AFD Ep 461 Links and Notes - The "Employee-Owned" Chicago and North Western Railway: Hype vs Reality [Bill/Rachel] - Recording Feb 26, 2023

- [Intro - Bill] In the United States, it is common for employees of a corporation to own shares of stock in the company. This has been a practice to some degree since the 19th century, originally often in lieu of pensions, but it has become especially prevalent with employee stock options as contract incentives, particularly at tech companies. Beginning in the late 1960s and with 1970s tax reforms, there was a bit of an ideological push to encourage employee stock ownership or even employee takeovers of privately-held companies (we'll talk more about this push later after examining today's focus company).
- [Rachel] More recently, Bernie Sanders and other progressives have at times proposed institutionalizing a percentage ownership requirement in major corporations – his plan involved a permanent employee trust with elected representation to act as a bloc for voting shares – as a mechanism for sharing profits and windfalls to the workers. However, ownership of some amount of stock in the company, whether in trust or individually, should not be confused with true employee ownership or control of management. It is not the same as "co-determination," where representatives of the company workforce sit on the board of directors and make decisions with the other directors, although some candidates like Sanders proposed that too. Stock ownership by employees is certainly not the same as a co-op either. And it is also important to bear in mind, as we have often noted, that there is a stratification within the broad category of company "employees," not all of which hold the same class position, alignments, or objectives within a company. Broadly there are owners and upper managers and there are wage and salary workers, but there are also fuzzier middle management type white collar roles within the company that are more highly compensated and often given shares of stock in the company, even if they don't actually control it, in order to align their interests toward profit performance. Ownership of shares can confuse and muddle the relative position and interests of various company employees without actually increasing their managerial control of the company's decisions or even merely improving labor conditions. In this episode we look at the cautionary example of a US railroad that was bought out by some of its own employees in the 1970s, adopting the proud branding "employee owned" for several years, and we find that the hype did not live up to the reality upon closer inspection and as events unfolded.
- [Bill] The main source this week is the book: "The North Western: A History of the Chicago & North Western Railway System" by H. Roger Grant (1996)
    - The Chicago & North Western Railway was one of the early railroads into the Wild West from Chicago in the 19th century, and it remained focused even into the later 20th century on raw commodities from the Great Plains and Mountain West, like timber and grain.
    - In the 1950s, new ownership and management enacted comprehensive reforms and reorganization of the struggling Chicago-based freight and commuter railroad, including some union-busting (telegraph operators), but also a huge amount of investment in upgrades and maintenance after years of deferral. This did turn things around for the railroad, going from a cumulative net income of negative $17.5 million from 1956 through 1962 to a net income for just 1965 of (positive) $16 million, a 20 year high (p.205). But by the mid-1960s, the era of diversified conglomerate holding companies had arrived and the ownership decided to branch out into acquiring other unrelated industries, under the banner "Northwest Industries." Within a few more years, they further decided that they were no longer interested in the railroad industry at all and they wanted to divest the original company altogether. By 1969, a sale was being floated, when rail revenues began dropping into losses again. (p.212 & 215) "Ben Heineman

recognized the difficulties of confronting railroad regulation. Nevertheless he understood how to cope with and even to manipulate the regulatory processes. He concluded by the mid-1960s that a better way to increase shareholder value would come not from modernization and mergers but from investments outside the transportation sector. Profits for the railroad were limited at best; the industry seemed unable to alter labor relations, pricing, and related regulatory matters. 'To put it simply,' Heineman told the business press, 'I've been discontented with the railroad industry and its long-range outlook under present circumstances, because its rate of returns is disgustingly inadequate.'" (p.214) By 1966, Northwest Industries was making after-tax profits of nearly $24 million from their non-rail holdings. (p.215) If you were a shareholder just looking to make money steadily, why would you even bother with operating a railroad anymore?

