The new math of ownership</u>
By Bill Gross
Harvard Business Review, 1998
Abstract: In order to solve high-tech's employee retention problems, Bill Gross, the chairman and founder of Idealab, proposes a radical solution: give all workers a significant equity stake. In 1994, when the software maker Knowledge Adventure decided to spin out a new venture--Worlds, Inc.--founder Bill Gross expected the worst. He had argued with the board

that it was in KA's best interests to maintain a controlling ownership stake in Worlds, whose powerful new software technology had enormous revenue potential. But the board prevailed, and KA took only a 20% ownership in the new company, giving the rest to Worlds' employees. Within a year, the company's performance had surpassed all expectations, and instead of owning 80% of a $5 million business, KA owned 20% of a $77 million business. The arithmetic may have been counterintuitive, but the lesson was clear. When KA let go of Worlds and gave its employees near total ownership, the company unleashed a new level of employee performance. That, in turn, led to the creation of economic value that more than made up for the equity KA had surrendered. So compelling was this "new math of ownership" that Gross founded a new company, Idealab, on this principle. The company, which develops ideas for Internet-based businesses and seeds the most promising ones, takes no more than a 49% equity stake in the new ventures and gives at least 1% of ownership to each employee. For Gross, this radical approach to ownership is the key to inspiring stellar performances. In part, employee-owners are motivated by their potential to earn great financial reward. But the drama of ownership, he argues, is even more important. In that drama, employees become personally involved in the struggle to outdo the competition and emerge victorious.

Books:

The decision-maker's guide to equity compensation.
By Corey Rosen, Pam Chernoff, Daniel N. Janich, Scott Rodrick.
The National Center for Employee Ownership, 2007.
Abstract: Companies can offer employees a variety of kinds of equity in their plans, with some restrictions. ESOPs, for instance, must own stock with the highest combination of voting and dividend rights (typically Class A common) or stock that is convertible into that class of stock. Profit sharing and 401(k) plans cannot own options or other forms of equity rights. The necessity that the ESOP get shares that carry voting rights (or shares convertible into such shares) is, as we will see later, not really a problem and should not be a factor in choosing or not choosing an ESOP as it does not mean that owners who want to maintain control of the company must cede that control to workers...

The entrepreneur's guide to equity compensation.
By David Binns, Martin Staubus, and Ron Bernstein. The Beyster Institute, 4th edition, 2006.
The Entrepreneur's Guide to Equity Compensation is a comprehensive overview of employee ownership practices and practicalities. From examining motivations for sharing ownership to determining plan types and features, the Entrepreneur's Guide is an excellent tool for entrepreneurs, executives, advisors, investors, and anyone else wishing to learn about using equity compensation effectively.

2. EO as a vehicle for incentive alignment, motivation, retention, engagement

Employees put "human capital" at risk in a new venture (like any other investor puts capital at risk) and should expect a return. EO motivates and retains employees, and it is often combined with more participatory ways of working. Some companies seek to create a "culture" of innovation and involvement by using EO.

Companies, at any stage, can differentiate themselves competitively with their high involvement human resource systems. The examples in the cases and book show how a profit-sharing system encourages employee cooperation, joint production, and retention. They also show how a company can create a culture of employee involvement and also of broad commitment to societal ideals of community and democracy.

Cases:

Keller Williams Realty
By Jim Baron and Brian Tayan, Harvard Business School, 2007.
Abstract: Describes the economic and cultural models that have led to the success of Keller Williams Realty. By 2006, Keller Williams was one of the most profitable real estate companies in the United States (if not the most profitable); in addition it was on its way to becoming one of the largest in terms of number of agents (over 70,000). Describes the factors that led to this company's success--including its operational model, compensation model, profit sharing model, and culture. Readers are asked to evaluate how these factors have worked together to lead to the company's incredible success and whether they can continue as the company continues to expand. In addition, explores the critical role that culture and organizational practices can have on a company's operating performance.

