Business Ethics

CORPORATE SOCIAL RESPONSIBILITY REPORT

Cover Story: Why social mission gets squeezed out of firms when they're sold, and what to do about it.

Building Mission Into Structure at Equal Exchange

Blowups at Vatex's Employee Ownership Lab

Social Programs Are at Risk as Charles Schwab Departs

Why social mission gets squeezed out of firms when they're sold, and what to do about it

By Marjorie Kelly

It was April 11, 2000 when the legacy problem burst into view. That was the day the Ben & Jerry's board was forced by law to sell the premier socially oriented firm in America to multinational Unilever, against the wishes of CEO Ben Cohen. In the three years since 4-11, Ben & Jerry's has seen its social mission begin to seep away—Unilever has laid off one in five B&J employees, stopped donating 7.5 percent of profits to the Ben & Jerry's Foundation, and hired a CEO Cohen didn't approve of. It's been a wakeup call in socially responsible business circles, where preventing mission loss when a company changes hands has become the problem of the hour.

Social firms are being sold to large public corporations in droves these days. The July news of Horizon Organic's sale to Dean Foods is only the latest in a long line of sales— Odwalla to Coca-Cola, Aveda to Estée Lauder, Stonyfield Farm Yogurt to Groupe Danone, Cascadian Farm and Muir Glen to General Mills, Seeds of Change to M&M Mars, Boca Burger to Philip Morris, Kashi to Kellogg's.

The founders of these firms, "they all lost big," says Jerry Gorde, founder of Vatex, a socially responsible promotional apparel firm in Richmond, Va. "Not in the traditional sense—most came out with more money than they will ever need. But the objective of a company as a force for change in the world, that mission is lost." Skeptical that social values can be engineered into public firms, Gorde is one of the rare entrepreneurs who understands how important ownership structures are, and how they can nurture or stifle social mission. He's worked for 20 years to make his company an ownership laboratory, and his experiments keep blowing up. (Gorde's experiments are detailed below). But he's determined to persevere, because it's not enough for him to sell and watch his firm's mission die. "I do not want to walk away with my pocket filled and my soul empty," he says.

If Gorde represents the unknowable future, where the ownership forms we need have yet to be created, Cohen represents the difficult present, where the ownership forms we have are inadequate. The struggles of these two brilliant business people signal that socially responsible business is entering a new era. The founders' era is passing. What is opening is a new era of institutionalizing social mission. Entrepreneurs have met the challenge of how to manage in socially responsible ways, but few even recognize the new challenge ahead: how to create the architectural forms that can hold social mission for generation after generation to come.

The change underway might be likened to the passage from the monarchical age to the democratic age. In a monarchy, the highest ideal is the philosopher king, the great leader who will set all things right. Democracies, by contrast, set things right by relying on system design. If social mission is to endure in companies—if we are to create an abiding socially oriented economic sector, instead of tasty morsels to be devoured by multinationals—a similar evolution must occur. Social concerns must be woven not only into management processes, but into ownership structures as well.

Companies run on the juice of the magical, visionary founder," says David Mager of Meadowbrook Lane Capital in Springfield, Mass., a socially responsible investment bank that put together an investor group that tried to buy Ben & Jerry's during the takeover battle, and which now consults with firms about the legacy issue. When a company grows large or changes hands, "then you need to build social responsibility into the various protocols and processes of the company," Mager says. "And if you don't do that it will evaporate. It will disappear if it's not institutionalized."

The task is far more difficult when a company is public, where the system design enforces a focus on one value: maximum profits. The law presumes maximum gain is all shareholders care about, and it permits Wall Street to use tactics like lawsuits and hostile takeovers to keep firms focused solely on the bottom line.

In terms of social mission, going public is thus the same as being sold outright, for both represent transition points where founders lose the ability to keep their mission front and center. "People talk about the triple bottom line. But nothing in capitalist law requires anything being done about two of those bottom lines," says Gorde. Greg Steltenpohl of Odwalla made a related observation at a Social Venture Network conference years ago, after he took his firm public. "I used to be in the business of making great juice," he said. "Now I'm in the business of making money."

Though the legacy problem is acute for public firms, it is not limited to them. Many private firms also suffer mission loss—as Jack Quarter of the University of Toronto showed in his study of 11 socially innovative private firms in six countries, published in his book Beyond the Bottom Line: Socially Innovative Business Owners. Depressingly, Quarter found that among these 11 social companies, reversion to traditional management occurred in every single case.