- One thing the railroad had not done during the reform years of the late 1950s and early 1960s was much in the way of abandonment of minor lines that were increasingly in competition with highway trucking. Not only that but – despite the regulatory approval hurdles – the railroad had taken to mergers and acquisitions of other railroads with enthusiasm, growing significantly despite the pre-existing financial problems. The vision which was never fully realized was that the Chicago & North Western would become the hegemonic railroad of the middle of the country between Chicago and the Mountain West, south of a planned hegemon mega-merger – the Burlington Northern – where there were a lot of competing and redundant railroads undercutting each other for business. Ultimately the railroad became embroiled in a protracted territorial struggle with the much larger and better-resourced Union Pacific, which was trying to finally extend east of the Missouri River to Chicago.
- As rail revenues began to collapse again after those few bright years in the early to mid-1960s, the railroad returned to its old habits of deferring maintenance and letting things slide into disrepair. Rail workers became increasingly frustrated. (p. 215)
- [Rachel] Nobody really seemed interested in buying the railroad from the holding company. Chicago & North Western Railway President Larry Provo, who had a good relationship with the unions, approached both the unions and the owners with a creative proposal: "a leveraged buyout of the railroad by its employees." (p.216) "On October 5, 1970, Northwest Industries entered into an agreement with the North Western Employees Transportation Company (NETCO) to sell substantially all of the assets of the Chicago & North Western Railway Company. For a modest sum, $19 million, to be paid over a 20-year period, and the assumption of the $340 million in company debt, the railroad would become an employee-owned corporation. 'The employees are getting what must be the cheapest railroad in history,' concluded a financial writer. 'They are paying little more than $100 a year per mile of railroad track.' NWI would walk away from an unwanted operation with $200 million of tax credits that it could use to offset profits from its many subsidiaries."
- For a sense of comparison to the rail assets they were divesting to employees, the rest of the holding company was sold 15 years later for $1.4 billion!
- At the time of the sale, the railroad had 14,000 employees and any employee was permitted to buy up to $100,000 worth of stock. Apparently among those who took advantage of this maximum were some of the union leaders who endorsed the takeover, although not all unions endorsed the plan as necessarily requiring a confusing labor relations status inside the new firm… (p.217, p.219) In reality, however, not all employees joined the purchase and the participants

skewed toward the management employees and the higher-compensated union workers and non-union white-collar workers. The minimum buy-in was $500. Some workers with firsthand knowledge of the poor state of repair on the railroad chose not to invest, fearing it was a money pit.

- The Interstate Commerce Commission granted official approval to the employee takeover on June 1, 1972. The railroad was now the Chicago and North Western Transportation Company. It was at least nominally employee-owned, although the reality was more complicated: By 1981, less than 40% of CNWT company stock was still owned by employees and the railroad decided to drop the phrase "employee-owned" from official branding.
- The first order of business in mid-1972, although it would take quite a few more years to obtain the necessary regulatory approvals, was to begin closing down low-profit lines finally. As early as 1973, the railroad seemed to actually be doing surprisingly well (actually posting profits! p.224) and the share price had climbed many times over and the board of directors split the stock in an effort to encourage more of the employees to buy in. The price of the newly split shares continued to climb several times over, throughout the 1980s. (p.220) During this period, thousands of miles of track were discontinued. Much of this track was pre-World War I and was in dire and dangerous condition. A lot of the physical infrastructure was in such bad shape by the 1970s that it wasn't even worth much if anything to rip up and sell or reuse for materials. The railroad repeatedly argued, over rural public opposition, that cargo could be trucked over these medium distances from low-density agricultural producers to more arterial railroad loading stations for long-distance hauling to market. Research by Iowa State University and the Iowa DOT suggested that upgrades to major line capacity in line with this strategy probably would actually improve overall economic conditions for the state and its farmers, without harming the local communities who were losing direct rail access. (p.222) The abandonment process for smaller rural lines sped up dramatically with federal deregulation of railroads in 1980.
- The new management forged a much more positive and collaborative relationship with Union Pacific, becoming its primary partner for access into Chicago, which boosted through-traffic for both railroads.
- [Bill] In the mid-1970s with the health of the railroad industry as a whole seemingly on the brink of catastrophe in the United States, Congress had established a number of emergency programs to directly fund or offer loan assistance for infrastructure repairs and upgrades. The CNW took advantage of these new programs and parlayed upgrades on key sections into new revenues and savings that could be applied to other problem sections or yards. The dire conditions of track maintenance on important arteries were gone by the early 1980s. (p.223) Federal loan guarantees also helped the railroad repair thousands of damaged freight cars at a cheaper cost than buying new ones would have involved.
- Larry Provo, who had envisioned and executed the employee purchase of the railroad, passed away in October 1976, just a few years after the ICC approval had gone through. There was a seamless transition just before Provo's death to James Wolfe, who had previously served as the railroad's Vice President for Labor Relations prior to the takeover by the employees, when he became Vice President of Operations. The two had worked closely together on the new employee-owned railroad's management strategy in those early years, and he continued the plans essentially unchanged.