Sportasia LTD: A community company
By Alan Coad, The University of Birmingham, 2002.
Abstract: This case study introduces the reader to Sportasia Ltd, whose senior management have sought to develop and maintain a philosophy they refer to as the 'Community Company Model'. It describes the early history of the organization, and how it came to develop and institutionalize a culture based on cultivating a caring and rewarding work environment, where its members feel inspired, respected and appreciated. Whilst pursuing these ideals, Sportasia has successfully and profitably grown from a seedling organization to a 100-member medium-sized company. Evident in the case are important themes such as the transformational leadership of its senior management, the effective use of human resource strategies to control organizational growth, and the adoption of values similar to Charles Handy's 'Citizen Corporation'.

Book:

The SAIC Solution: How we built an $8 billion employee owned technology company.
By J. Robert Beyster and Peter Economy.
Abstract: In 1969, Dr. J. Robert Beyster founded Science Applications International Corporation (SAIC) with a unique vision of creating an employee-owned organization run

according to 12 principles of success that encourage entrepreneurship and accountability. Today, SAIC has grown from a handful of scientists to over 43,000 employees–most of whom hold company equity–and more than $8 billion in annual revenue, a steadily rising stock price, and top rankings as a contractor to government and business organizations. In this book, Dr. Beyster tells the story of SAIC, and offers valuable lessons to entrepreneurs and managers on how to build a company in which loyalty to values goes hand in hand with success.

In discussing his reaction to the traditional accounting proposal to seek private placement and then do an IPO, Robert Beyster writes: “Something must have stopped me from buying into this traditional approach. I had observed that it can destroy a company, and harm all but a limited number of insiders – most often the top executives – who do very well financially” (2007: p.5).

Article:

Creating a bigger pie? The effects of employee ownership, profit sharing, and stock options on workplace performance.

By Richard Freeman, Joseph Blasi, Douglas Kruse, Christopher Mackin.

In Joseph Blasi, *The Economics of Shared Capitalism*, 2008.

Abstract: This paper uses data from NBER surveys of over 40,000 employees in hundreds of facilities in 14 firms and from employees on the 2002 and 2006 General Social Surveys to explore how shared compensation affects turnover, absenteeism, loyalty, worker effort, and other outcomes affecting workplace performance. The empirical analysis shows that shared capitalism has beneficial effects on all outcomes save for absenteeism and that it has its strongest effects on turnover, loyalty, and worker effort when it is combined with: a) high-performance work policies (employee involvement, training, and job security), b) low levels of supervision, and c) fixed wages that are at or above market level. Most workers report that cash incentives, stock options, ESOP stock, and ESPP participation motivate them to work harder. The interaction of the effects of shared capitalism with other corporate policies suggests that the various shared capitalist and other policies may operate through a latent variable, “corporate culture”.

3. EO and the growing business

How does employee ownership bolster the sustainability of growing businesses? How does the change to employee ownership enhance employee commitment? These materials provide lessons for start-ups by showing what employee owned businesses look like in more mature companies. The cases include organizations that were well-known as novel and innovative start-ups in their time, such as Southwest Airlines and Whole Foods.

Cases:

Southwest Airlines Corporation
By Vijay Govindarajan and Julie B. Lang
Tuck School of Business, Dartmouth College, 2002
Abstract: Southwest initiated the first profit-sharing plan in the U.S. airline industry in 1974 and offered profit sharing to its employees every year since then. Through this plan, employees owned about 10 percent of the company stock. In 2000, Southwest offered its employees a record-setting $138m in profit sharing. This tax-deferred compensation represented an additional 14.1 percent of each employee's annual salary.