As companies wrestle with the legacy problem, Business Ethics plans to collect their stories over the coming year, to build a library of approaches and ideas. Watch for future articles on legacy issues, a Business Ethics Legacy Award, and possibly a national meeting. Here we offer a starting look at some early themes emerging.

1. Ownership remains primary in determining company values.

“The reality is owners get to decide” a company’s mission, emphasizes Bob Wahlstedt, co-founder of Reell Precision Manufacturing in St. Paul, an employee-owned firm committed to ethical management and employee well-being. “You can’t control what future owners will do, you can only influence who the owners will be,” he says. In recent years, the three founders of Reell have passed 30 percent of ownership to their children, 40 percent to employees, and kept 30 percent themselves. Leadership of the firm, with $21 million in revenue, has been passed to a pair of co-CEOs.

Reell—whose name means “integrity”—is an example of a successful legacy transition. Ethical practices continue at the firm, such as limiting executive pay to seven times that of entry-level workers, and donating 10 percent of profits to charity. But the real vigor of legacy was demonstrated in 2001, when the company wrestled with how to manage a 30 percent drop in revenue. Management decided to cut pay rather than make layoffs, and executives took cuts of 16 percent, mid-level workers took cuts of 7 percent, while lower-paid folks took no cuts at all. Avoiding layoffs was possible because shareholders were willing to take their own profits to zero, notes co-CEO Bob Carlson. This paid off when orders picked up and the company could resume production quickly, because a seasoned staff was on board.

Shareholders at public companies lack similar power to express humane values. “The stock market is a filter,” says Wahlstedt. “When you own stock and have values you aren’t able to get through the filter, it’s dysfunctional because it doesn’t allow owners to express what they care about.”

Kodak, for example, was not able to avoid layoffs like Reell did—even though it has a long history of social responsibility, tracing back to founder George Eastman. The company’s practice had been to reduce staff through voluntary early retirements. Then pressure came down from Wall Street and Kodak’s board in 1993 to make 10,000 layoffs. CEO Kay Whitmore refused, and he was fired. Two weeks later the cuts were made.

The moral of the story: In the long run it’s not founders or CEOs who control company mission, it’s owners.

2. Values imbedded into a business model enjoy special protection.

When Gary Hirshberg sold Stonyfield Farm, he said he believed organic ingredients and social mission were “genetically encoded” in his company, so mission was safe no matter who owned the company. That may be true, for something as integral to a product as organic ingredients. But it’s probably less true for issues peripheral to consumers—like layoffs or employee benefits—where a company can cut costs and suffer no consumer backlash. Some values are less like DNA and more like barnacles on the side of a whale: easy to knock off.

The best-protected values will always be those that are closest to what makes a company tick. “Values have to be part of the mental model of what makes the business a success,” says Anita Ryan, who runs the Family Business Success consulting firm in Bloomington, Minn. “You need the capacity to know you can produce cash flow and profit in running a sustainable company.”

Orin Smith, who recently replaced founder Howard Schultz as CEO of Seattle-based Starbucks,

agrees. “Corporate social responsibility is built into our business model, the loyalty circle,” he says. Profits correlate highly to customer loyalty, and customer loyalty correlates to employee loyalty. “When you have social commitments like making a difference for the environment and for farmers, that builds loyalty. It builds a passion for this company.” And passionate employees create loyal customers, which creates profits.

Because Starbucks considers corporate social responsibility (CSR) integral to its success, the company has been a leader at institutionalizing it—through innovative steps like the audited social report created in 2002, and regular CSR training for upcoming company leaders. “It’s such an inherent part of the business model, our company can’t work without it,” Smith says. That’s probably the best insurance a social mission can have.

3. Protecting legacy through contract can work—but it’s difficult.

When the sale of a company is imminent, the most immediate way to protect legacy is through contracting, which can preserve certain details of social practice. This is the approach Mel Bankoff took in August 2002 when he sold Emerald Valley Kitchen in Eugene, Ore. to the public corporation Monterey Pasta Co. of Salina, Calif.

