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Employee-Owned Airlines: The Cure for an Ailing Industry

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EMPLOYEE-OWNED AIRLINES: THE CURE FOR AN AILING INDUSTRY?

PAUL CAVER

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I. INTRODUCTION

ON JULY 12, 1994, seventy percent of the shareholders of UAL Corporation, the parent company of United Airlines, Inc. (United), approved a buyout of fifty-five percent of UAL's stock by its employees.¹ With approximately fifty-four thousand of United's seventy-six thousand total employees participating,² the transaction made United the only major airline and the second largest company in the United States that is majority-owned by its employees, based on number of employees.³

The majority ownership of the world's largest airline⁴ by its employees has renewed the debate over the advantages and disadvantages of employee-owned companies, including airlines. The increasing growth of employee-owned businesses over the last two decades has fueled this debate. As of October 1994, approximately ten-thousand U.S. companies, "employing more than 11 million workers, have adopted some form of employee ownership. . . . [C]ompany employees now own stock in nearly one-third of the Fortune Industrial 500 and one-fifth of the Fortune Service 500."⁵ The dismal past performance of the U.S. airline industry highlights the significance of the introduction of large-scale employee-ownership of airlines: U.S. airlines lost \$12.7 billion between 1990 and 1993;⁶ more than 170 airlines

¹ Michael J. McCarthy & Carl Quintanilla, *Holders of UAL Approve Bold Buyout That Gives Workers Majority Control*, WALL ST. J., July 3, 1994, at A3; Stanley Ziemba, *Uniting United 1st Task for Worker-Owners*, CHI. TRIB., July 13, 1994, at 1.

² Ziemba, *supra* note 1, at 1.

³ *Top Employee-Owned Firms*, USA TODAY, July 13, 1994, at 1B. Publix Supermarkets, with approximately 87,000 employees, remains the largest company in the United States that is majority-owned by its employees. *Id.*

⁴ Janice Castro, *Fly It? They Own It; Now That United Airlines Employees Have Bought Control, Can They Do What It Takes to Run It?*, TIME, July 25, 1994, at 46.

⁵ *Washington State Community, Trade and Economic Development: Governor Calls Employee-Owned Firms Hig[h] Performers*, PR Newswire, Oct. 4, 1994, available in NEXIS, News Library, Wires file.

⁶ Robin Sidel, *U.S. Airlines Headed for More Turbulence in 1995*, Reuters, Dec. 20, 1994, available in NEXIS, News Library, Wires file.

failed in the 1980s;⁷ and several carriers are currently on the brink of bankruptcy or liquidation.⁸

This Comment explores several of the major issues underlying the debate over the effectiveness of employee-owned airlines. Part II provides background on employee stock ownership plans, which companies often use to structure employee buyouts. This section also explains the mechanics and goals of the United buyout. Part III discusses the history of employee ownership in the airline industry. Part IV covers the history of employee ownership in other industries. Part V looks into the advantages of employee-owned airlines, while Part VI covers the disadvantages. Finally, Part VII forecasts the future of employee ownership in the U.S. airline industry.

II. THE MECHANICS OF EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS) AND THE UNITED BUYOUT

A. HOW ESOPS WORK

Although workers may gain control of their companies through a variety of means, such as codetermination, labor representation on corporate boards, and collective bargaining, this Comment focuses on the most popular form of employee ownership—employee stock ownership plans (ESOPs).⁹ Over the last decade, ESOPs have enabled millions of American workers to become shareholders of their companies.¹⁰ The basic definition of an ESOP is “an employee benefit plan which is qualified under I.R.C. § 401(a) and is designed to invest primarily in qualifying employer securities.”¹¹

The invention of ESOPs is credited to Louis O. Kelso, a San Francisco lawyer and investment banker who saw ESOPs as a method for spreading ownership of corporate America among the workers.¹² In 1958 Kelso helped the employees of a West

⁷ Julie Schmit, *Employee-Owners Make Kiwi Fly; Small Airline Glides Upward on Loyalty*, USA TODAY, Sept. 22, 1994, at B1, B2.

⁸ Sidel, *supra* note 6.

⁹ JOHN L. COTTON, *EMPLOYEE INVOLVEMENT: METHODS FOR IMPROVING PERFORMANCE AND WORK ATTITUDES* 203 (1993).

¹⁰ Carol A. Glick, Note, *Labor-Management Cooperative Programs: Do They Foster or Frustrate National Labor Policy?*, 7 HOFSTRA LAB. L.J. 219, 241-42 (1989).

¹¹ Scott P. Spector, *Special Rules and Tax Provisions Relating to Employee Stock Ownership Plans (ESOPs)*, in UNDERSTANDING ERISA 1994: AN INTRODUCTION TO BASIC EMPLOYEE RETIREMENT BENEFITS 1 (PLI Tax Law and Estate Planning Course Handbook Series No. J4-3674, 1994).

¹² Glick, *supra* note 10, at 242.

Coast newspaper take over their company by using an existing stock bonus plan as collateral on a loan.¹³ ESOPs did not really catch on, however, until 1974, when Senator Russell Long of Louisiana pushed favorable tax legislation for ESOPs through Congress. This legislation made contributions to ESOPs by the plan sponsor tax-deductible to the sponsor.¹⁴

The first step in implementing an ESOP is the creation of a trust to hold the shares of stock acquired for the ESOP.¹⁵ The trust may purchase the stock on the open market, from individual stockholders, or from the company's treasury.¹⁶ The trust then allocates shares of stock to individual employee's accounts. Employees who have vested in their shares receive the stock or its cash value when they retire or otherwise terminate employment with the company.¹⁷

A special form of ESOP that provides a method for financing the purchase of stock for the trust is the leveraged ESOP.¹⁸ With a leveraged ESOP, the company borrows money through its ESOP to purchase some of its own stock (from its treasury or on the open market), securing the loan with corporate assets.¹⁹ The company then uses its earnings to make tax-deductible contributions to the ESOP to repay the loans.²⁰

Companies primarily use their ESOPs to accomplish one or more of the following purposes:

1. As a method of providing their employees with an additional fringe benefit;²¹
2. As a means for fighting a hostile takeover attempt,²² or otherwise preventing an outside ownership interest (*e.g.*, to purchase

¹³ COTTON, *supra* note 9, at 203-04 (citing LOUIS O. KELSO & MORTIMER J. ADLER, *THE CAPITALIST MANIFESTO* (1958)).

¹⁴ *Id.* Other favorable tax rules enjoyed by ESOPs are discussed *infra* Part V.

¹⁵ Glick, *supra* note 10, at 243.

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ Robert B. Moberly, *New Directions in Worker Participation and Collective Bargaining*, Address at the 1985 Russell Dunbar Labor Law Lecture, West Virginia University College of Law, in 87 W. VA. L. REV. 765, 772 (1985).

²² Corey Rosen & Michael Quarrey, *How Well Is Employee Ownership Looking?*, HARV. BUS. REV. Sept.-Oct. 1987, at 126.

the stock of an owner who is retiring from a closely-held company);²³

3. As a financing vehicle, because a company can borrow through a leveraged ESOP and deduct the contributions used to repay the loan;²⁴

4. As a bargaining tool during union negotiations, especially for a financially-troubled company (*e.g.*, stock-for-concessions deals in the airline industry, such as the United Airlines transaction).²⁵

This comment focuses on the use of ESOPs to give employees stock in exchange for wage concessions because this has been the primary motive for awarding employee ownership in the airline industry. This basic understanding of ESOPs provides a basis from which to examine the details of the United Airlines transaction.

B. THE UNITED BUYOUT

The fifth time was finally the charm for United Airlines employees. On July 12, 1994, following four unsuccessful attempts at an employee buyout since 1987, seventy percent of the shareholders approved a plan to sell fifty-five percent of the airline to certain employee groups in return for wage concessions from the participating employees.²⁶ Apparently, the shareholders approved the buyout²⁷ this time to avoid a likely but unpopular alternative: sales of corporate assets and layoffs of thousands of workers.²⁸ Poor financial results experienced by United in the early nineties would have eventually forced United's management to implement such measures to cut costs and improve liquidity.²⁹ From 1991-93, United's losses totalled \$1.3 billion.³⁰

United structured the buyout with the following terms:

1. Participating employee groups, approximately fifty-four thousand of United's seventy-six thousand total employees, received a

²³ Moberly, *supra* note 21, at 773. One commentator estimated that this is the most common use of ESOPs, probably accounting for at least one-third of all plans. See Rosen & Quarrey, *supra* note 22, at 127.

²⁴ Moberly, *supra* note 21, at 773.

²⁵ *Id.* Although as of 1985 this use of an ESOP only accounted for about 2% of the total ESOPs in the U.S., such a transaction usually involves very large companies and saving many jobs. *Id.*

²⁶ McCarthy & Quintanilla, *supra* note 1, at A3.

²⁷ Shareholder approval was the last step in authorizing the transaction. The board of directors and the two major participating union groups—the pilots and mechanics—had already voted to approve the stock-for-concessions buyout.

²⁸ McCarthy & Quintanilla, *supra* note 1, at A3.

²⁹ *Id.* at A3, A6.

³⁰ Castro, *supra* note 4, at 46.

fifty-five percent equity stake in UAL Corporation, United Airlines' parent company;³¹

2. United gave its existing shareholders \$84.81 in cash and a half share of new UAL common stock for each share of common stock that they held at the time of the buyout;³²

3. United financed the transaction by issuing \$741 million of debentures due in 10 to 20 years, and \$400 million of preferred stock;³³

4. Through September 30, 1994, United incurred pre-tax costs of \$169 million in connection with its "Employee Investment Transaction";³⁴

5. Participating employees were entitled to elect three out of the twelve members of UAL's board of directors;³⁵

6. Two of United's top executives were forced to resign, and participating employees picked the new chairman and chief executive officer, Gerald Greenwald;³⁶

7. Participating employees agreed to more than 5 years of wage cuts (ranging from 8.25% to 15.7%) and certain work rule changes, which United's management expects to save the airline approximately \$3.3 billion over the nearly 6-year period of the buyout contract;³⁷

8. Participating union employees are protected from layoffs and they must approve certain asset sales, and restrictions were placed on certain operations of United.³⁸

Specifically, the buyout's purpose was to "put in place a lower cost structure which is designed to allow United to compete effectively against low-cost carriers currently influencing the domestic marketplace and improve UAL's long-term financial

³¹ Ziemba, *supra* note 1, at 1. United will ratably allocate the 55% equity interest to individual employee accounts through the year 2000. UNITED AIRLINES CORP., SEC FORM 10-Q FOR THE QUARTER ENDED SEPT. 30, 1994 18. The entire 55%, however, can presently be voted by the ESOP trustee at the direction of, and on behalf of, the employees participating in the ESOPs. *Id.* Therefore, this Comment treats the employees as presently owning 55% of the airline.

³² UAL CORP., *supra* note 31, at 24.

³³ *Id.* at 15.

³⁴ *Id.* at 11.

³⁵ James Ott, *Vote Sets UAL on New Course*, AVIATION WK. & SPACE TECH., July 18, 1994, at 20, 21.