- The company which had been sold to its own employees for just $19 million in the early 1970s ended the 1970s by selling its entire Chicago commuter rail fleet to the newly created Regional Transit Authority for $20.8 million. The railroad continued to operate the commuter service, but as a mere operational contractor for the RTA. (p.225)
- The CNW, Union Pacific, and Burlington Northern engaged in a joint project to extend and physically strengthen a seemingly insignificant line into Wyoming's Powder River Basin coal country, which was previously largely untapped up to that point. New environmental regulations suddenly made Wyoming's coal more economically attractive than coal in historically more significant mining regions in the US. This fateful infrastructure investment decision and the resulting long, slow hopper trains of nothing but Wyoming coal, ended up generating massive coal traffic profits for all involved, even if it required significant improvements to be viable. This was primarily a Burlington Northern project, but the federal government had forced them into a joint arrangement with the CNW, and when the CNW struggled to come up with the funding for the necessary infrastructure upgrades to support the heavy coal trains, their new friends at the Union Pacific stepped in to join the project, mostly in a financing role, despite their rivalry with BN. Joint ownership over the single line saved everyone infrastructure costs in a challenging physical environment but still maintained competition to keep regulators and customers happy. The CNW had been studying the feasibility of this new coal exploitation effort since 1973 and ground was finally broken in 1983, 10 years later, with coal trains beginning operations in August 1984. Various power companies around the country signed lucrative long-term contracts for entire trainloads of coal to be delivered directly from Wyoming to specific facilities. (pp.226-230) This was mimicked later in the 1980s with dedicated contracts to deliver unit trains of ore to steel mill customers. (p.240)
- One key step in facilitating the Chicago and North Western's embrace of massive bulk commodity unit trains like coal dated back to 1971, when the employees were still awaiting regulatory approval to buy the railroad. The management team negotiated with the unions for a new model of crewing this type of trainload, because it was simpler and traveled longer distances without being reorganized than traditional mixed-freight train consists or short train consists. This was used first, over a decade before the Powder River Coal unit trains were under way, to move 20-25 car rock trains with fewer crew members per train journey, in exchange for which the growth in business would be so substantial that there would be even more jobs for the union crew members. (p.240) (This is similar to the effect seen with containerization of port facilities, which we covered in our series on that topic, whereby massive labor efficiencies being achieved per ship actually vastly increased the total volume of shipping traffic, creating more jobs in the early adopter seaports.)
- [Rachel] During the 1980s, despite the pruning back of minor lines in the 1970s, the CNW continued to emphasize a focus on serving grain producers west of the Mississippi River, as it had always done. Acquisitions and main line upgrades were often geared toward strengthening arterial service of fast and vast grain shipments, especially in Iowa. The railroad soon applied the new labor logic of the unit trains carrying rocks to unit trains carrying grain. They also reached a deal with agribusiness giant Cargill in the early 1980s to cancel planned abandonment of a line and instead have Cargill, a shippers' association, and certain government agencies loan money to refurbish the line so that Cargill could ship 10,000 carloads per year of unit trains from agricultural producers to

their plant near Eddyville, Iowa. The line and this system became such a success that some of Cargill's peer businesses began relocating plants to the line as well for efficiency. (pp.240-241) (As a side note, about a decade later, family-owned Cargill also became partially employee-owned, according to Wikipedia.)