For Bankoff, selling to employees wasn’t an option. It would have required a loan paid off through company cash flow, leaving him on the hook, when he was ready to move on after running EVK for 19 years. The company—a maker of natural salsa, dips, and sauces, with $4 million in revenue—was set to grow 25 percent a year, simply keeping up with demand. So Bankoff decided to sell to a company that could back growth, like Monterey Pasta Co., with $68 million in revenue. He set out to safeguard social legacy through contract.

“Most of the employee benefits package was written into the contract,” Bankoff says. An employee ownership plan was cashed out through the sale, netting employees 15 percent of the proceeds, plus 5 percent in profit sharing. Employee ownership will not be continued under Monterey, but profit-sharing will be—if growth and profitability targets are met. “They want 25 percent growth annually,” Bankoff says, adding that many of the benchmarks in the deal are reasonable. “The success of the company will determine the continuation of benefits. But benefits overall can never go below 70 percent of what employees have now.” He acknowledges that the need for growth will add pressure on the staff. “But when you buy a company, a lot of the value is the perceived ability to expand,” he says.

With Bankoff still in management, EVK’s focus on employee empowerment continues—with monthly meetings, an annual vision retreat, pay for doing personal growth seminars, and compensated volunteer time. Whether this management style will survive his departure is an open question.

Overall, Bankoff’s contract seems a relatively good one. But Ben & Jerry’s contract with Unilever seemed good, and it seems less so three years later. Unilever stood by most terms, like a commitment to donate $1 million annually to the Ben & Jerry’s Foundation. But key issues didn’t make it into the contract—like a verbal commitment never to hire a CEO Cohen disapproved of, which Unilever did. “The devil is in the details,” says Mager. “You can have a meeting of the hearts, but what it will eventually come down to is what’s in writing. What you don’t document you lose.”

In B&J's cases, some contract terms can't be monitored—like Unilever's pledge to continue buying non-rBGH (bovine growth hormone) dairy goods from Vermont family farms. "It's been disappointing," says Joe Sibilia of Meadowbrook Lane Capital. "Provisions in the Unilever contract are legally binding, but we have not been able to enforce them. It costs money, we would have to do an audit. In the next evolution, enforcement mechanisms should be improved."

Overall, as another person close to the B&J deal remarked, the Unilever contract "is working, but it could be working better." A similar assessment might be made of contracting itself as a way to protect mission: it works, but it could work a whole lot better.

4. Little-known state laws offer protection to social mission.

Contracting was Cohen's second choice among ways to protect his mission. His first choice was to buy the company outright. The story of why that didn't work offers insight into how the law of directors' duties works against social mission, and why existing state laws could offer a solution.

When the hostile takeover battle for Ben & Jerry's was launched in 1999 by Unilever and Dyer's, Cohen worked with social investors like Sibilia and Terry Mollner, formerly of the Calvert Group, to form Hot Fudge Partners, which tried to buy the company. They put together a $38 per share offer—nearly double the $17 price of the stock before the battle began. The board was on the verge of accepting that bid, even though it was slightly slower than a $40 per share offer from Unilever.

But then the New York Times published a leaked account of the board's deliberations. Within weeks, three shareholder lawsuits were filed, opposing the Hot Fudge offer because it didn't maximize shareholder return. A flurry of new offers followed. And when Unilever upped its offer to $43.60, the board felt it had to accept.

Ironically, there was a Vermont law that could have helped the board win those lawsuits, had it sold to Hot Fudge Partners. It's even called the Ben & Jerry's Law. And it's similar to stakeholder laws in place in 32 states, including Illinois, Massachusetts, Minnesota, New Jersey, and New York. These laws say boards need not sell to the highest bidder, but can take other factors into account—like the well being of employees and the community—in deciding who should own a company.

Stakeholder laws represent a potential Copernican revolution in corporate purpose. Though little used, there are cases where they've been upheld. In a 1997 Pennsylvania case involving the sale of railway giant Conrail Inc., directors accepted an offer from CSX rather than a significantly higher bid from Norfolk Southern, in part because the CSX deal was better for shippers and employees. The judge said focusing on maximum value for shareholders was "myopic," and that the board could consider the railway's role in the entire economy.

