INVESTING IN EMPLOYEE OWNERSHIP: FINANCING CONVERSIONS THROUGH A PRIVATE EQUITY FUND MODEL

A N D R E A  A R M E N I  A N D  C A M I L L E  K E R R  |  O C T O B E R  2 0 1 9
ABOUT TRANSFORM FINANCE

Transform Finance is a non-profit organization building a world where capital is deployed in alignment with social justice values and where non-investor stakeholders can influence, access, and govern capital.

We provide investors with insights on how their activities affect different stakeholders, advocate for more transformative practices, develop values-aligned fund and investment models, and convene a community of practice with the Transform Finance Investor Network.

We support social justice practitioners and community leaders through trainings that break down the financial landscape and inspire actions to reclaim it, hands-on learning journeys to develop strategies and organize around capital, and tailored support for investment projects that center the voices and priorities of community residents and grassroots organizations.

Together with both investors and social justice practitioners, we advance financial innovations and movement building strategies that explicitly redress the issues with capital for workers, communities of color, and marginalized communities.

Questions, Comments, Feedback? Please contact us via email at info@transformfinance.org.
# Investing in Employee Ownership: Financing Conversions Through a Private Equity Fund Model

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**Investing in Employee Ownership:**

Financing Conversions Through a Private Equity Fund Model
The Open Society Foundations work to build vibrant and inclusive societies, grounded in respect for human rights and the rule of law, whose governments are accountable and open to the participation of all people. Through its grant making and impact investments, Open Society’s Economic Justice Program seeks to help answer the question: What are the economic institutions, policies and practices that can foster these goals? All else being equal, how wealth is distributed and used shapes the distributions of power and privilege. Open Society has long sought to advance the cause of equity by strengthening civil society, supporting human, consumer and labor rights, and advocating for stronger regulation. The role of capital, with its growing influence on all spheres of society, is becoming more and more a locus of intervention, which necessitates a hard look at concrete interventions that use capital as a tool for change. This is why we turned to Transform Finance, given its work at the intersection of social justice and capital in radical yet pragmatic ways, to explore and outline an investment vehicle to accelerate employee-ownership as a new approach to our pursuit of decent societies, one that explores how the structure and distribution of assets can be modified at some measure of scale.

This moment in history presents a unique window of opportunity. The retirement of Baby Boomer owners from millions of private businesses and trillions of dollars in capital assets in the United States, Europe and elsewhere creates the possibility of converting these companies into ones that owned by workers, in particular those from disadvantaged communities. As with all ambitious projects, the challenge has been to make sure our reach does not exceed our grasp, while at the same time not falling short of it. Here, the question of how looms large.

While the systemic change we seek does not lend itself to solely technical solutions, the technical and practical elements are essential. We believe that capital can play a pivotal role in helping accelerate conversions. Can it do so in ways that are patient, risk-taking, and replicable while not being extractive or exploitative? Can it do so in ways that keep the targets of equity, voice and resilience
for workers, communities and perhaps even our broader societies dead square in the center?

This report is a major contribution, as it elaborates concretely and practically the central features of potential funds dedicated to these goals and impacts. We suspect that these are not the only possible avenues. But we do know that nearly any feasible solution will require mobilizing the capital markets in ways that address their incentives, objectives and constraints. As a player who seek systemic impact through investments, this is deeply relevant to our work.

At a larger level, this inquiry offers one answer to a deeper question: What are the practical ways, if any, that capital can address marginalization, vulnerability, and especially inequality? Can a vehicle such as private equity be repurposed to address these problems - problems that, if we are to be honest, such vehicles have exacerbated in recent history? This report presents practical steps to a way forward.

ROBIN VARGHESE
Economic Justice Program and
Soros Economic Development Fund
OPEN SOCIETY FOUNDATIONS
Wealth inequality continues to grow as gains in the economy accrue to the holders of capital rather than to the providers of labor. Throughout the economy, asset ownership skews toward white owners, while a higher percentage of non-owning workers come from communities of color. The wealth gap is set to widen over the coming decades and exacerbate class and racial inequalities, underscoring the urgency to create asset-building opportunities at scale for workers, especially those from marginalized groups. While initiatives such as the increase of the minimum wage help provide a floor, much more will have to be done to start closing the wealth gap in the United States.