³⁶ James Ott, *Workers Take Expensive Risk With Their Airline*, AVIATION WK. & SPACE TECH., July 18, 1994, at 20. United had to make golden parachute payments to former chairman Stephen M. Wolf and former president and chief operating officer John Pope in amounts of \$20 million and \$16 million, respectively. *Id.*

³⁷ Michael J. McCarthy, *Risky Flight Plan: Unlike Rival Airlines, United is Setting Off on Costly Expansion*, WALL ST. J., Mar. 6, 1995, at A1.

³⁸ Ott, *supra* note 35, at 20.

viability.”³⁹ United plans on using the labor savings produced from the buyout to fund “Shuttle by United,” a short-haul low-fare airline that began competing with Southwest Airlines on the West Coast on October 1, 1994.⁴⁰ This is an important strategic move for United because low-cost carriers in short-haul markets, such as Southwest Airlines, increased their share of the U.S. market from nineteen percent to thirty percent during 1992-93.⁴¹

Wall Street appears cautious about United’s buyout and its investment in United Shuttle. During the 7 months following the buyout, the price of UAL’s stock increased only 3.5%, compared to 64% and 21% increases for Northwest Airlines and Delta Air Lines, respectively.⁴² Investors seem skeptical, despite the fact that UAL posted a net income of \$51 million in 1994, compared with a \$50 million loss in 1993.⁴³ United’s management attributes the skepticism to its unusual degree of employee ownership, as summed up by its manager of investor relations: “We’re the airline stock the Street loves to hate.”⁴⁴ Investor also may be worried by the rapid exhaustion of the labor savings due to higher fuel costs, expenses associated with the United Shuttle expansion, and higher rental and landing fees at the new Denver airport.⁴⁵

The substance of the United buyout was basically the same as any issuance of stock, except the investors were United’s employees and they paid for their stock with paycheck reductions over approximately a five-year period. Theoretically, the present value of the wage concessions is equal to the value of the stock awarded to employees. Because it is too early to judge the wisdom of the United buyout, the next section examines employee ownership of other airlines to determine whether those buyouts were effective in improving those airlines.

³⁹ UAL CORP., *supra* note 31, at 18.

⁴⁰ *Id.*

⁴¹ Del Jones & Julie Schmit, *Airline Employees Taking Over: UAL Plan May Put Industry in New Hands*, USA TODAY, Dec. 20, 1993, at B1, B2.

⁴² McCarthy, *supra* note 37, at A1.

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

III. HISTORY OF EMPLOYEE-OWNED AIRLINES

A. BACKGROUND OF U.S. AIRLINE INDUSTRY

Before discussing the history of employee-owned airlines, it is helpful to discuss briefly the history of the U.S. airline industry over the last two decades. Prior to the deregulation of the airline industry in 1978, airline unions successfully negotiated high wages and good benefits for their members.⁴⁶ The airlines tolerated the high labor costs because they could pass the costs on to passengers.⁴⁷ Following deregulation, however, airlines (especially weaker carriers) began to feel the pressure of high labor costs from the old union contracts because the airlines could no longer pass the costs on to passengers as easily.⁴⁸ This environment led to experimentation in methods for reducing labor costs.

At Eastern Air Lines, management first attempted to simply approach the unions and ask them for wage reductions.⁴⁹ The employees, who had enjoyed regular wage increases prior to deregulation, were unreceptive to management's request.⁵⁰ Next, Eastern successfully implemented a plan that reduced employees' wages, but the reduction constituted a "loan" to the airline, which Eastern would have to repay if the company made a certain profit.⁵¹ After a few years during which Eastern made only minimal profits, employees refused to continue entering into such profit-sharing arrangements.⁵²

Continental Airlines tried a more indirect approach to reduce its labor costs. In 1983, Continental declared bankruptcy in order to get out of its union contracts and then rehired workers at approximately half of their previous wages.⁵³ Continental reduced the salaries of its pilots from \$77,000 to \$43,000, and the salaries of its flight attendants from \$29,000 to \$14,000.⁵⁴ Cur-

⁴⁶ Beverly Smaby, *Cooperation vs. Competition at Eastern Air Lines*, 23 HARV. C.R.-C.L. L. REV. 29, 29-30 (1988).

⁴⁷ *Id.*

⁴⁸ *Id.* at 30.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.* at 31.

⁵⁴ Kathryn A. English, *Updating the Mandatory-Permissive Distinction to Enable Unions to Protect the Job Security and Economic Interests of Their Members*, 20 N.Y.U. REV. L. & SOC. CHANGE 573, 579 (1993-94).

rent laws prevent companies from using this type of tactic to break labor contracts.⁵⁵

"Double breasting" was another method used in the post-deregulation airline industry to reduce the costs of unionized labor.⁵⁶ Double breasting involves restructuring an airline by forming a subsidiary corporation that denies recognition to an incumbent union at the parent or sister corporation.⁵⁷ The problem with double breasting, however, was the autonomy requirements that the non-union subsidiary airline had to meet in order to avoid being bound to the existing present corporation labor contract.⁵⁸

The methods for reducing labor costs mentioned above either failed initially or are no longer viable alternatives for airlines. Continuing the pursuit of lower labor costs, United is leading the U.S. airlines in the latest trend—awarding stock to employees in return for wage concessions. But while the scope of the United buyout may be a bit unprecedented, the following section demonstrates that employee ownership is nothing new to the U.S. airline industry.

B. PAST EXPERIENCES IN EMPLOYEE OWNERSHIP OF AIRLINES

Along with United, several other U.S. airlines that are still in business have granted partial ownership to their employees. The following list of major airlines that feature employee ownership shows the amount of ownership distributed to employees, and, if ownership arose through a buyout, the year in which the buyout took place:

⁵⁵ Paul S. Dempsey, *Employees Can't Save Airline Industry*, USA TODAY, Aug. 23, 1994, at A11.

⁵⁶ John V. Jansonius & Kenneth E. Broughton, *Coping with Deregulation: Reduction of Labor Costs in the Airline Industry*, 49 J. AIR L. & COM. 501, 504-05 (1984).

⁵⁷ *Id.* at 505-06.

⁵⁸ *Id.* at 506.

<u>Airline</u>	<u>Employee Ownership</u>	<u>Buyout Year</u>
United Airlines	55%	1994
Northwest Airlines	33% ⁵⁹	1993
America West	30% ⁶⁰	Gradual
Trans World Airlines (TWA)	30% ⁶¹	1993
Southwest Airlines	13% ⁶²	Gradual

Several other airlines that experimented with employee ownership in the past either went bankrupt or were taken over, sometimes fairly compensating the employee-owners. The largest such airlines and the highest employee ownership percentages that they achieved are listed below:⁶³

<u>Airlines</u>	<u>Peak Employee Ownership</u>
Western Airlines	33%
Eastern Air Lines	25%
Pacific Southwest Airlines	15%
Republic Airlines	15%
Pan American World Airways	13%
Continental	9%

To provide insight on the U.S. airline industry's experience with employee ownership, the following subsections examine three airlines that have had varying degrees of success with employee ownership: Eastern Air Lines, TWA, and Kiwi International Air Lines.

1. *Eastern Air Lines*

In December 1983, Eastern granted employees 25% of its voting stock in return for \$292 million in wage concessions, productivity improvements worth an additional \$75 million,⁶⁴ and

⁵⁹ Del Jones, *United Deal Means More Low Air Fares*, USA TODAY, July 13, 1994, at A1, A2. This percentage will increase to 37.5% within 10 years. Jones & Schmit, *supra* note 41, at B2.

⁶⁰ Jones & Schmit, *supra* note 41, at B2. This percentage approximates the amount of employee ownership prior to America West entering bankruptcy protection. *Id.* America West had required all new hires to use 20% of their first-year salary to purchase its stock, but the employees' equity interest was wiped out in bankruptcy proceedings. James S. Hirsch, *Debt-Burdened America West Seeks a Safe Landing*, WALL ST. J., Apr. 22, 1992, at B4.

⁶¹ TWA Exits Chapter 11; Creditors Get Bigger Stake, WALL ST. J., Aug. 24, 1995, at A6.

⁶² Bridget O'Brian, *Southwest Wins Pilots Accord Offering No Wage Boost in First Five of 10 Years*, WALL ST. J., Nov. 18, 1994, at A2.

⁶³ Richard Tomkins, *A Triumph of Hope Over Experience-The Background to United Airlines' Employee Ownership Deal*, FIN. TIMES (London), Dec. 20, 1993, at 17.

⁶⁴ Deborah Groban Olson, *Keeping Capital and Jobs at Home*, 8 NOVA L. REV. 583, 591 (1984).

18% pay reductions.⁶⁵ In addition, each of the four participating labor groups—pilots, flight attendants, mechanics and non-contract workers received a seat on Eastern's twenty-seat board of directors.⁶⁶ Eastern also implemented "codetermination"—opportunities for employee representatives to review jointly with management items such as company books and the business plan.⁶⁷

This stock-for-concessions trade failed to save Eastern. In 1984, the first year following the buyout, Eastern benefited greatly from the reduced labor costs and productivity improvements, while labor-management relations also began improving.⁶⁸ At the end of 1984, however, despite his promise of joint problem solving, Eastern's chairman "unilaterally extended the wage concessions fee another year," causing a total collapse in labor-management relations and codetermination.⁶⁹ The unions and management could not agree on further concessions, and the airline began a spiralling descent.⁷⁰ Frank Lorenzo bought Eastern in 1986, and under his ownership poor labor relations led to a strike and several failed employee buyout attempts, until the company filed bankruptcy in 1990. Finally, in January 1991, losses of \$2 billion over the past 22 months forced Eastern to cease operations permanently.⁷¹

At the time of the employee buyout, Eastern was probably beyond saving. Poor customer service and loss of reputation, resulting from years of labor wars, had already cost Eastern hundreds of millions of dollars in passenger revenues.⁷² But some observers argue that employee ownership might have salvaged Eastern, "were it not for the particularly poisoned atmosphere between the headstrong individuals."⁷³

⁶⁵ Smaby, *supra* note 46, at 32.

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ JOSEPH R. BLASI & DOUGLAS L. KRUSE, THE NEW OWNERS: THE MASS EMERGENCE OF EMPLOYEE OWNERSHIP IN PUBLIC COMPANIES AND WHAT IT MEANS TO AMERICAN BUSINESS 102 (1991). The machinists' union committees alone were responsible for estimated productivity gains of \$30 million in the first year of employee ownership. COTTON, *supra* note 9, at 41.

⁶⁹ BLASI & KRUSE, *supra* note 68, at 102.

⁷⁰ *Id.*

⁷¹ James L. Linsey, *Labor Perspectives on the Airline Implosion*, C656 ALI-ABA 269, 271 (1991).

⁷² Smaby, *supra* note 46, at 31-32.

⁷³ BLASI & KRUSE, *supra* note 68, at 103.

