What Are the Definitions of Employee Ownership and Employee Buyout?

The definitions that follow are based on common usage in the United States.

Employee ownership is defined by The National Center for Employee Ownership “as ownership of company stock through an ESOP, stock awards, stock purchase plans, and/or stock-based benefit plans offered in such a way that most or all employees meeting nondiscriminatory criteria, such as a requirement to work one year, are able to participate in the plan. This definition is only a term of art, however, not a legal definition, and others will define it differently.”

An employee buyout is defined by The National Center for Employee Ownership “as the purchase of a majority interest in a company by that company's employees in ways that most or all employees meeting nondiscriminatory criteria, such as a requirement to work one year, are able to participate in the plan. Most are generally accomplished in whole or in part through an ESOP structure within the employee buyout structure, leaving employees, management, investors and an ESOP trustee as the new owners of the majority interest. This definition is only a term of art, however, not a legal definition, and others will define it differently.”

Employee ownership is ownership of common or preferred stock of a publicly (open) or closely held (closed) corporation by a group of employees which includes substantially more employees than the senior executive team and key middle managers (“Management”). The term "employee owned" is reserved for a corporation that is more than 50% owned by its employees. Such firms are also called "majority employee owned." Firms with less than 51% employee ownership are commonly called "employee ownership companies," "companies with significant employee ownership," "companies with minority employee ownership," or "employee-held companies."

In an employee buyout, management and a broad group of employees complete a transaction or transactions which result in an enterprise being more than 50% owned by its employees, or a "majority employee owned enterprise." Management is included, but the buyout is not limited to Management and investors. Investors are often needed and included when a change of control (majority) buyout is necessary or desired. However, please note that some majority employee-owned firms in the U.S. that were the result of an employee buyout involved the employees making several successive purchases of stock over a number of years to effectuate the buyout, since they were unable to purchase a majority of the company at one single point in time. In a partial employee buyout, a broad group of employees complete a transaction that results in employees owning a minority of the enterprise's shares. The term "employee buyout" is used incorrectly and in a misleading fashion when it is applied to a transaction where employees gain less than a majority of shares. Such transactions can be accurately described as "providing an opportunity for employee ownership," "allowing for some employee ownership," or "providing an option of minority employee ownership." Note that an employee buyout should not be confused with trading stock for wage, benefit and work rule changes. In the last two decades, there

are numerous examples in the airline, steel, and trucking industries where employees made significant compensation concessions to save the enterprise in return for generally 15-30% of the stock of the enterprise. In only a few of these cases did the employees receive a majority of the firm's shares. On the other hand, as we shall see below, some restructuring of compensation does occur in employee buyouts.

A management buyout is a transaction that normally results in the ownership of a majority of the company by a small group of managers and investors. Management buyouts may allow for some ownership by a broad or a narrow group of other employees. This type of management buyout, where the employees play a very minor role, is typically confused with employee buyouts in transitional economies in other countries. Please note that every successful employee buyout requires some significant ownership by the management team—Management is a key element.

One common feature of employee buyouts and management buyouts in the United States is that they are typically events that take place at one single point in time, when the owners of the enterprise change, although, as noted above, some eventual employee buyouts take place in several transactions over a number of years. In the United States, this is typically accomplished through a leveraged buyout ("LBO"). In an LBO the buyers of the firm use cash to purchase the entire firm, including equity from investors, money generally borrowed from financial institutions, and when appropriate, seller financing. The firm then pays down the loans over five to seven years and the buyers, who may be managers, employees, and (or) investors, end up owning the company.

When an employee buyout occurs, the ESOP or Employee Stock Ownership Plan is the most common format used in the United States to effect an LBO by the employees resulting in a total change in control or ownership. Sometimes in leveraged buyouts an ESOP is set up that purchases minority ownership for the employees and, as noted above, this can be thought of as a partial employee buyout. Briefly, an ESOP is a trust that typically borrows the money from a financial institution in order to buy the stock on behalf of the employees of the enterprise. The trust holds the stock for all employees, although each employee has an individual stock account. Individual employees can turn their stock into cash when they leave the firm or when they retire. In U.S. law, ESOPs have been defined as very special retirement plans, as well as a technique of corporate finance, which allows them to gain certain tax incentives, and avoid many otherwise restrictive qualified retirement plan rules. The tax incentives make it far easier to effect an employee buyout.

Please note that there are several other formats that can lead to employee ownership in enterprises. They all have in common the fact that, unlike employee buyouts or partial employee buyouts, they effect gradually accumulating employee ownership and not a change in control or ownership of the enterprise at one single point in time. One is the employee share purchase plan, which allows employees to put aside money from their paycheck on a weekly basis to purchase stock at a 10-15% discount to its market price. The shares are held by individual employees. Another is a 401k plan ("401k" refers to

a section in the Internal Revenue Code), which is a qualified employee benefit defined contribution plan to which the employer and the employee contribute. It operates like an investment fund or a mutual fund that invests the employee and employer contributions in stocks, bonds, real estate, or money market funds. The employee makes contributions to this fund regularly and the employer usually matches these contributions to assist the employee in saving for his or her retirement. The employer contribution can be in the form of company stock, and the employee can also buy company stock (or be required to do so by the employer) with his or her cash contribution. Both result in gradually building employee ownership. Other versions of this defined contribution plan simply involve employee contributions to a savings plan or a profit sharing plan where the company's contribution is based on a share of its annual profits.

There are several relevant conclusions from this section on definitions: (1) Precision in the definitions in this area are important because substantial emotions, and strong economic interests often surround the discussion of employee ownership. Many people believe that employees are not viable purchasers because they "…have no money." Current tax incentives have money lining up from investors and the financial community to invest alongside the employees. Only problems and confusion will be the result of an intentional or even an unintended miscommunication about the ownership transaction; (2) Employee buyouts involve borrowing money from financial institutions and involving investors to effect LBOs.

We gratefully acknowledge the Foundation for Enterprise Development and Joseph R. Blasi of Rutgers University for their original article in March, 1993, "Employee Buyouts and Employee Ownership in the West," from which this article was derived.