As part of its efforts to create more equitable approaches to wealth creation through different uses of capital, Transform Finance has explored the potential for financing democratic employee ownership as a strategy for asset building to address inequality via a dedicated buyout fund for companies in a succession context, that is, when the owners are retiring or moving on.

Employee ownership is a way for workers to participate in the value they create, building material assets along with their power and agency, which reflects the worker’s contribution vis à vis capital. Worker owners experience higher quality jobs that are more secure and resilient to economic shocks.

More broadly, employee ownership is also a boon for low-income communities and the families within them. It roots jobs in the communities they operate in, as employee owned companies are less likely to be uprooted through acquisitions and move out of their founding location.

The worthwhile efforts to create worker-owned cooperatives can be complemented by the conversion of mature companies to employee ownership. This has the advantages, among others, of avoiding some of the inherent risks of start-up businesses and building on the existing capital of viable companies. It also addresses the negative impact on a community of a business closing down in a succession context, with the ensuing loss of jobs and overall economic activity, particularly in already depressed areas.

Owners are indeed mindful of the effect of shutting down or moving operations and are often motivated by a wish to preserve their legacy in a local community via the business they created. Given the tremendous number of healthy, successful businesses about to undergo a succession, with baby-boomer owners gearing up for retirement, why are we not seeing more conversions?

The opportunity to create more employee ownership will be likely missed unless retiring owners are given an easy way to convert. The
conversion success stories, from New Belgium Brewery to Real Pickles, serve as a starting point. Yet even where an owner may be in favor of a conversion, he or she may not pursue it for reasons that ought to be surmountable, such as:

- Lack of knowledge of employee-ownership as a potential exit/succession strategy
- Lack of understanding of the conversion mechanism and its financial arrangements
- Lack of values-aligned financing for transactions that are intrinsically fair to workers
- Concern about a lower sale price as compared with a transaction with a financial buyer
- Concern about the increased timeline to exit and the need for capacity building around creating a culture of ownership
- Concern about creating a true asset for the workers, rather than an over-leveraged company

A fund that serves as an intermediate actor – a financial vehicle that can acquire companies from the exiting owners and shepherd them to employee ownership – may overcome these obstacles in a way that enables conversions at scale.

Through such a vehicle – and its replications – the wave of exiting owners of closely-held companies can become a pipeline for a drastically higher prevalence of employee ownership. The vehicle resembles a private equity model in its facilitation of the sale via a leveraged buy-out transaction, with the ultimate purpose of having the company’s equity vest in the workers.

This vehicle presents several advantages:

- It provides a pool of available capital to be deployed immediately, allowing access to businesses as they come on the market, rather than requiring a pre-planned strategy for succession to employee ownership
- It provides an alternative to a sale of the business to a competitor or a fund, potentially accelerating the seller’s exit without requiring the selling owner to provide the financing
- It can reduce the gap in valuation between what a seller could obtain in a financial transaction and the returns from a conversion to employee ownership
- The timeline of the investment under the model matches well the period generally required for a successful conversion; during the life of the investment, the vehicle can foster the conditions for successful employee ownership, such as the creation of a culture of ownership
- It signals to the current owner the organized and capitalized interest in fostering employee ownership, reducing uncertainty around the conversion's potential
- It benefits from the learning and shared capacity that is built in a fund, can support the creation of standardized tools, models, and term sheets, and benefits from the natural synergies among the portfolio companies
This document sets out a blueprint for how outside-financed conversions can be done, in a manner that is grounded in impact considerations and takes an explicit racial and economic justice lens. It is not geared, however, toward the creation of a specific fund. Rather, we seek to demonstrate the viability of the model in a way that can activate a drastically higher amount of capital for employee ownership.