- However, by the annual meeting of June 1985, shareholders voted to create a diversified holding company, tentatively returning to the situation from which the railroad had emerged into employee ownership in the first place back in 1972. These hesitant diversifications were outside of rail but still relevant to the core business of the railroad. For example, the railroad was a major timber carrier and the new holding company purchased a manufacturer of snowplows and log splitters. They flipped this acquisition just a couple years later at a profit and used that sale to pay off some high-interest financing on the balance sheet. Another acquisition was an intermodal brokerage service, which was intended to advance a partnership with Union Pacific to run intermodal trains from Chicago straight through to points west. (pp.228-.239)
- CNW was a more enthusiastic adopter of shipping container train traffic than many peer railroads had been. In 1984, it became possible to run a double-stack container train filled with East Asian imports from a US West Coast port over the Union Pacific, across the CNW through Chicago, and onto Conrail for delivery to the US East Coast. The double-stacks were just 30% heavier than a single-stack train, but with twice the cargo capacity. In 1985 and 1986, the CNW expanded their handling capacity in Chicago for container trains, increasing weekly round trips across the continent from 8 to 14 and then eventually in 1988 to 38. The 1992 annual report boasted that despite the relatively lower revenues of cheap container cargo traffic, the profit margins were actually quite high on them because their operating costs were even lower. (p.239)
- [Bill] PAGES 241-243: DISCUSSION OF LABOR PRACTICE RENEGOTIATIONS AND WORKER LAYOFFS
    - Computerization eliminated hundreds of jobs
    - Many railroad crew rules were at the state level instead of the federal level and had existed since the early 20th century if not earlier. These had never been updated for modern diesel trains. Postwar reforms did eventually tackle some of these in various states and by 1972, only Wisconsin and Arkansas were still considered hopelessly out of date. Wisconsin did reform at that point too, which benefited the CNW in terms of cutting labor costs. The reform bill was submitted as a joint compromise between representatives of industry management and industry unions, whereby excess rail workers (particularly firemen) would not be laid off immediately but would also not be replaced when they did leave.
    - Like many railroads today, the CNW management insisted in the 1980s that they could safely operate most trains in most scenarios with a single crew member and kept trying to lobby for reducing crews from four to two or even one. CNW and the United Transportation Union held unsuccessful bargaining sessions in 1987 and into 1988 to address the crew size and mandatory early retirement questions. A federal mediation board was appointed to force a resolution. Eventually the union went on strike in September 1988, but Congress (as they did very recently at the end of 2022) intervened within a matter of hours to end the strike and force a compromise of 3-person crews in most cases and 2-person crews in select cases determined by arbitration, instead of 4 or 1. Additionally

    the Congressional package mandated an early retirement buyout for redundant workers.
  - Negotiations between the CNW management and the UTU continued into 1991 for further crew reduction agreements and voluntary early retirements, which were concluded successfully.
  - The CNW workforce back in 1981 had been 14,345 and was down to 6,841 in 1991. A company official in 1986 acknowledged that worker morale on the railroad was quite low amid all these cuts, redundancies, and line abandonments – and that management was viewed as “cruel and rather heartless.”
  - In 1985, senior management got really into something called “Total Quality Improvement System,” which was a new philosophy of business management they picked up at a seminar, which emphasized listening more to employees about how things could be done better. It was regarded with some contempt by the workers but also did seem to result in more feedback to management and “the number of company investigations of employee conduct significantly decreased” before the TQI System was sidelined in 1988 under new leadership…
- [Rachel] After federal deregulation, more than 1000 miles of “marginally profitable” branch lines (as opposed to money-losing branch lines slated for abandonment or pre-deregulation minor lines whether profitable or not) were sold off to short line operators who were under less restrictive crew level mandates and often completely non-union, allowing them to continue service on the lines at a higher profit margin and still send business to the CNW’s main lines. These independent but captive short line operators were also often showered with state assistance to keep branch lines running. (p.244)
- The third President of the CNW in the employee-ownership era was Robert W. Schmiege, the hand-picked successor to the hand-picked successor, taking over in 1988. Like his predecessor Wolfe, he was also formerly the railroad’s Vice President for Labor Relations. He was reportedly more of a consensus-oriented manager as the new president. (p.247)
- Unfortunately by 1987, even with all the unit trains of commodities and the double-stack transcontinental container trains, the railroad was in crisis again, potentially on the verge of implosion, although this time due to external forces instead of internal factors. Because the railroad had failed to become hegemonic in its geographic territory and had failed in several merger and acquisition attempts to nearby rivals, the CNW found itself very vulnerable to rate wars between some of the nearby railroads, who entered a revenue race to the bottom to attract customers. In 1987 and 1988, the railroad contemplated a near-total liquidation of all routes and assets for everything except the two critical moneymaker lines bridging between other, bigger railroads – the Wyoming coal line and the connection between Chicago and Omaha – which would have been a massive one-time windfall for shareholders at the expense of having much of a railroad left afterward. This plan was only thwarted by the anticipated cost of retiring that many workers early under generous severance agreements. The rate war finally ended and the Wyoming coal traffic continued to boom, bringing the railroad back from the brink by the end of 1988. (p.248)
- [Bill] Employee ownership of the CNW could have expanded significantly once more in 1989 when union employees of 16 unions on the railroad as a group offered to buy one-third of the common stock of the company in order to fend off corporate raiders who were attempting a hostile takeover to raid credit and sell

assets, but the railroad's new management opted to accept a different friendly bid, from the recently formed Blackstone Group and from Union Pacific, which needed to maintain its speedy and traffic-heavy link to Chicago. Union Pacific's shares were non-voting. The result in 1989 instead of more employee ownership or corporate raider ownership was a Delaware corporation called "Chicago and North Western Holdings Corporation," parent of "Chicago and North Western Acquisition Corporation," controlling CNW Corp, the 1985 holding company that owned the 1972 railroad known as "Chicago and North Western Transportation Company." (pp.248-249) For a few years after the takeover battle the company was not publicly traded.