Why didn't the Ben & Jerry's board use the Ben & Jerry's law? Sibilia nearly jumped from his chair when the question was asked, because no reporter had ever asked it—though the buyout battle was covered in papers like the Wall Street Journal, New York Times, and London Times. "People don't know about these laws," he said. When the idea of using the law came up during the takeover battle, "I remember exactly what was going on," he continued. "We paused and went into the other room. And we said to ourselves, if we use this law we'll lose

and have to appeal. It could go to the Supreme Court." The group couldn't afford to take that on.

"The lawyers told us, 'you're gonna lose, but it's worth the fight,'" recalls Mollner. The problem was that the law says directors can accept a lower bid for social reasons—but it doesn't say how much lower. The group felt it could win at $38 vs. $40. But at $38 vs. $43.60, "there was no way we could beat that," Mollner says.

Until these laws are better established, the legal tradition remains that "shareholders are entitled to an unlimited upside, and that's an immoral contract with society," says Mollner. "The laws need a test case," adds Sibilia—by someone with the deep pockets to see it through.

Ben & Jerry's might have been that test case. But instead, its spirit is slowly withering in the grip of Unilever. As Cohen told Mother Jones, "I think that most of what had been the soul of Ben & Jerry's is not gonna be around anymore."

Perhaps it's too much to expect of B&J, that it could have changed the legal landscape of capitalism, in the same way that it changed the landscape of social management. "You're talking in one generation, one deal, trying to shift the consciousness of capitalism," says Sibilia.

Ultimately, solving the legacy problem will require a major cultural shift in our mental model of what business is about, says Anita Ryan—and companies like Ben & Jerry's have helped to bring that day closer. "Ben & Jerry's is not a loss," she says. "What's going to be here in a hundred years because Ben and Jerry did their thing?" She adds with a laugh, "If you're frustrated with how long this change takes, you're being like Wall Street and thinking short-term."

Judy Wicks of the legendary White Dog Cafe in Philadelphia is similarly philosophical about possible mission loss. She says that perhaps the real legacy founders leave behind is the model of how to run a company differently. She adds with a twinkle in her eye, "Would it be the end of the world if the White Dog didn't last forever?"

Building Mission Into Structure at Equal Exchange

The most effective way to address the legacy question is at a company's founding, when anything is possible. An example of this approach is Equal Exchange, a $10 million dealer in coffee, tea, and cocoa, which has a unique worker-owned cooperative structure. The company aims to serve small coffee farmers in developing countries by paying fair trade prices, and in so doing to foster mutually beneficial relationships between farmers and consumers. Equal Exchange is known for its fair dealing with farmers – providing advance credit for crop production, paying a guaranteed minimum price, and trading directly with democratic farmer cooperatives. What's less well known is how elegantly Equal Exchange's legal structure supports its social mission.

When founders Rink Dickinson, Jonathan Rosenthal, and Michael Rozyne set out to create an enterprise that would maximize social contribution, not profits, they custom built Equal Exchange to support this mission—with attention to capital structure, bylaws, personnel

policies, and so forth.

To safeguard the interest of employees, the founders in essence gave away most of their ownership, incorporating as a worker-owned cooperative where each employee has one share and one vote. Employees alone may nominate board candidates, electing all nine directors and themselves holding six seats. The board hires and supervises management, so the president is accountable to those he or she manages.

To prevent a worker-owner aristocracy—where some hold stock and others do not—membership is open to all employees. The top executive can earn no more than three times the lowest paid worker, a rule only the worker-led board can change. To ward off pressure to cash in, the founders added a dissolution clause: If Equal Exchange is ever sold, net proceeds will be given to another fair trade organization.

In raising capital, the company uses below-market debt and non-voting equity. The conceptual change is profound: the workers hire capital, capital doesn't hire the workers. There is no speculation: Stockholders can only sell stock back to the company. They do, however, enjoy a healthy average 5 percent dividend annually.

Like other Bostonians 200 years before, Equal Exchange's founders understood that their community's welfare could not be entrusted to a few persons, even themselves. Forefathers like James Madison knew they needed more than good leaders: they needed a constitution to secure their freedoms. Similarly, the founders of Equal Exchange used the company's legal fabric to safeguard their vision.

Seventeen years later, that foresight has been affirmed. Employees have begun to take real psychological ownership of the cooperative, making the bylaws and division of profits even more egalitarian, and creating new structures to increase employees' role in and capacity for governance. Two of the three founders, Rosenthal and Rozyne, have gone on to other pursuits in fair trade. Dickinson remains as company president, splitting responsibilities with Rob Everts.