In addition to Eastern's poor financial position, employee ownership failed because neither the employees nor management viewed employee ownership as an opportunity to genuinely work together to improve the airline. Management merely viewed the employee ownership as "a bridge to permanent wage concessions," while employees simply thought of it as "a way of securing lost wages."⁷⁴ But at least one commentator suggests that if Eastern had implemented employee ownership earlier, it may have worked—it simply required time to change the old views of both management and the employees.⁷⁵

2. TWA

TWA, the nation's seventh-largest airline, has filed for Chapter 11 bankruptcy twice in the last four years.⁷⁶ TWA emerged from its first bankruptcy proceeding in November 1993 by awarding its employees forty-five percent ownership in return for wage concessions.⁷⁷ Prior to entering bankruptcy protection, TWA had experienced periods where it lost almost \$1 million a day.⁷⁸ Similar to Eastern, TWA was in severe financial difficulties at the time it implemented the employee buyout, and employee ownership has probably not yet been in place long enough to make a substantial difference. Expected cost savings and revenues from the buyout have yet to materialize, and TWA has abandoned its expansion plans for an Atlanta hub, retreating to its single domestic hub in St. Louis.⁷⁹ After watching its stock price decline by more than fifty percent during one six-month period in 1994, some industry executives believe that TWA has few options left except slashing its work force of more than twenty-five thousand employees.⁸⁰

TWA saw a glimmer of hope in the fall of 1994 when its three major union groups—mechanics, pilots, and flight attendants—agreed to new wage concessions, which management hoped would save TWA approximately \$130 million a year in operating

⁷⁴ Smaby, *supra* note 46, at 34.

⁷⁵ *Id.* at 34-35.

⁷⁶ *TWA Exits Chapter 11; Creditors Get Bigger Stake*, *supra* note 61, at A6.

⁷⁷ Michael J. McCarthy, *TWA, Out of Bankruptcy Court, Struggles to Take Off*, WALL ST. J., July 27, 1994, at B6.

⁷⁸ Edwin McDowell, *TWA Closes in on Deal for Employee Buyout*, S.F. CHRON., Aug. 25, 1992, at D1.

⁷⁹ McCarthy, *supra* note 77, at B6.

⁸⁰ *Id.*

costs.⁸¹ The new contracts were part of an overall restructuring that TWA claimed was necessary for it to fly through the winter of 1994-95.⁸² Possibly the employees were more willing to accept another round of concessions because of their forty-five percent ownership stake in the airline. TWA emerged from its second Chapter 11 filing in August 1995 by increasing creditors' stake in the airline from 55% percent to 65%, in exchange for the creditors forgiving \$500 million of debt.⁸³ This reorganization reduced the employees' ownership percentage from forty-five percent to approximately thirty percent.⁸⁴ TWA's financial status is still questionable because of more than \$1 billion of debt, an expensive older fleet, and limited domestic and foreign routes.⁸⁵

Though still struggling financially, TWA has improved in certain areas that may be attributable to its employee ownership. TWA has improved its customer service by such means as removing seats to increase legroom. Improved service has helped TWA earn the top ranking for customer satisfaction among domestic carriers for long flights, and second place for shorter flights in a 1993 survey of frequent business travellers.⁸⁶ Before it became forty-five percent employee-owned, TWA had the worst complaint record in the industry.⁸⁷ Also, since implementation of employee ownership, some TWA flight crews have "giv[en] up their spare time to take part in promotional tours for the airline around U.S. travel agencies."⁸⁸ But TWA is fighting an uphill battle, according to several analysts.⁸⁹

3. *Kiwi International Air Lines*

In 1993, former employees of Eastern Air Lines and Pan American World Airways, both now defunct, founded a new one hundred percent employee-owned airline, Kiwi International

⁸¹ *TWA's Debt Restructuring Plan Wins Approval From Pension Agency*, DAILY LAB. REP. (BNA), Dec. 28, 1994, at A1, A2.

⁸² Julius A. Karash, *TWA, Workers Accept Contract; New Cost-Cutting Deal to Help Airline in Restructuring*, KAN. CITY STAR, Nov. 5, 1994, at B2.

⁸³ *TWA Exits Chapter 11; Creditors Get Bigger Stake*, *supra* note 61, at A6.

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ McCarthy, *supra* note 77, at B6 (based on survey by J.D. Power & Associates).

⁸⁷ Jones & Schmit, *supra* note 41, at B2 (during period from 1985-92).

⁸⁸ Tomkins, *supra* note 63, at 17.

⁸⁹ McDowell, *supra* note 78, at D1.

Air Lines (Kiwi).⁹⁰ Kiwi has a fleet of sixteen planes that it uses to make seventy-three flights a day between the seven cities that it serves.⁹¹ "[D]espite its award-winning service and one of the lowest cost structures in the [industry]," Kiwi lost \$24 million in 1994 and nearly filed for bankruptcy in December 1994.⁹² In that same month Kiwi voluntarily grounded its entire fleet after the FAA questioned its record-keeping regarding pilot training.⁹³

Kiwi's problems continued in 1995, when it replaced its founder and chairman, and two other top executives left.⁹⁴ Although the airline made its first profit in the first half of 1995, its load factor (percentage of seats filled) was only 53%—well below the industry average of 66.2%.⁹⁵

Kiwi has sought to build employee loyalty through the manner in which it implemented employee ownership. When Kiwi fills a position, the new hire must buy between \$5,000 to \$50,000 of Kiwi stock, depending on the position.⁹⁶ Employees demonstrated their loyalty during the crisis in December 1994, when they agreed to temporary salary reductions in order to reduce operating expenses.⁹⁷

Despite their sizeable investments, however, Kiwi's employees have no voice in the management of the airline because a voting trust of seven pilot-directors makes all key management decisions.⁹⁸ Kiwi's current chairman summarized the three years which the voting trust managed the airline with the following remarks: "Pilots have always wanted to run an airline. Well, this was the first one they ran. And it was the first one they screwed up."⁹⁹ Recognizing this problem, the pilots have promised to give more control to Kiwi's new chief executive officer, who

⁹⁰ *Kiwi Resumes Flights After FAA Probe*, UPI, Dec. 18, 1994, available in LEXIS, News Library, Wires File.

⁹¹ Carl Quintanilla, *Kiwi's Pilots Are Bailing Out of the Company Cockpit*, WALL ST. J., Sept. 19, 1995, at B4.

⁹² *Id.*

⁹³ *Kiwi Chairman Quits Carrier Amid Shakeup*, WALL ST. J., Feb. 7, 1995, at B11.

⁹⁴ Carl Quintanilla, *Kiwi Appoints Murphy as CEO and President*, WALL ST. J., Aug. 25, 1995, at B12.

⁹⁵ *Id.*

⁹⁶ Schmit, *supra* note 7, at B1.

⁹⁷ Anne E. Tergesen, *Low Fare Airlines Hit Turbulence*, THE REC., Dec. 9, 1994, at C1.

⁹⁸ Quintanilla, *supra* note 94, at B4.

⁹⁹ *Id.*

stated "I think one needs to recognize that this company is employee-run, but you need to run it as a business."¹⁰⁰

As the experiences at Eastern and TWA demonstrate, the implementation of employee ownership does not magically transform a troubled airline into a healthy one. While it is too early to judge the success of Kiwi's employee ownership, the growing pangs that it has suffered demonstrate the problems caused by a single employee group dominating the management of an airline. Because the number of airlines that have implemented employee ownership on a large scale is limited, the next section will look at some companies in other industries that have had more experience with employee ownership.

IV. HISTORY OF EMPLOYEE OWNERSHIP IN OTHER INDUSTRIES

As employee ownership of American companies has increased, there has been much debate regarding the conditions necessary for employee ownership to succeed, and the frequency with which employee-owned companies do succeed. Professor Alan Hyde refers to the extreme positions of the debate as the "always" and "never" schools of thought as to how often employee ownership will benefit a company.¹⁰¹ Professor Hyde points out that it is difficult for the never school to explain the diversity of several of the industries that feature employee-owned business, such as plywood manufacturing, refuse collection, steel manufacturing, professional partnerships, taxi cab collectives, construction companies, and supermarkets.¹⁰² Successful employee ownership and management occur in the production of goods and services, among educated and less-educated employees, in jobs performing tasks both simple and complex, and in enterprises of varying size.¹⁰³

Professor Hyde also points out that it is difficult for the always school to explain why employee-owned firms seldom dominate entire industries, except where the law prohibits alternative arrangements, such as law firms.¹⁰⁴ The always school has several explanations for employee ownership's failure to dominate a

¹⁰⁰ *Id.*

¹⁰¹ Alan Hyde, The Kenneth M. Piper Lecture: In Defense of Employee Ownership, Given at Chicago-Kent College of Law (Mar. 19, 1991), in 67 CHI.-KENT L. REV. 159, 164 (1991).

¹⁰² *Id.* at 168.

¹⁰³ *Id.* at 169.

¹⁰⁴ *Id.* at 170-71.

particular industry, such as tradition and lack of awareness of options.¹⁰⁵ Professor Hyde's analysis seems to illustrate that employee ownership is no panacea for all companies in every industry, but it does have the potential to work in many diverse circumstances, subject to the specific operating environment of the particular company considering employee ownership. This section proceeds on this assumption and considers different case studies in employee ownership, keeping in mind that there are limitations in extrapolating the likelihood of success in employee ownership based on other companies' experiences.

A. RATH PACKING CO

Rath Packing Company of Waterloo, Iowa was one of the first industrial plants to be worker-owned and controlled.¹⁰⁶ Although Rath enjoyed a reputation as one of the most modern meatpackers in the industry during the 1940s, poor management decisions and lack of capital investment had placed Rath on the brink of closing its plant by the late seventies.¹⁰⁷ In 1979, the 2,200 union employees of Rath took wage cuts and deferred benefits in return for 60% of the company's treasury stock.¹⁰⁸ This new equity enabled leverage for Rath to obtain loans from several government agencies for capital investment.¹⁰⁹ The union had numerous reasons for acquiring control of Rath: saving jobs, limiting concessions, gaining control of management decision-making, protecting the pension plan, and preventing a proposed buyout that would have included drastic wage and benefit cuts without giving the union or employees any control over the company.¹¹⁰

While Rath adopted ownership for its employees through an ESOP, management instituted additional mechanisms for allowing worker participation and control.¹¹¹ Rath created a top level steering committee, jointly chaired by union and management officials, which met monthly with a strategic planning

¹⁰⁵ *Id.* at 171.

¹⁰⁶ Toni Delmonte, *In Defense of Union Involvement in Worker Ownership*, 10 IN PUB. INTEREST 14, 16 (1990).

¹⁰⁷ *Id.*

¹⁰⁸ *Id.* at 17.

¹⁰⁹ *Id.*

¹¹⁰ Deborah G. Olson, *Union Experiences With Worker Ownership: Legal and Practical Issues Raised by ESOPs, TRASOPs, Stock Purchases and Co-Operatives*, 1982 WIS. L. REV. 729, 754.

¹¹¹ Delmonte, *supra* note 106, at 17.

group to monitor developments and to oversee the future of the company.¹¹² Rath provided its employees with the opportunity to join Action Research Teams, in which discussion and problem solving were open to all topics related to the management of the company.¹¹³

Unfortunately, employee ownership did not save Rath, which ceased operations and liquidated its assets in 1985.¹¹⁴ The employee buyout had yielded a twenty percent reduction in labor costs per unit of production, yet labor costs were only fifteen percent of Rath's total costs.¹¹⁵ External conditions, such as high interest rates, non-union competition, and outdated plant and marketing strategies contributed significantly to Rath's downfall.¹¹⁶

Rath also demonstrates the strain that can develop when a union representative sits on the company's board of directors. The president of Rath's predominant union ultimately became president of Rath after he chose not to run for re-election as union president.¹¹⁷ Soon thereafter, Rath successfully convinced a bankruptcy court to void the firm's contract with the union.¹¹⁸ This does not necessarily imply that Rath's president "sold out" his former union and its members, because voiding the union contract might have benefitted the employees and the company.¹¹⁹ Surely, however, during his transition from union to corporate president, he experienced divided loyalty between union employees, other employees, and the best long-term interests of the company and its non-employee shareholders.