- Employee buyouts and workforce reductions continued and computerization and electronic centralization of operations advanced rapidly in 1989. Hundreds more miles of track were sold off in the early 1990s to other nearby major railroads or shortline operators, or they were simply abandoned and turned into "rail trails." In 1993, it was 60% smaller by mileage than it was 21 years earlier when the employee takeover happened. (p.250)
- Lower sulfur Wyoming coal became even more in demand with the 1990 Clean Air Act amendments on acid rain control. (pp.250-251)
- [Rachel] In March 1993, Union Pacific asked the Interstate Commerce Commission to convert its non-voting shares of the CNW into voting shares – representing 30% of the company – and to allow them to buy all remaining 70% of common stock in the railroad, against the stated wishes of the smaller railroad's management, which was not interested in being acquired. This was approved two years later in March 1995 with a purchase of about $1.1 billion from shareholders. By this point the federal regulators had already approved the mega-merger of what is now BNSF Railway and it was becoming more likely that all western United States railroad operations at the Class I level were probably going to be consolidated into two or three railroads. The CNW management stopped fighting and accepted the reality of the situation. (p.251) Union Pacific had already become an incredibly closely connected business partner even before participating in the defensive takeover in 1989 and the CNW was essential to their traffic between the Missouri and Mississippi Rivers, but they were increasingly unhappy with operational handling at the interchange points, which was becoming slower and more expensive instead of more efficient and more cost-effective. Customers were happy with the consolidation because it did not represent a change in competition within a territory but rather a faster and less expensive longer-haul service between the Great Lakes and points west. (In fact, this end to end consolidation of the two railroads had been repeatedly favorably contemplated or recommended by both private sector analysts and government planners as far back as the 1890s and 1920s.) One challenge that Union Pacific did not seem to fully appreciate before the CNW merger was that outside of their existing through-traffic partnerships the CNW did actually have a lot of other regional commodity operations, especially in rural grain traffic, which many of the early-retired CNW employees had specialized in dealing with. So those regional customers struggled with the new situation for a while. (p.252) Almost immediately after acquiring the CNW, Union Pacific went on to announce its own mega-merger with Southern Pacific, basically completing the duopoly consolidation of the west. It would have been virtually impossible for an independent CNW to survive competition with either BNSF or UP/SP, let alone both mega-mergers transpiring at the same time. (p.253)

- [Rachel] To go back to the concept of Employee Stock Ownership Plans as a whole, let's talk about the man who almost single-handedly popularized ESOPs. Louis Kelso, along with his academic friend Mortimer Adler, published *The Capitalist Manifesto* in 1958, extolling the virtues of employee stock ownership. In this book, he states that: 1) Workers can't make a living wage from their labor alone; 2) Workers need expanded access to capital ownership to provide a second source of income, and 3) Employee Stock Ownership Plans were the key to acquiring that capital. Furthermore, he wrote, as technology makes labor more efficient, the need for worker-ownership of capital becomes even more crucial to prevent catastrophic levels of income inequality. Unlike Marx and his *Communist Manifesto*, Kelso wanted to crank the capitalism dial up to 11 by promoting capital ownership for everyone. To keep capital from accumulating to the top, he also proposed a "precipitously" high top marginal income tax rate and restructuring the estate tax so that the rate depended on the wealth of the recipient rather than the size of the estate. During his life, he courted Republicans, but he abhorred Reaganomics, correctly predicting that the concentration of wealth would have disastrous social consequences, and he equated wealth inequality as a moral sin akin to genocide. (STUMPFF, ANDREW W. "Fifty Years of Utopia: A Half-Century After Louis Kelso's 'The Capitalist Manifesto', a Look Back at the Weird History of the ESOP." *The Tax Lawyer* vol. 62, no. 2 (2009): 419–31.)
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See also: https://en.wikipedia.org/wiki/Chicago_and_North_Western_Transportation_Company

- http://www.encyclopedia.chicagohistory.org/pages/1036.html
- The Chicago & North Western Historical Society was founded shortly after the employee takeover: https://cnwhs.org/wp1/about/