Whole Foods Market, Inc.
By John R. Wells, Travis Haglock
Harvard Business School Publishing, 2005.
Abstract: Can a short-sleeved, sandal-wearing, college dropout create a company manifesting love, joy, and happiness? Chainsaw John Mackey did. This CEO took a five-month sabbatical to hike the Appalachian Trail. More credentials: Sales-per-square foot of $690 and rising. Hiring by means of teams and a vote requiring a two-thirds majority. A single store in Austin, Texas in 1980; 144 stores in 2004. A seven-year streak near the top of Fortune's list of best companies to work for in America. Team-based hiring with a two-thirds majority required. Incentives based on the bottom line. Morale surveys. No salary higher than eight times the average salary. So how did John Mackey come to be christened Chainsaw John Mackey?

King Arthur Flour
By Thomas DeLong, James Holian, Joshua Weiss
Harvard Business School Publishing, 2006
Abstract: The success of King Arthur Flour could be attributed both to the quality of the product and to the company culture, which treated employee-owners with respect and allowed them to meaningfully contribute to the future direction of the company.

Articles:

Employee ownership: An unstable form or a stabilizing force?
By Margaret M. Blair, Douglas L. Kruse, and Joseph Blasi
In Margaret M. Blair and Thomas Kochan, Eds., *The new relationship: Human capital in the American corporation*, 2000.

Abstract: Is it a viable, efficient, and stable organizational form for the equity of an enterprise to be all or substantially owned by employees? The question is part of a long debate about the nature of capitalism and the way in which capitalism distributes the economic gains from production. In this paper, we take on a seemingly very simple set of empirical questions that we hope will shed light on whether employee ownership of firms "works" in some sense. We do this by examining the actual track record of the 27 publicly-traded firms that we were able to identify for which approximately 20 percent or more of their stock was held by or for employees in 1983, and compared the experience of these firms over time (through the end of 1997) to that of a control sample of 45 firms that were similar in size and in similar industries as of 1983. Our results suggest that, far from being an unstable form, or a form used primarily for transitions, the ownership of a substantial block of shares by employees appears to be a relatively stable arrangement. Indeed, it may be an arrangement that "stabilizes" the firm itself, by making it less likely that the firm will be acquired, taken private, or thrust into bankruptcy. The form may also be associated with more stable employment levels. And it appears to achieve this without cost in terms of productivity or financial performance, and may, in fact, enhance performance.

Employee ownership as a catalyst for change

By Barbara Bartkus

Journal of Organizational Change Management, 10(4), 1997.

Abstract: The creation of an employee ownership plan is viewed as the catalyst enabling a sociotechnical change process. Identifies several key factors as mediating links between employee ownership plans and organizational effectiveness: the initiator's purpose of the employee ownership plan; perceptions of ownership; level of participative decision-making systems; and organizational culture. These elements are affected by the introduction of employee ownership arrangements and can be specific areas in which organizational development consultants can focus effort to facilitate change generated by

4. EO and social entrepreneurship

Some may view EO as principally about social entrepreneurship – a move made mainly to reflect founder values or social purposes. The above sections show that there is a strong business case for EO and that values are not the sole rationale for their use. At the same time, given the widespread attention to social entrepreneurship, the relevance of EO for this topic should not be overlooked.

Founders' visions can shape employee-owned businesses. The reputation for employee ownership can be a draw for customers concerned about socially responsible investing. The mini case below shows how a bank created a novel opportunity for investing in an employee owned fair trade cooperative. The following two cases show how employee ownership fits into the strategic planning and positioning of growing enterprises. The book on the "third sector" introduces varieties of gain-sharing through cooperatives that enhance community economic development.

Mini-Case:

Equal Exchange and Wainwright Bank

SustainableBusiness.com, May 2006

Fair trade and beverage pioneer, Equal Exchange, has teamed up with socially progressive bank, Wainwright Bank, to raise capital, protect its independence, and create a new financial product for investors. Small and large investors alike can now buy a Certificate of Deposit (CD) at Wainwright Bank (Nasdaq: WAIN), the proceeds of which will go to Equal Exchange.

While other small, growing natural product brands continue to get bought up by large corporations, Equal Exchange - the Fair Trade coffee pioneers - and Wainwright Bank have created a unique, company specific CD to raise affordable capital for Equal Exchange while protecting its unorthodox structure of employee ownership. In keeping with its Fair Trade mission Equal Exchange is a worker cooperative, owned and democratically controlled by its employees.