B. WEIRTON STEEL CORP.

Weirton Steel Corporation, in Weirton, West Virginia, was another pioneer in employee ownership, although it is still struggling to survive in the competitive United States steel industry. In 1984, when employees gained control of seventy-five percent of the stock, Weirton became the largest employee-owned com-

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ *Id.* at 18.

¹¹⁵ *Id.*

¹¹⁶ Delmonte, *supra* note 106, at 18.

¹¹⁷ Michael C. Harper, *Reconciling Collective Bargaining with Employee Supervision of Management*, 137 U. PA. L. REV. 1, 62 (1988).

¹¹⁸ *Id.*

¹¹⁹ *Id.* at 63.

pany in the United States in terms of employees.¹²⁰ Weirton is currently the seventh-largest steel producer and ninth-largest employee-owned company in the U.S., employing approximately six thousand employees.¹²¹

Weirton has experienced several difficulties during its first ten years of employee ownership. Some of Weirton's recent problems include: a lawsuit filed by employees against management, fire damaging a mill, cyclical demand for steel, losses of \$336.8 million over the past 3 years, and remaining debt from a major modernization program.¹²²

Despite these problems, some Wall Street analysts are optimistic about Weirton's future.¹²³ One analyst has attributed Weirton's reduced employee headcount and improved productivity, each better than industry averages, to employee ownership.¹²⁴ Employees have made the following sacrifices to improve Weirton's financial condition: cuts in pay and profit sharing, job eliminations, dilution of their control in stock from 75% to 50%, and acceptance of a managed health care plan expected to cut costs by \$28 million over the next 3 years.¹²⁵ Investors showed support for Weirton through a successful offering of 15 million new shares of common stock in August 1994, which raised \$117.5 million in badly needed new capital.¹²⁶

Other industrial companies have had mixed success with employee ownership. The three hundred employee-owners at Toledo's Textileather Corp. earned tens of thousands of dollars when their company was sold to a privately-held Canadian firm.¹²⁷ But workers at Northwestern Steel & Wire Co. in Sterling, Illinois took big wage cuts during its 1988 employee buyout, only to watch their fifty-nine percent stock ownership fall to eighteen percent.¹²⁸

¹²⁰ Len Boselovic, *Steelled for the Future; Weirton Steel Enters its Second Decade with CEO Elish at Helm—and Employees at the Rudder*, PITTSBURGH POST-GAZETTE, Sept. 18, 1994, at C1.

¹²¹ *Id.*

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ Boselovic, *supra* note 120, at C1.

¹²⁶ *Id.*

¹²⁷ Robert L. Rose, *A Special Report About Life on the Job*, WALL ST. J., Apr. 11, 1995, at A1.

¹²⁸ *Id.*

C. *AVIS-RENT-A-CAR*

In the past, many experts regarded Avis Rent-A-Car, the fourth-largest company in the country that is majority-owned by its employees,¹²⁹ and the largest fully employee-owned company,¹³⁰ as a model of success in employee ownership.¹³¹ United's non-union employees showed their confidence in Avis's employee ownership by selecting Joe Vittoria, Avis's chairman and CEO, as their representative on the UAL board of directors.¹³²

Avis's recent problems, however, have caused observers to doubt the success of its employee ownership. The nation's second-largest car rental company has suffered scattered layoffs, frozen salaries, and a fifty percent reduction in the value of its stock during 1994.¹³³

Avis recognized that creating the right attitude regarding the employees' new role was essential to Avis's successful buyout. "The company created employee participation groups (EPGs), in which managers function as facilitators but all employees play a role."¹³⁴ The managers took on roles resembling coaches more than traditional managers, and over a five-year-period Avis changed the "us and them" attitude to an atmosphere of teamwork and open communication among the different employee groups.¹³⁵ Avis believes that this environment is responsible for such instances as a Philadelphia employee introducing a new way to keep cars locked and safe overnight, and a Palm Beach employee fixing a flat tire for an individual who was driving a competitor's car.¹³⁶

Despite management's receptiveness to employees' ideas, the 12,800 employee-owners have no direct representation on Avis's 12-member board of directors.¹³⁷ They have no voting rights because a trustee holds their stock until after they leave the com-

¹²⁹ *Top Employee-Owned Firms*, *supra* note 3, at 1B.

¹³⁰ James S. Hirsch, *Avis Employees Find Stock Ownership Is Mixed Blessing*, WALL ST. J., May 2, 1995, at B1.

¹³¹ Alan Fredericks, *Avis' Vittoria Tapped for Role in UAL's Switch in Ownership*, TRAVEL WKLY., July 21, 1994, at 1.

¹³² *Id.*

¹³³ Hirsch, *supra* note 130, at B1.

¹³⁴ Fredericks, *supra* note 131, at 1.

¹³⁵ *Id.*

¹³⁶ Robert L. Rose & Erle Norton, *ESOP Fables: UAL Worker-Owners May Face Bumpy Ride if the Past is a Guide*, WALL ST. J., Dec. 23, 1994, at A1.

¹³⁷ Hirsch, *supra* note 130, at B1.

pany.¹³⁸ Also, Avis refuses to disclose certain financial information to employees, such as executives' salaries and bonuses.¹³⁹ One Avis director defends this policy on the basis that many of the employees would not understand the information.¹⁴⁰ Such an attitude by Avis's management may account for the low morale the employees are currently experiencing.¹⁴¹

In addition to the problems that Avis has encountered in implementing employee ownership, United faces several additional challenges. Avis was a privately-held company approximately one-sixth the size of United at the time of Avis's buyout.¹⁴² United's sheer size makes it more difficult for employees to feel as if they can individually contribute to the company's success. Another difference is the fact that 100% of Avis's employees participated in its buyout, while so far only 54,000 of United's 76,000 total employees have participated in that buyout.¹⁴³ Also, unlike many employee buyouts, including United's, Avis employees did not have to give up wages or pension benefits to buy their company.¹⁴⁴ Perhaps the biggest difference, however, is the intense competitiveness of the airline industry and its current weakened financial condition that resulting from years of net losses.

The common thread among these three non-airline case studies in employee ownership may be the employees improved attitudes and willingness to sacrifice after the buyouts, although Avis's morale has suffered recently. Employees' sacrifices almost certainly extended the time that Rath was able to remain in business, and Weirton's employee-owners probably deserve credit for enabling their company to withstand tough times. But Rath, Weirton, and Avis demonstrate that certain adverse external factors can weaken or destroy a company in spite of employee cooperation. Airline employees who are deciding whether to accept concessions-for-stock deals should be aware of this reality.

¹³⁸ *Id.* Employees who quit Avis must wait six years for their shares. *Id.*

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ Hirsch, *supra* note 130, at B1.

¹⁴² Fredericks, *supra* note 131, at 1.

¹⁴³ *Id.*; Rose & Norton, *supra* note 136, at A1.

¹⁴⁴ Hirsch, *supra* note 130, at B1.

V. ADVANTAGES OF EMPLOYEE-OWNED AIRLINES

A. LOWER LABOR COSTS

Labor costs have been one of the most significant factors in putting the airline industry in the red. On average, wages and benefits account for approximately thirty percent of airline operating expenses.¹⁴⁵ Professor Paul Dempsey lists low wages and flexible work rules among his nine "survival characteristics" of U.S. airlines.¹⁴⁶ A spokesman for American Airlines has concluded that "costs are going to be the principal competitive advantage of the 1990s."¹⁴⁷ Reducing labor costs was certainly the primary motivation for the United buyout, which should yield significant labor savings over the five year period covered by the buyout agreement.

As noted above, prior to deregulation airlines allowed the unions to negotiate high wages and benefits, because the airlines could pass the costs on to customers. Airline workers became some of the highest paid employees in American industry, with many pilots making over \$100,000 a year for flying less than eighty hours a month, and even baggage handlers making over \$30,000 a year.¹⁴⁸ But since deregulation in 1978, and since competition has driven down fares, airlines have been scrambling to cut costs—especially labor costs. The older airlines, with a long history of collective bargaining, have found it difficult to compete with new airlines paying substantially lower wages and enjoying greater flexibility in areas such as employee scheduling and job assignments.¹⁴⁹

United is hoping that the wage concessions obtained in the buyout will bring its costs more in line with the low-cost industry leader—Southwest Airlines. Southwest enjoys a low 7.2 cents per available seat-mile (the cost of flying one passenger one

¹⁴⁵ Jeffrey M. Laderman, *Bulls on the Runway Start to Bellow*, BUS. WK., Aug. 8, 1994, at 63. This percentage, however, appears to be decreasing, as demonstrated by the decrease from 37.3% to 33.8% from 1980-90. Paul S. Dempsey, *The Disintegration of the U.S. Airline Industry*, 20 TRANSP. L.J. 9, 27 n.63 (1991).

¹⁴⁶ The rest of Dempsey's list includes: multiple hubs, strategically located; frequent flier programs; computer reservation systems; sophisticated yield management; fuel efficient fleet of standardized aircraft; low debt (conservative growth); superior service; and international routes. Dempsey, *supra* note 145, at 14.

¹⁴⁷ Terry Maxon, *Southwest Pilots Trade Raises for Stock*, DALLAS MORNING NEWS, Nov. 18, 1994, at 4D.

¹⁴⁸ Michael A. Katz, *The American Experience Under the Airline Deregulation Act of 1978—An Airline Perspective*, 6 HOFSTRA LAB. L.J. 87, 92 (1988).

¹⁴⁹ Jansonius & Broughton, *supra* note 56, at 552-53.

mile), compared to United's pre-buyout cost of 9.3 cents.¹⁵⁰ United's new airline-within-an-airline, United Shuttle, is aiming for 7.4 cents per available seat-mile, a sharp reduction in costs made possible by the employee buyout.¹⁵¹ After achieving comparable costs, United Shuttle hopes that its low fares, amenities and broader frequent flier perks will draw customers from Southwest, despite Southwest's more frequent flights.¹⁵² The ability to compete successfully with Southwest is vital to United's future, because competition with Southwest in 20% of United's markets turned what would have been a \$700 million profit into a \$1 billion loss for United in 1992.¹⁵³

Although United will enjoy lower labor costs over the next five years, it will have to reckon with the issue of employee wages again after the five-year buyout period expires. United will surely want to maintain the lower labor costs that it enjoyed during the buyout period, but it will have to find a new bargaining incentive to offer the employees because offering more stock will probably not be an attractive inducement. United publicly acknowledged this challenge in a list of factors upon which the success of the buyout was dependent, including "enduring cost savings through . . . the renegotiation of labor agreements at the end of the investment period. . . ."¹⁵⁴

B. PRODUCTIVITY GAINS

This section discusses another major reason for awarding employee ownership of an airline—arguably employees will work harder and smarter. Following a buyout, employees not only have their jobs riding on the survival of the airline, but their compensation and pensions depend on its survival and profitability.