Over 17 years company revenues have grown an average of 35 percent annually, and today there are 40 worker-owners with 14 more in line. Equal Exchange remains a leader in the fair trade field it pioneered. Best of all, it has no chance of hostile takeover, and little chance of losing its mission. The legacy problem was solved before it ever arose.

—Rodney North

Rodney North (rnorth@equalexchange.com), The Answer Man, works in marketing at Equal Exchange, 251 Revere St., Canton, MA 02021; phone 781/830-0303. See www.equalexchange.com.

Blowups at Vatex's Employee Ownership Lab

Solving the legacy problem is Jerry Gorde's obsession. How do you sell your company without selling its soul? It's harder than anyone might imagine, but Gorde is determined to turn his company into a laboratory modeling a solution. Vatex—a Richmond, Va. maker of T-shirts and promotional apparel with $7 million in revenues—is now on its third experiment. After

creating an Employee Stock Ownership Plan in 1980, Vatex moved to a worker cooperative in 1995, then in 2001 went back to an ESOP. “It’s blown up each time,” Gorde said with a laugh. “This time I don’t think it will blow up.”

A key aim of Gorde’s experiment is the redistribution of wealth and power. He wants to put company wealth in the hands of those who help create it, employees. He wants to create a democratic structure to carry on the social mission of the firm, while also ensuring good management. And he wants to cash out of his 30 percent ownership stake at about $2 million, so his own financial future is secure.

As Gorde puts it, he has equal concern for legacy, succession, and exit strategy. “Exit means getting your money out,” he explained. “Succession is how the company can sustain itself,” with competent leadership. “Legacy means preserving the values, the core values.”

The form Gorde has settled on is an ESOP, whereby an employee trust uses company cash flow to buy out the founders’ shares. The company can take a tax writeoff, which “can bring your tax liability to zero,” Gorde said. Plus the founders take cash tax-free. “I can make more money selling to an ESOP than to Attila the Hun,” he said.

If Gorde is now enthusiastic about the ESOP, in the mid-1990s he was disillusioned with it. “If you can’t read an income statement and balance sheet, you’ll be a lousy capitalist,” he told Business Ethics in a 1996 interview. Because Vatex is in a disadvantaged area and offers entry-level work, its employees are “at the bottom of the food chain,” Gorde said. Vatex had to break T-shirts out of twelve-packs into packs of ten before packing slips started to be accurate, he explained. “We put signs all over the plant, ‘Think 10.’ That’s how basic things are here.” He also found the ESOP created an incentive for employees to leave, since they couldn’t cash out unless they quit or retired. Fed up, Gorde dropped the ESOP in 1990. The company began buying employees out, to the tune of $700,000. That was blowup No. 1.

After five years the smoke cleared and the buyout was complete. That led Gorde in 1995 to launch experiment No. 2: the worker-owned cooperative, where employees would be taught economic democracy. Common stock was converted to non-voting preferred stock, and employees each got one ownership share in the company. “That’s what creates the democratic structure,” Gorde told us in that same 1996 interview, a few months into the experiment. The bylaws of Vatex became its constitution, with every right enumerated—a detailed grievance process, procedures for workers to elect the board, a committee structure whereby employees set up wage scales and employment policies, plus a stated goal of passing 30 percent of profits to workers. It seemed ideal.

“My theory is if capitalism is the most potent economic form, and democracy is the most potent political form, why not put them together?” Gorde said in a 2003 interview. “Except when you do both in an orthodox way, it’s like oil and water. Capitalism is nimble. Democracy is cumbersome.” With so much focus on process, “the organization becomes internally myopic,” he said. “It forgets the customer.” The constitution was so over the top it became a distraction. Hence came blowup No. 2. The worker co-op was terminated in 2000.

“Now we’re going for a little less democracy, a little more nimble,” Gorde said about his third experiment, ESOP redux. Created in 2001, the ESOP over 10 years will acquire 100 percent of the company. With no stars in his eyes about employee governance, Gorde says he won’t

hand employees control until the ESOP owns over 50 percent.