Unlike funds raised by other CDs which go into a general account at the issuing bank, and might help finance a subdivision in Miami or a hotel in Las Vegas, purchasers of the Equal Exchange Certificate of Deposit will know their investment goes to creating a line of credit dedicated to Equal Exchange's use. To their knowledge this is the first company-specific CD to be issued in the United States.

Thanks to Equal Exchange's strong growth - it has grown 100% since 2002 - the worker cooperative needs more cash each year to purchase the fairly traded coffee, tea, and cocoa that it is known for. In 2005 alone the cooperative bought 4.3 million pounds of Fair Trade Certified™ coffee, costing more than $5.7 million.

To understand how the CD supports Fair Trade - Rink Dickinson, Equal Exchange co-founder and President, described it this way: "Each time someone buys a $2,000 CD that provides the cash Equal Exchange needs to purchase, at a Fair Trade price, the coffee grown by a typical family farm supporting 6-8 people. Over 100,000,000 Americans drink coffee every day, so even if a tiny fraction of them were to add this CD to their portfolio that would make a huge, direct contribution to supporting small-scale coffee farmers around the world."

Wainwright will handle the sales and customer service for the CD's, which are now available alongside other Wainwright financial products. The CD has a 3-year term, a competitive rate (currently 4.20% APY) and a $1000 minimum."

Cases:

Just Us! Coffee Roasters
By J. Sagebien, S. Skinner, and M. Weshler, Richard Ivey School of Business, 2007.
Abstract: The founders of Just Us! Coffee Cooperative (Just Us!) are involved in a strategic planning process. The growing demand and acceptance of fair trade products is good news for the industry and opens many opportunities for Just Us!, but there are also risks. Just Us! will likely face increased market competition from major US retail coffee brands and Canadian supermarket brands, pressure on margins as more brands crowd the shelves, and more competition for access to top quality sources of supply. Just Us! will have to make strategic choices and will have to develop a clear and focused marketing

A Slice of the Sun: Namaste Solar Electric Takes Employee Ownership to the Limit
By Mitchell Karen, Entrepreneur.com, 2007.
Abstract: It's the kind of place where everybody knows your name. And they know what's on your paycheck. Namaste Solar Electric Inc., a Boulder-based company that designs and installs residential and commercial solar Photovoltaic Electric systems throughout the Front Range, is heating up the concept of operating a 100-percent employee-owned business. Each of Namaste's 27 co-owners receives the same compensation, has equal voice in decision-making, and is afforded the same opportunities to participate in company ownership, says Namaste president Blake Jones, who reluctantly adopted his title to give customers and the media a sense of company leadership.

Book:

Third-Sector Development: Making Up for the Market
By Christopher Gunn. ILR Press, Cornell University, 2004.
Abstract: Nonprofit corporations, cooperatives, and credit unions constitute an alternative avenue of hope and action for communities that have come up short in the normal operation of the market economy. These organizations comprise the third sector, which accounts for approximately 10 percent of U.S. economic activity. As part of the fastest growing sector in the economy, these dynamic organizations play an increasing role in strengthening local economies. In the United States, they help to compensate for a

state that is, in Gunn's view, relatively disengaged from meeting basic human needs. This book helps move thinking about the third sector beyond traditional nonprofits centered on education, health care, and charity, and into the realm of often smaller, dynamic organizations that engage in collective entrepreneurship. Throughout, Gunn illustrates how organizations founded with little in the way of financial resources have made substantial contributions to economic development and general well-being in the communities they serve and from which they arise. After explaining why local development is a problem in such a wealthy and resource-rich country as the United States, Christopher Gunn profiles more than two dozen organizations ranging from child-care cooperatives to retirement communities, from co-housing "villages" to financial institutions. He also investigates public-policy changes that could strengthen this alternative sector's contribution to economic development.