¹⁵⁰ Kenneth Labich, *Will United Fly?*, FORTUNE, Aug. 22, 1994, at 70.

¹⁵¹ Wendy Zellner et al., *Dogfight Over California*, BUS. WK., Aug. 15, 1994, at 32.

¹⁵² *Id.*

¹⁵³ Labich, *supra* note 150, at 70.

¹⁵⁴ UNITED AIR LINES INC., SEC FORM 10-Q FOR THE QUARTER ENDED SEPT. 30, 1994 18. United also cited the following factors:

[T]he state of the competitive environment in the airline industry, competitive responses to United's efforts, United's ability to achieve enduring cost savings through productivity improvements . . . and, in the case of the Shuttle by United, United's ability to deliver a product which is competitive in both qualitative and price terms and which is accepted by the marketplace.

Id.

Although there is only a limited amount of empirical evidence, and what is available is disputed by commentators or contradicted by other studies, several studies performed in the late seventies and early eighties reached the following conclusions about the companies sampled in the respective survey:

1. Companies with ESOPs were 150% as profitable as comparable conventional companies without them;
2. Over a five-year period, employee ownership companies had twice the average annual productivity rate of comparable conventional companies studied;
3. Majority employee-owned companies generated three times more net new jobs than comparable conventional companies;¹⁵⁵
4. Companies featuring ESOPs with high worker participation grew 11% to 17% faster than similar firms with little or no worker involvement (although only one-fourth of ESOPs actually increase worker participation in the company).¹⁵⁶

Although commentators have attacked the credibility of such limited empirical evidence, one concept appears fairly uniform: a company should combine employee ownership with greater employee participation in the management of the company to maximize gains in productivity.¹⁵⁷ Mere partial ownership of the company may not be enough to motivate employees to make the necessary changes required to increase productivity. Michael Quarrey and Corey Rosen, who analyzed the results of nine major studies of employee ownership's impact on corporate performance, stressed this concept when they summarized their findings:

The studies come to a very clear consensus. Employee ownership can, in fact, substantially improve corporate performance, but only when combined with 'participative management' programs. By this, the researchers mean programs for employees to have regular and meaningful input into decisions affecting their work. Self-managing teams, employee participation groups, employee advisory committees, and similar structures are often used to accomplish this. Absent this input, employee ownership has no consistent impact on performance. This does not suggest, however, that employee participation itself is adequate. The research

¹⁵⁵ Moberly, *supra* note 21, at 774.

¹⁵⁶ Alex Kotlowitz & Ed Bean, *Spate of Corporate Buy-Outs by ESOPs Raises Questions of Benefits to Workers*, WALL ST. J., Sept. 30, 1987.

¹⁵⁷ Hyde, *supra* note 101, at 173.

on the impact of participation on performance is ambiguous, indicating that it will have an impact only in some cases.¹⁵⁸

Professor Hyde also believes that productivity increases from employee ownership are more apparent in companies that have experienced past conflicts between management and labor, such as United and most of the other airlines.¹⁵⁹ United is surely hoping that employee ownership will improve service indicators such as their on-time performance, which has suffered in the past because of distractions related to failed buyout attempts and labor disputes.¹⁶⁰

A company may also experience increased productivity when employee ownership motivates employees to not only reduce their own "shirking"—which includes goofing off, and, in a broader sense, not taking opportunities for improving their employer—but also to monitor other employees.¹⁶¹ Employee ownership may have the effect of an extra layer of supervision over employees, without the extra labor costs of additional supervisors. In addition, workers with an ownership stake should be more likely to invest in firm-specific education or other investments of their time, energy, or savings that are specific to the firm.¹⁶² Such firm-specific investments by employees may also reduce turnover, resulting in additional productivity gains by not having to continuously train new employees.

At least one commentator has questioned, however, the assumption that productivity increases with employee ownership of a company for four reasons:

1. Employees may become discouraged and discontinue performing their job as efficiently as possible after watching outside market forces cause declines in the company's stock price, despite lower labor costs and productivity gains resulting from the employee ownership;
2. After noticing that other employees have become more concerned with reducing waste, certain employees may become less concerned (because someone else is worrying about productivity), offsetting the others' gains;

¹⁵⁸ MICHAEL QUARRY & COREY M. ROSEN, *THE NATIONAL CENTER FOR EMPLOYEE OWNERSHIP, EMPLOYEE OWNERSHIP AND CORPORATE PERFORMANCE* 1 (1995).

¹⁵⁹ Hyde, *supra* note 101, at 174.

¹⁶⁰ Judith Valente & Randall Smith, *United Effort: Unions' Bid for UAL Requires Less Debt But Carries New Risks*, WALL ST. J., Apr. 9, 1990, at A1.

¹⁶¹ Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749, 1761-62 (1990).

¹⁶² Hyde, *supra* note 101, at 201.

3. The amount of stock held in the employee's individual account will probably be small, which will affect their perception of the ESOP's reward;
4. The exclusion of employees from ESOP investment choices and the lack of full information disclosure to the employees is likely to reduce motivation.¹⁶³

C. IMPROVED EMPLOYEE RELATIONS

Employee ownership may also improve employee relations within a company. This intangible benefit is difficult to quantify in the same manner as lower labor costs or productivity gains, but may nevertheless contribute to the firm's survival. This may be especially so in companies that periodically have to negotiate new contracts with employee unions.

Worker participation in the management of a company may improve employee relations in a variety of ways. First, workers may derive satisfaction from the process of collective decision-making quite apart from the character of the decisions reached.¹⁶⁴ Second, employee ownership creates a joint goal of maximizing profits and strengthening the firm, which may reduce the inherent adversarial relationship between the employees and the firm—created by the employees' goal of maximizing wages and benefits and the firm's conflicting goal of minimizing the same.¹⁶⁵ Third, workers may gain psychological satisfaction from the sense of being in control, which their participation in firm decision-making enhances.¹⁶⁶ Fourth, employee involvement in collective decision-making within the firm may be useful training for participation in democratic political processes in the larger society, which both the workers and the rest of society should value.¹⁶⁷ Obviously, these benefits only occur in a company that has input from employees in its decision-making process, rather than mere stock ownership by employees without any true managerial input into matters affecting their company's direction.

¹⁶³ Michael W. Melton, *Demythologizing ESOPs*, 45 TAX L. REV. 363, 385-86 (1990).

¹⁶⁴ Hansmann, *supra* note 161, at 1769.

¹⁶⁵ *Id.* at 1769-70.

¹⁶⁶ *Id.* at 1770.

¹⁶⁷ *Id.*

D. FAVORABLE POLITICAL ENVIRONMENT

Discussion of the favorable legislation and tax treatment that Congress has given ESOPs is important because ESOPs were created by statute and are wholly dependent on federal tax subsidies for their existence.¹⁶⁸ As mentioned earlier, Kelso and others have promoted ESOPs since the 1950s, although the substantial federal tax subsidies that Congress has granted to ESOPs since 1974 has caused their increased popularity in the last two decades.¹⁶⁹ ESOPs cost the federal government \$2.5 billion in tax revenues in 1986 and approximately \$4.4 billion in 1990.¹⁷⁰

Although a discussion regarding whether ESOPs are worthy of these generous subsidies is beyond the scope of this Comment, at least one commentator has concluded that ESOPs have failed to meet the original policy goals found in the legislative history supporting their statutory creation.¹⁷¹ Members of the House Ways and Means Committee, which introduced legislation to limit the principal tax subsidy to ESOPs (the 50% lender interest exclusion on ESOP debt, discussed below), apparently share this view.¹⁷² This legislation, designed to lessen an estimated \$8 billion loss of tax revenues over a 5-year period, along with other such legislation, could possibly reduce the popularity of ESOPs.¹⁷³ Despite the criticism of tax incentives awarded to ESOPs, these incentives continue to be a substantial benefit of employee ownership, and warrant a discussion of the tax advantages currently available to companies with ESOPs under the existing legal framework.

All ESOPs must satisfy certain qualification requirements of I.R.C. section 401(a) to enjoy the tax advantages available under the code.¹⁷⁴ For instance, the employee must have the choice of either receiving benefits in cash, based on the fair market value of the stock, or receiving shares of the stock directly.¹⁷⁵ In addition to such qualification requirements, there are numerous re-

¹⁶⁸ Elana R. Hollo, Note, *The Quiet Revolution: Employee Stock Ownership Plans and Their Influence on Corporate Governance, Labor Unions, and Future American Policy*, 23 RUTGERS L.J. 561, 592 (1992).

¹⁶⁹ Hansmann, *supra* note 161, at 1797.

¹⁷⁰ Hollo, *supra* note 168, at 592.

¹⁷¹ *Id.* at 594.

¹⁷² Hansmann, *supra* note 161, at 1816 nn.205-06.

¹⁷³ *Id.* at 1812, 1816 n.205.

¹⁷⁴ Spector, *supra* note 11, at 765.

¹⁷⁵ I.R.C. §§ 409(h), 4975(e)(7) (1988).

strictions placed on leveraged ESOPs.¹⁷⁶ The loan made to the ESOP must meet the following requirements along with other restrictions: primarily benefit plan participants and beneficiaries; bear a reasonable rate of interest; feature terms comparable to an arm's length transaction between independent parties; and the ESOP may only use the proceeds to purchase qualified employer securities, such as publicly-traded common stock, if the company has such stock.¹⁷⁷

Employer contributions to an ESOP or any other qualified plan are deductible by the employer.¹⁷⁸ This effectively permits an employer to repay the principal of a bank loan to a leveraged ESOP on a pre-tax basis.¹⁷⁹ In addition to the employer deducting the ESOP contributions used to repay the loan, I.R.C. section 133 permits the lender to exclude fifty percent of the interest income that it receives on loans made to leveraged ESOPs for the purpose of acquiring employer securities.¹⁸⁰ This allows the ESOP to obtain a lower interest rate from the lender, possibly reducing financing costs by as much as one-third.¹⁸¹

Congress placed a significant restriction on section 133 by making this benefit available only when the leveraged ESOP owns more than 50% of the company's stock, along with other restrictions.¹⁸² This limitation, added in 1989, "suggests that Congress may be interested in limiting special tax treatment to cases where the ESOP holds a meaningful portion of the employer's stock, and may be moving away from the prior approach which valued any employee stock ownership, even a minority interest in a closely held company."¹⁸³ United may have considered this factor when it structured its buyout to award employees a majority of its stock.

¹⁷⁶ Spector, *supra* note 11, at 765. A leveraged ESOP acts as a corporate financing vehicle by allowing the company to borrow through the ESOP.

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

¹⁷⁹ *Id.* (citing I.R.C. § 404(a)(3)).

¹⁸⁰ *Id.*

¹⁸¹ William R. Levin, *The False Promise of Worker Capitalism: Congress and the Leveraged Employee Stock Ownership Plan*, 95 YALE L.J. 148, 156 (1985).

¹⁸² Melton, *supra* note 163, at 408.

¹⁸³ *Id.* at 408-09. Congress may also be yielding to the many critics of the generous subsidies that leveraged ESOPs receive, such as William Levin, who attack Congress's three justifications for favorable treatment of leveraged ESOPs: subsidized financing creates wealth for employees; the leveraged ESOP program distributes future wealth over a broader base; and increased ownership improves productivity. Levin, *supra* note 181, at 159.