This time employees must earn their ownership. Instead of being paid for learning time, as under the co-op, employees learn about employee ownership on their own time. They can learn about company financials by attending quarterly town meetings, where attendance is not required but is noted in appraisals and is rewarded with door prizes like toaster ovens and lava lamps. Vatex also instituted cliff vesting, so employees earn shares over time but they don't vest for five years. If in that time employees have not demonstrated a capacity to be owners, they'll be terminated before vesting, Gorde said. "I will not spoon feed you concepts of responsibility. It's what you're doing to earn the equity being given you."

You might call it an experiment in tough love. More than two years into it, Gorde seems to be right: this time it's not blowing up.

—Marjorie Kelly

Jerry Gorde, Vatex, 2395 Hermitage Rd., Richmond, VA 23220; www.vatex.com. Phone 804/353-9010.

Social Programs Are at Risk as Charles Schwab Departs

The brokerage firm Charles Schwab is a company whose founder is in the process of stepping aside, and whether the firm's ethical and social focus will survive is an open question. Billionaire founder Charles Schwab, now 66, gave up his co-CEO position in May 2003, retaining the chairman role. The firm's ethics-grounded brokerage practices are well known, and since they permeate the firm's DNA, they are likely to persist. At risk, however, are the company's less well known initiatives in progressive employee relations and corporate social responsibility.

In ethical customer relations, Schwab eliminated conflicts of interest by taking several key steps to put customer interests first. It refrained from offering investing advice (always conflicted, in Schwab's view); it prohibited selling investment products (which often means "pushing" products); and it paid Schwab brokers by salary instead of commission on sales. If other brokerages had embraced Schwab's values and practices, they would have avoided the scandals that brought multi-million-dollar fines to Merrill Lynch, Bear Stearns, Goldman Sachs, and others.

But Schwab has still more to its social mission. When the meltdown in high tech stocks forced Schwab to shed jobs in 2001, the Schwab Foundation set up a $10 million fund that paid the tuition (up to $20,000) so affected employees could go back to school. This was in addition to the company's generous severance policies: three to 10 months of base salary, outplacement help, stock options, and cash to cover continuing insurance premiums.

From the beginning, Schwab's San Francisco-based brokerage welcomed people no other brokerage would consider. No college degree? No problem. People of color? Welcome. Gay, lesbian, transgendered? Can you do the job? Over the years, the company built a community committed to the company's goal of providing the most ethical financial services in the world. It was a community so cohesive that it enabled Schwab to survive multiple crises that would have swamped other organizations. The culture enabled employees to take on charitable activities, and people up and down the organization formed formal relationships with

organizations such as Habitat for Humanity and programs for the homeless.

As Chuck Schwab retreats from personal involvement with the company, it is likely that the company's social responsibility will diminish. If his successor does not step up to the plate with an equal commitment, the company will have a harder time maintaining its reputation as a progressive, values-based organization. Thus far the evidence is ambiguous. On the one hand, the company continues to match on a two-for-one basis the charitable contributions of employees. Schwab's personal wealth will likely still flow to his foundation, which will continue to do good work in education, teaching, and research on dyslexia. On the other hand, the brokerage firm has cancelled its program of matching employee 401(k) retirement contributions. The $10 million employee education fund has been depleted, and Schwab will not replenish it.

When Schwab retires or dies, the organization will be at a crossroads faced by all founder companies: will it maintain its founder's identity and values (think Walt Disney), be swallowed up by a competitor (Data General, bought by Digital Equipment), or fail by mismanaging the succession issue (Wang Laboratories)?

—John Kador

John Kador (jkador@kador.com) is the author of Charles Schwab: How One Company Beat Wall Street and Reinvented the Brokerage Industry (John Wiley 2002).

The Business Ethics Legacy Project

Join us in our continuing exploration of the legacy problem:

• Nominate a company for a Legacy Award.

• Help shape a national meeting on the legacy problem.

• Submit your succession story for a web-based collection of company stories.

• Send us your innovative ideas on new ownership structures.

Business Ethics is looking for partners and sponsors of the Legacy Project. Contact Jean Madson, phone 952/937-2285 (email Jean.Madson@business-ethics.com), or Marjorie Kelly, phone 612/879-0695 (email Marjorie.Kelly@business-ethics.com).

This article first appeared in the Summer 2003 issue of Business Ethics. Click here to subscribe or request a free sample copy by e-mailing Free.Sample@business-ethics.com