Another tax advantage to corporations with ESOPs is the deductibility of dividends paid on stock held by the ESOP.¹⁸⁴ This avoids the double taxation that usually occurs when a corporation pays dividends to its stockholders.

Along with tax subsidies and other favorable legislation Congress has granted ESOPs in the past two decades, ESOPs also appear to have the support of the Clinton administration. Following the United buyout, U.S. Labor Secretary Robert Reich remarked: "This is a landmark agreement. United's shareholders have signaled to corporate boards and shareholders throughout the country that employee ownership can renew companies and preserve jobs."¹⁸⁵ In early 1995, Transportation Secretary Federico Peña unveiled several changes the Clinton administration was proposing for the airline industry, and on the list he included "examining ways to encourage more employee ownership of airlines, along the lines of United Airlines' recent accord with its workers."¹⁸⁶

Along with the blessing ESOPs have received from Congress and the Clinton administration on the federal level, several states have enacted broadened ownership assistance acts (BOAAs) encouraging employee ownership through ESOPs.¹⁸⁷ The BOAAs range from simple declarations of the state's policy to broaden the base of capital ownership through ESOPs, to legislation supporting broadened employee ownership through securities and tax law reforms.¹⁸⁸ Employee ownership assistance acts are similar to BOAAs, but legislatures specifically designed them to encourage employee ownership to prevent a plant closure.¹⁸⁹ Such legislation demonstrates the favorable political environment that ESOPs currently enjoy at both the federal and state levels.

¹⁸⁴ Glick, *supra* note 10, at 243.

¹⁸⁵ Ziemba, *supra* note 1, at 14. Reich also noted that "[f]or years, top CEOs' incomes have been linked to stock prices. Now, even blue-collar workers at the bottom of the totem pole will be reading the daily quotes in the New York Stock Exchange." Jones & Schmit, *supra* note 41, at B1.

¹⁸⁶ Kevin G. Salwen & David Wall, *Pena Unveils Proposal for Corporation to Manage Air-Traffic Control System*, WALL ST. J., Jan. 7, 1994, at A2.

¹⁸⁷ Virginia L. Duquet, Note, *Advantages and Limitations of Current Employee Ownership Assistance Acts to Workers Facing a Plant Closure*, 36 HASTINGS L.J. 93, 106 (1984).

¹⁸⁸ *Id.* at 106-07.

¹⁸⁹ *Id.* at 107.

VI. DISADVANTAGES OF EMPLOYEE-OWNED AIRLINES

A. REQUIRES COMPROMISE AMONG DIFFERENT
EMPLOYEE GROUPS

As the United buyout demonstrates, it is difficult to package an employee buyout in a manner that satisfies the airlines' four major employee groups: pilots, mechanics, flight attendants, and non-union employees. United has more than 17,000 flight attendants, and their union has refused to participate in the buyout because of United's decision to establish flight attendant bases in foreign countries.¹⁹⁰ At the time that talks broke down in September 1994, United had sought a \$416 million investment from its flight attendants in exchange for a 13% stake in UAL and a seat on the board of directors.¹⁹¹ Following the lead of their counterparts at United, in June 1995, USAir flight attendants turned down an offer to exchange nine percent of their pay for a twenty percent equity stake to be divided among all of USAir's employees.¹⁹² Kiwi's new CEO is considering adding a board seat for its flight attendants because of their resentment for the pilots' management of the airline.¹⁹³

The participation of the flight attendants, the front-line employees of an airline, is crucial for the public's perception that an employee buyout is working.¹⁹⁴ The flight attendants are in contact with, and making impressions upon, United's 182,000 daily passengers.¹⁹⁵ Morale would also suffer at United if the flight attendants continue to receive scheduled pay increases that other employees gave up in return for employee owner-

¹⁹⁰ Judy Ward, *United Front*, FIN. WORLD, Sept. 1, 1994, at 27. United has obtained wage concessions in exchange for stock from approximately 800 of its 6300 employees abroad. Michael J. McCarthy, *Top 2 UAL Officers Got \$17 Million in '94 Stock Options*, WALL ST. J., Apr. 5, 1995, at B4.

¹⁹¹ Ramon Lopez, *Cabin Crew Alone at United/TWA*, FLIGHT INT'L, Sept. 14, 1994. At the time the flight attendants' union formally disbanded its negotiating committee, it issued a statement citing the reason as "flight attendants were not receiving sufficient value for their proposed concessions." *United Airlines Names Magary to be President of Short-Haul Shuttle*, WALL ST. J., Sept. 1, 1994, at B5.

¹⁹² Carl Quintanilla & Michael J. McCarthy, *Airlines: A Survey*, WALL ST. J., Aug. 22, 1995, at A1.

¹⁹³ Quintanilla, *supra* note 94, at B4.

¹⁹⁴ Ward, *supra* note 190, at 27. As Professor Dempsey puts it: "Happy employees can give passengers a lovely trip, and lure them back for another, and another. Angry, embittered employees can do the opposite." Dempsey, *supra* note 145, at 26.

¹⁹⁵ Rose & Norton, *supra* note 136, at A1.

ship.¹⁹⁶ It is also necessary for United's last major union group to join the buyout to avoid the untenable prospect of a union going on strike against a union-owned company.¹⁹⁷ To avoid this situation, observers believe that United will probably continue trying to include the flight attendants in the buyout before their union contract expires in the spring of 1996.¹⁹⁸

Each of United's two union groups that participated in the buyout had a substantial number of opponents. Dissident pilots circulated a survey claiming that 1,250 of 1,700 pilots polled opposed the buyout.¹⁹⁹ The mechanics voted to approve the buyout by a narrow fifty-four percent majority, with dissidents going to court in an unsuccessful last-minute attempt to block the deal.²⁰⁰ In addition, the Aircraft Mechanics Fraternal Association focused on the resentment surrounding the buyout when it campaigned to replace the International Association of Machinists, United's largest union, as the union representing United's mechanics.²⁰¹ Although the buyout contract binds whichever union represents the mechanics, the union battle has further divided the mechanics at a time when management would like to have labor harmony and a focus on improving customer service.²⁰² The union leaders of these two important union groups, both the pilots and mechanics, must mend their internal rifts in order for United's buyout to work.

There were also many dissatisfied members of United's fourth employee group—its 28,000 non-union employees.²⁰³ The complaints ranged from the perception that the non-union employees were forced into the buyout without the benefit of a vote, to the notion that their 8.25% pay cut was deeper than the two participating union groups' higher percentages because those employees had enjoyed substantially higher salaries prior to the buyout.²⁰⁴ Outgoing Chairman Stephen M. Wolf replied to this criticism by stating that the non-union employees would have

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

¹⁹⁸ *Id.*

¹⁹⁹ Labich, *supra* note 150, at 72.

²⁰⁰ *Id.*

²⁰¹ Michael J. McCarthy, *UAL's United Could Face an Upheaval by Mechanics as They Vote on a Union*, WALL ST. J., Dec. 15, 1994, at B9.

²⁰² *Id.*

²⁰³ Labich, *supra* note 150, at 72.

²⁰⁴ *Id.*

suffered the most in a downsizing if the buyout did not occur.²⁰⁵ Wolf's justification did not appear to convince the six nonunion reservation agents who filed a lawsuit, which is pending in federal court in Atlanta, to try to overturn the concessions that their group gave up in the buyout.²⁰⁶

B. LIMITS OPTIONS AVAILABLE TO MANAGEMENT

In some cases, awarding ownership to employees in return for wage concessions may limit certain options that would otherwise be available to the company's management. The United buyout contained the following agreements that restrict the carrier's operational flexibility: job protection for participating union members, prohibitions against selling a Denver training center and certain maintenance facilities, and restrictions on the sharing of computer reservation system codes with other domestic and international airlines.²⁰⁷ These concessions are not without critics. Standard & Poor's Ratings Group and Moody's Investors Service Inc. cited "reduced management flexibility" and "concern over the company's future financial flexibility" for their negative ratings of UAL securities following the buyout.²⁰⁸

Indeed, these restrictions may already be hampering United in its possible merger with USAir. The no-layoff guarantees that were granted to United's workers would restrict its ability to reduce its workforce if it added the 45,000 USAir workers.²⁰⁹ The decision-making granted to United's employees in the buyout may also impede a merger with USAir.²¹⁰

²⁰⁵ The buyout preserved many of the non-union jobs. Ott, *supra* note 35, at 20.

²⁰⁶ McCarthy, *supra* note 37, at A8.

²⁰⁷ Ott, *supra* note 35, at 20.

²⁰⁸ McCarthy & Quintanilla, *supra* note 1, at A6. Even United acknowledges that the buyout will limit the options available to management:

The new labor agreements and governance structure could inhibit management's ability to alter strategy in a volatile, competitive industry by restricting certain operating and financing activities, including the sale of assets and the issuance of equity securities and the ability to achieve additional reductions in wages and benefits. UAL's ability to react to competition may be hampered further by the fixed long-term nature of these various agreements.

UNITED AIR LINES INC., SEC FORM 10-Q FOR THE QUARTER ENDED SEPT. 30, 1994 19.

²⁰⁹ Carl Quintanilla et al., *USAir Merger Discussions Could Spark a Consolidation Movement by Airlines*, WALL ST. J., Oct. 4, 1995, at A4.

²¹⁰ *Id.*

Along with limiting the options available to management, many experts fear the direction that management might take after a buyout: that employee-owners will manage the airline to fulfill workers' needs, not customers.²¹¹ One expert doubts whether union-elected directors could make the tough cost-cutting and layoff decisions, stating that "I don't think they'll have the necessary discipline."²¹² One United director voiced concern about the owner-employees pushing for unprofitable growth, expressing "I'm worried the employees, with a few good quarters under their belt, will want to start buying more planes."²¹³ Of course, in the United transaction, only three of UAL's twelve directors represent employees, which reduces the fear that union directors will significantly shift the focus of United's management.

C. RISKS TO EMPLOYEES

A disadvantage to employee ownership from the employees' perspective is the inherent risks involved in trading wage increases and other benefits for ownership of the airline. Professor Hyde believes that employees' risk aversion is the single greatest problem with employee ownership and the single greatest obstacle to its wider spread.²¹⁴ After all, employees of many companies already depend on their employers' continued existence for wages, health care and other benefits, retirement security, and possibly even maintaining the market value of their home.²¹⁵ Why should the employees take on any more risks associated with the failure of their company by actually buying the company?

Hyde attributes the historical low incidence of worker ownership in most industries and the tendency of worker-owned firms to revert to private ownerships to this risk aversion.²¹⁶ Employ-

²¹¹ Jones & Schmit, *supra* note 41, at 1B. Gerald Greenwald, the new CEO at United, strongly disagreed with this concern during another UAL buyout attempt, when he stated that (assuming the buyout would take place) "professional management—not union leadership—will run the airline." Gerald Greenwald, *Letters to the Editor: Union-Run United an ESOP Fable*, WALL ST. J., Aug. 3, 1990, at A11. Greenwald further argued that research of other employee-owned companies would reveal that neither union politics nor short-term planning typifies the management of such firms. *Id.*

²¹² Jones & Schmit, *supra* note 41, at 1B.

²¹³ McCarthy, *supra* note 37, at A1.

²¹⁴ Hyde, *supra* note 101, at 205-06.

²¹⁵ *Id.* at 203.

²¹⁶ *Id.*

ees may justify their risk aversion by looking back to the growth of employee stock ownership in the 1920s—and the millions of dollars lost by employees after the 1929 market crash.²¹⁷

When employees agree to concessions-for-stock buyouts they are gambling their future incomes and pensions on hopes of the airline achieving stability, profitability, and stock appreciation. For the United employees, the price of UAL's stock determines how much stock the employees receive in return for their wage concessions.²¹⁸ The employees missed an opportunity to receive an additional eight percent stake in United because UAL's stock failed to reach the required level.²¹⁹ Eastern and other such airline failures serve as prime examples of employees losing their gamble with airline stock ownership. Professor Paul S. Dempsey, Director of the Transportation Law program at the University of Denver College of Law and president of Americans for Sound Aviation Policy, warns that "[n]o employee should bet his kids' college education on the stock certificates which replace what was once in his pay envelope."²²⁰ He pessimistically views the trend towards employee ownership in the airline industry as employees "exercising the opportunity to own a piece of the rock in an industry falling like one."²²¹

Professor Dempsey has good reason for concern. An airline is probably experiencing financial difficulties if it is even entertaining a concessions-for-stock trade, so it is questionable how desirable it would be to become a part-owner. The counter-argument is, of course, that it is better to have lower wages and risky stock ownership than no job at all.

D. ERISA ISSUES

Another disadvantage of employee ownership through an ESOP is the restrictions imposed on ESOPs by the Employee Retirement Income Security Act of 1974 (ERISA).²²² ERISA's classification of ESOPs as retirement plans is interesting, given Senator Long's statement introducing the Employee Ownership Act of 1983: "The ESOP's primary purpose, however, is not to serve as a retirement vehicle but, rather, to serve as an incentive for corporations to structure their financing in such a way that

²¹⁷ *Id.* at 204.

²¹⁸ McCarthy, *supra* note 37, at A8.

²¹⁹ *Id.*

²²⁰ Dempsey, *supra* note 55, at A11.

²²¹ *Id.*

²²² Pub. L. No. 93-406, 88 Stat. 829 (1974).

employees can gain an ownership stake in the company for which they work."²²³ ESOP inventor Louis Kelso persuaded Senator Long to include ESOPs in ERISA in 1974.²²⁴ Kelso "would have preferred that ESOPs not be considered retirement plans, but ERISA was the vehicle that was most available and practical at the time."²²⁵ If Congress had not classified ESOPs as retirement plans, they would have had to stand on their own to justify their special tax treatment.²²⁶

ERISA rules conflict with ESOP goals in the following three areas: 1) investment diversification requirements; 2) prohibited transaction rules; and 3) restrictions on the price at which an ESOP may purchase stock.²²⁷ Exceptions within ERISA have resolved the practical conflicts in the first and second areas, yet the policy conflicts remain.

Central to any retirement plan investment strategy is the desire to maximize return and minimize risk.²²⁸ Theoretically, acquiring stock in a variety of companies with different risk characteristics reduces the risk that a certain company's stock will decrease in value.²²⁹ ERISA adopted this policy by requiring that the assets of a retirement plan be diversified.²³⁰ ERISA, however, exempts ESOPs from the diversification requirement because ESOPs have a separate requirement that they must invest primarily in employer stock.²³¹

There is a substantial risk to ESOPs investing all of the employees' savings in the employer's stock. In a corporate liquidation, employees' status as shareholders places them behind even unsecured creditors in their claims on the assets of the company.²³² Although the risk of loss is higher when plan investments are not diversified, ESOP proponents argue that the risk is necessary and acceptable because diversification of the ESOP

²²³ Melton, *supra* note 163, at 419 n.124 (quoting 129 CONG. REC. S16,637 (daily ed. Nov. 17, 1983)).

²²⁴ *Id.*

²²⁵ *Id.* (quoting Corey Rosen, *How Well Are ESOPs Working?*, 28 TAX NOTES 1605, 1606 (Sept. 30, 1985)).

²²⁶ *Id.* at 394.

²²⁷ *Id.* at 389.

²²⁸ Melton, *supra* note 163, at 389.

²²⁹ *Id.*

²³⁰ *Id.*

²³¹ *Id.*

²³² Melton, *supra* note 163, at 390. To a limited extent unsecured claims for contributions to pensions and other retirement benefits are priority claims in bankruptcy. *Id.* at 390 n.132 (citing 11 U.S.C. § 507(a)(4) (1988)).

portfolio eliminates the alignment of employee interests with shareholders.²³³ ESOPs' absence of investment diversification, however, runs counter to a basic goal of retirement income policy.²³⁴

A second conflict exists between ERISA's prohibited transactions' rules and an ESOP's investment in the stock of the employer-sponsor.²³⁵ Retirement plans are separate entities from the plan sponsor, and ERISA prohibits certain transactions with that sponsor.²³⁶ Similar to diversification requirements, ERISA allows an exception from the prohibited transaction rules for an ESOP's investment in the stock of the sponsor.²³⁷ But a retirement plan's ownership of the employer-sponsor's stock arguably defeats ERISA's goal of maintaining independence from the employer-sponsor.

A third area of conflict between ERISA and ESOP involves the requirement that retirement plans pay "adequate consideration" when acquiring employer stock.²³⁸ ERISA defines adequate consideration as follows: 1) for public securities it is the price "prevailing on a national securities exchange," and 2) for private securities it is "the fair market value of the asset as determined in good faith" by a plan fiduciary.²³⁹

ERISA's adequate consideration provision killed certain transactions that otherwise met the policy goals of ESOPs.²⁴⁰ The Senate Finance Committee proposed legislation in the past to exempt ESOPs from the adequate consideration provisions of ERISA, but Congress ultimately deleted that portion of the legislation.²⁴¹ The adequate consideration provision is another example of ESOPs' employee ownership goals conflicting with ERISA's retirement plan goals.

²³³ *Id.* at 390.

²³⁴ *Id.*

²³⁵ *Id.* at 391.

²³⁶ Melton, *supra* note 163, at 391.

²³⁷ *Id.*

²³⁸ *Id.* at 392 (citing 29 U.S.C. § 1108(e)(1) (1994)).

²³⁹ *Id.* n.143 (quoting 29 U.S.C. § 1002(18) (1994)).

²⁴⁰ *Id.* at 393 (citing the failed leveraged buyout of Scott & Fetzer Co., which the Department of Labor stopped because the consideration to be paid by the ESOP for its percentage of the company was too high, resulting in an unfair deal for employees).

²⁴¹ Melton, *supra* note 163, at 393-94.

E. SECURITIES REGULATIONS

In addition to the ERISA requirements, companies structuring employee ownership through ESOPs must also consider the applicability of the federal securities laws. The courts are split on the issue of whether participants' interests in ESOPs are "securities" within the meaning of the federal securities laws.²⁴² The importance of this determination on ESOP transactions warrants a brief background of the federal securities laws and a look at the different courts' analyses in the seminal cases that address the issue of whether an ESOP constitutes a security.

As a general rule, purchasers of securities are entitled to the protections afforded by the Securities Act of 1933, [as amended,²⁴³] (1933 Act) and the Securities Exchange Act of 1934, [as amended,²⁴⁴] (1934 Act) [(collectively referred to as "the Acts")²⁴⁵]. These protections include mandatory disclosure of financial information necessary to make an informed investment decision as well as broad remedies entitling investors to redress for any [materially] false or misleading statements made in connection with the purchase or sale of [securities].²⁴⁶

Arguably, these disclosures would especially benefit blue-collar union employees, like many of those currently participating in employee buyouts in the airline industry because these employees are probably "unsophisticated in the intricacies of the financial markets, and . . . would probably not otherwise own financial securities."²⁴⁷ The protections afforded by the Acts are only available, however, when the particular investment being offered fits the Acts' definition of a security.

One approach used by the courts in determining whether an ESOP interest is a security is the application of the *Howey* test, named after the United States Supreme Court case *SEC v. W.J. Howey Co.*²⁴⁸ This test, used to determine whether an instrument qualifies as an investment contract and thus subject to the Acts contains three prongs: 1) the instrument involves an investment of money; 2) it is an investment in a common enterprise; and 3)

²⁴² Sean S. Hogle, Note, *The Employee as Investor: The Case for Universal Application of the Federal Securities Laws to Employee Stock Ownership Plans*, 34 WM. & MARY L. REV. 189, 191 (1992).

²⁴³ 15 U.S.C. §§ 77a-77mm (1988).

²⁴⁴ *Id.* §§ 78a-78kk.

²⁴⁵ Hogle, *supra* note 242, at 190.

²⁴⁶ *Id.*

²⁴⁷ *Id.* at 191.

²⁴⁸ 328 U.S. 293 (1946).

there is a reasonable expectation of profits to be derived from the managerial or entrepreneurial efforts of others.²⁴⁹

The Supreme Court applied the *Howey* test to an employee benefit pension plan in *International Brotherhood of Teamsters v. Daniel*.²⁵⁰ The plan in *Daniel* was “involuntary,” meaning all union members had to accept the plan as a condition of employment if a majority of employees voted to participate in it, and “noncontributory,” meaning the employees paid nothing to the plan on an individual basis, although they did relinquish an unspecified amount of higher wages.²⁵¹ According to the Court, the plan failed the first and third prongs of the *Howey* test.²⁵² First, the wages given up by the employees were not a significant enough portion of the employees’ total compensation to constitute an “investment.”²⁵³ Second, the transaction failed the “expectation of profits” prong because the plan derived eighty percent of its income from employer contributions, not investment profits, and the realization of plan benefits depended on meeting vesting requirements, not the fund’s investment success.²⁵⁴ The Court added that ERISA already regulated this type of noncontributory, involuntary plan, and neither congressional intent nor actions by the SEC indicated that they meant for the Acts to cover such pension plans.²⁵⁵

In *Landreth Timber Co. v. Landreth*, the Supreme Court adopted a textual approach to determine whether the Acts apply to a certain transaction or investment.²⁵⁶ The Court noted that the language itself is the starting point for interpreting any statute.²⁵⁷ Because *Landreth* involved the sale of stock, though the label of the instrument is not determinative, and the definitional provisions of the Acts contained the term “stock,” the instrument at issue must possess the traditional characteristics of stock; they include the distribution of dividends, appreciability, and voting rights.²⁵⁸ Subsequent to *Landreth*, courts only use the *Howey* test in cases involving unusual instruments that the other

²⁴⁹ Hogle, *supra* note 242, at 196.

²⁵⁰ 439 U.S. 551 (1979).

²⁵¹ Hogle, *supra* note 242, at 197 (citing *Daniel*, 439 U.S. at 553).

²⁵² *Id.* at 197-99.

²⁵³ *Id.* at 198.

²⁵⁴ *Id.*

²⁵⁵ *Id.* at 198-99.

²⁵⁶ Hogle, *supra* note 242, at 199.

²⁵⁷ *Id.* at 200.

²⁵⁸ *Id.*

specifically enumerated securities listed in the Acts do not describe, including ESOP interests.²⁵⁹

Several cases have arisen since *Landreth* requiring the courts to analyze whether a concessions-for-stock trade falls under the Securities Acts. Two such cases used the *Howey-Daniel* test with conflicting outcomes: *Childers v. Northwest Airlines, Inc.*,²⁶⁰ holding that the Acts were inapplicable, and *Useton v. Commercial Lovelace Motor Freight, Inc.*,²⁶¹ holding a ESOP to be a security, thus making the Acts applicable.²⁶² An important fact distinguishes the cases as to the investment prong of the test. In *Childers* the union vote bound all its employees to the involuntary wage-ESOP swap, while in *Useton* the individual employees could decide whether or not to participate.²⁶³ The *Useton* case probably would have come out the same as *Childers*, finding no existence of a security thereby rendering the Acts inapplicable, had the employer required that its employees vote collectively to participate in the plan, which is probably the majority method for adopting a concession-for-stock trade.²⁶⁴

These two cases also differed in the the "expectation of profit" prong. The *Useton* court held that the employees were relying on the efforts of their employer's management for profit, thus satisfying the prong.²⁶⁵ The *Childers* court, however, held that the employees were merely relying on the financial recovery of the company as a whole for stock appreciation, not on the efforts of their managers, thereby failing the third prong of the test.

Two other cases dealing with the same issue held that the Acts did apply to ESOPs formed through concessions-for-stock trades, basing their analyses on the *Landreth* approach instead of the *Howey-Daniel* test.²⁶⁶ Both *Hood v. Smith's Transfer Corp.*²⁶⁷ and *Harris v. Republic Airlines, Inc.*²⁶⁸ held that the ESOP interest

²⁵⁹ *Id.* at 202.

²⁶⁰ 688 F. Supp 1357 (D. Minn. 1988).

²⁶¹ 940 F.2d 564 (10th Cir.), *cert. denied*, 502 U.S. 983 (1991).

²⁶² Hogle, *supra* note 242, at 215-16.

²⁶³ *Id.* at 216-17.

²⁶⁴ *Id.* at 217.

²⁶⁵ *Id.*

²⁶⁶ *Id.* at 222-25.

²⁶⁷ 762 F. Supp. 1274 (W.D. Ky. 1991).

²⁶⁸ [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,772 (D.D.C. May 18, 1988).

constituted stock, which is a security within the definitions provided in the Acts.²⁶⁹

In light of the uncertainty in this area, a company contemplating the formation of an ESOP or a concessions-for-stock trade should probably comply with the registration requirements of the Securities Acts. Although this adds time and expense to the buyout process, it provides the employees with the disclosures necessary for an informed decision and helps avoid future litigation resulting from the transaction.

F. OTHER LEGAL OBSTACLES

The National Labor Relations Act (NLRA)²⁷⁰ also impedes employee ownership in collective bargaining through its limitations regarding information disclosure and subjects of bargaining.²⁷¹ Information regarding the company's operation and financial condition is important both during negotiations for employee ownership, and in implementing employee ownership.²⁷² But, unless an employer claims an inability to pay, the NLRA fails to impose a duty to disclose financial information such as profits, costs, sales, and production levels.²⁷³ Such information is important to allow the employees to make informed decisions regarding concessions and other buyout provisions. The company may disclose such information voluntarily, but is under no requirement to do so under NLRA guidelines.

The narrow interpretation of subjects for which collective bargaining is required under the NLRA also limits the flexibility to implement employee ownership and other forms of labor-management cooperation.²⁷⁴ The "mandatory/permissive" distinction requires collective bargaining only for matters within the "mandatory category."²⁷⁵ The following matters, though certainly of importance to employees, are interpreted as "permissive": selling a business or component, disposing of assets, restructuring or consolidating operations, subcontracting, investing in labor-saving machinery, changing the methods of finance or sales, advertising, product design, and other such

²⁶⁹ Hogle, *supra* note 242, at 222-25.

²⁷⁰ 29 U.S.C §§ 151-169 (1993).

²⁷¹ Moberly, *supra* note 21, at 781.

²⁷² *Id.*

²⁷³ *Id.*

²⁷⁴ *Id.* at 782.

²⁷⁵ *Id.*

decisions.²⁷⁶ Such a narrow interpretation of mandatory leaves it up to company management to involve employees or their representatives in major corporate decisions—regardless of whether the company is employee-owned or not.

To summarize, there are numerous advantages and disadvantages of an airline implementing employee ownership. While the financial incentives of lower labor costs and favorable tax breaks are easily measurable, the intangible benefit of improved employee productivity and morale should not be underestimated. These advantages must be weighed by the airline's management and employees against the numerous hurdles to implementation, decreased flexibility, and the risks associated with trading wages for stock. There is obviously no formula for weighing the advantages and disadvantages, and each airline and its employees must consider how employee ownership would affect its unique short and long-term business plan and financial condition.

VII. THE FUTURE OF EMPLOYEE-OWNED AIRLINES

Experts expect employee ownership to continue to grow in this country: "By the year 2000, more than a quarter of the companies traded on the New York Stock Exchange, the American Stock Exchange and Over-the-Counter Market will be more than 15 percent owned by their employees."²⁷⁷

In the airline industry, other carriers recently considered concessions-for-stock trades. In July 1994, the same month as the United buyout, the pilots' union at USAir recommended to the other unions that they trade wage concessions for a minority stake in the airline and board representation.²⁷⁸ Concessions-for-stock discussions broke off, however, with both pilot²⁷⁹ and flight attendant²⁸⁰ unions. USAir, which lost more than \$3 billion in the last 6 years, has the highest labor costs in the indus-

²⁷⁶ Moberly, *supra* note 21, at 783 (citing *United Technologies v. NLRB*, 115 L.L.R.M. (BNA) 1281 (1984)).

²⁷⁷ Hyde, *supra* note 101, at 160 (quoting JOSEPH BLASI & DOUGLAS KRUSE, *THE NEW OWNERS: THE MASS EMERGENCE OF EMPLOYEE OWNERSHIP IN PUBLIC COMPANIES AND WHAT IT MEANS TO AMERICAN BUSINESS* 3 (1991)).

²⁷⁸ Carl Quintanilla, *USAir's Pilots Propose Equity for Concessions*, WALL ST. J., July 22, 1994, at A3.

²⁷⁹ Carl Quintanilla, *USAir Pilot Union Chairman Resigns After Criticism*, WALL ST. J., Oct. 11, 1995, at A4.

²⁸⁰ Quintanilla & McCarthy, *supra* note 192, at A1.

try.²⁸¹ Larger airlines have targeted USAir as a possible merger candidate.

American Airlines's CEO Robert Crandall likes the idea of employee ownership for his airline, declaring that one way or another, "major airlines must deal with the labor-cost problem."²⁸² Crandall would certainly favor such an arrangement over a strike, after the five-day strike by American's flight attendants in November 1993 cost the company \$160 million in net income.²⁸³

In January 1995, pilots at Southwest Airlines agreed to forgo pay raises for five years and accept only slight increases over the following five years in exchange for options to buy fourteen million Southwest shares over the same ten-year period.²⁸⁴ Industry analysts believe that the agreement will be a bargain for both the pilots and Southwest, with one analyst calling the terms and length of the agreement "indicative of the cooperation between Southwest pilots and its management, . . . [which] continues to stand in stark contrast to the standard, adversarial industry norm."²⁸⁵ Airlines tend to emulate Southwest, probably due to its unbroken string of profitable years since 1973.²⁸⁶ Southwest also has a history of labor peace and is one of the few major carriers that has never asked its employees for wage givebacks.²⁸⁷

Professor Dempsey predicts that virtually all of the major airlines in the United States will soon be employee-owned in order to match the cost advantage of those airlines that have already adopted employee ownership.²⁸⁸ Whether this trend will spill into other industries on such a large scale will probably depend on the success that the airline industry enjoys after it becomes employee-owned. Professor Joseph Blasi predicts that "[a]irlines will be a bellwether for the future of employee ownership in this country."²⁸⁹

²⁸¹ Quintanilla et al., *supra* note 209, at A4.

²⁸² Jones & Schmit, *supra* note 41, at B1. Crandall has openly stated that "partial employee ownership—regardless of the level—is one of the options available to help labor and management restructure. Other options may emerge elsewhere." Susan Carey, *Airline-Worker Ownership May Make a Slow Ascent*, WALL ST. J., Dec. 23, 1993, at A6.

²⁸³ Jones & Schmit, *supra* note 41, at B1.

²⁸⁴ Maxon, *supra* note 147, at D1.

²⁸⁵ *Id.*

²⁸⁶ O'Brian, *supra* note 62, at A2.

²⁸⁷ *Id.*

²⁸⁸ Dempsey, *supra* note 55, at A11.

²⁸⁹ Jones & Schmit, *supra* note 41, at B1.

VIII. CONCLUSION

As this Comment demonstrates, there are numerous advantages and disadvantages in adopting employee ownership in the airline industry. While employee ownership may prove useful in reducing labor costs and providing tax advantages in the short term, it is too early to determine whether it is the best ownership structure for the long term.

The benefit of a lower cost structure, even if for a limited period, should not be underestimated. To increase traffic, airlines reduced fares, which are lower now in real dollars than the industry's pre-1978 regulated period.²⁹⁰ Because of lower fares, the airlines that swapped stock for labor savings responded to the industry's obvious need for lower costs to achieve profitability. Airlines are relying on their new equity-for-concessions deals to varying degrees: some are trying to remain profitable, while others are counting on the savings to survive the nineties.

Though beneficial from a cost standpoint, employee ownership should not be expected to cure all of the problems in the troubled U.S. airline industry. As Professor Dempsey and other airline deregulation critics point out, a major problem with the airline industry is its "primordial tendency to engage in destructive competition."²⁹¹ Employee ownership cannot magically shield the airline from external forces such as market conditions and fuel prices. Many analysts predict that, whether employee-owned or not, some of the weaker airlines will continue to fail, especially those that lack a viable niche in the marketplace.²⁹²

To maximize the benefits of their ownership, the employees must actively participate in the airline, and not simply be silent stockholders.²⁹³ The airlines that are making stock-for-concessions deals with their employees are counting on "soft" benefits such as improved morale, productivity, and customer service, in addition to "hard" benefits such as lower labor costs and tax benefits.

²⁹⁰ Amy K. Bock, Comment, *How to Restore the Airline Industry to Its Full Upright Position: An Analysis of the National Commission to Ensure a Strong, Competitive Airline Industry Report*, 59 J. AIR L. & COM. 663, 666 (1994).

²⁹¹ Dempsey, *supra* note 55, at A11.

²⁹² McCarthy, *supra* note 77, at B6.

²⁹³ As Professor Blasi argues, "[j]ust spreading stock certificates around a restructured company is not going to do it. [The company has] to focus on the grass-roots stuff, the dirty details out of which long-term improvements are made." Rose & Norton, *supra* note 136, at A1.

This Comment does not attempt to persuade the reader that the U.S. airline industry should or should not implement employee ownership on a large-scale basis. Because of the unique characteristics of the U.S. airlines it would be difficult, perhaps impossible, to assess whether the advantages outweigh the disadvantages for each airline comprising the industry, or to make any generalizations that apply to the whole industry. The pros and cons of employee ownership must be carefully weighed by both the management and employees of each airline contemplating a buyout, and only if their expectations are realistic and they are willing to give-and-take will they look back and consider the transaction a success.