Conversions and their outside financing are not without risks to the workers, in particular around extraction of value and over-leveraging. A vehicle that aims to promote employee ownership as a socioeconomic strategy must do so on terms that are fair and conducive to the well-being of the enterprise and the worker-owners. Throughout this report, we will refer to and investigate implementing the following Impact Recommendations that are required in any ESOP transaction to ensure that the workers are properly centered, with specific focuses on racial and economic justice.

**IMPACT RECOMMENDATIONS**

1. **LONG-TERM, BROAD-BASED EMPLOYEE OWNERSHIP:**
   Investments are structured to create long-term, broad-based employee ownership

2. **CENTERING POC AND LOW-WAGE WORKERS:**
   Investors build a pipeline of companies where employee ownership would generate wealth and agency for low-wage workers and people of color

3. **MEASURED IMPACT:**
   Investors develop and track a set of metrics to measure wealth building, employee social capital, job quality, and other key impact areas

4. **EMPLOYEE PARTICIPATION AND POWER:**
   Transactions are structured to build an ownership culture, engage workers in governance, and implement other pro-worker practices

5. **NON-EXTRACTIVE DEAL STRUCTURES:**
   Investments are based on a fair valuation and are structured to protect workers from harm, by avoiding practices that, for example, reduce wages and benefits, decertify a union, over-leverage the company with excessive warrants or debt, or otherwise use financial engineering to shift the value of the company to selling owners or management

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1 The vehicles profiled in Appendix III meet several of these impact recommendations. We suggest that a prospective investor into any employee ownership fund diligence and engage the fund manager explicitly on each of the five recommendations.
SETTING THE CONTEXT:
EMPLOYEE OWNERSHIP IN THE UNITED STATES

At an employee-owned business, (1) workers own a significant percentage (at least 30% and often a majority) of the company's shares, and (2) share ownership is open to workers at every level. A primary purpose of employee ownership is to distribute a company's profits more broadly with the workers who create that value. Some forms of employee ownership were designed to share governance and other decision-making rights with workers as well. Employee-owned companies comprise a small but significant segment of the US economy, with the 100 largest majority employee-owned companies employing over 600,000 people.

ESOPs

The most common form of employee ownership in the US is the employee stock ownership plan, or ESOP, with approximately 6,400 ESOP companies in the US currently. Well-known ESOP companies include Publix Super Markets, W.L. Gore and Associates (makers of Gore-Tex), Davey Tree Service, Recology, New Belgium Brewing Company, McCarthy Building Company, and King Arthur Flour.

An ESOP is an employee benefit plan that holds equity of the company for the benefit of the employees. The ESOP was designed to give employees the opportunity to acquire company stock without paying for the ownership interest using their savings or payroll deductions. Instead, the company pays for the interest on behalf of employees over time using future cash flow. Notably, an ESOP is allowed to borrow in order to acquire company shares. Louis Kelso, the lawyer who developed the ESOP model, implemented the first ESOP in 1956 to enable the employees of Peninsula Newspapers Inc. in Palo Alto, California to buy the newspaper chain from its retiring owners. Between 1956 and the mid-1970s, Kelso and his law firm established a handful of ESOPs throughout the US. Kelso viewed employee ownership as a step toward the appropriate distribution of value created, and is quoted as saying, "If capital ownership is good for the rich, it is a thousand times better for the middle class and the poor."

ESOPs rose in popularity in the 1980s, after Kelso

2 CertifiedEO, a certification program for employee-owned companies, has a minimum requirement of 30% owned by employees, with additional certification levels at 50% and 100% of shares. See “About Employee Ownership,” CertifiedEO, accessed April 8, 2019, https://www.certifiedeo.com/eo/about.
5 Both specific to the American context, ESOPs are defined contribution benefit plans, like the better known 401(k) plans and IRA plans. Defined contribution benefit plans (“DC” plans) should be distinguished from more traditional Defined Benefit Plans (“DB” plans) also known as pension plans. DC plans are designed as retirement plans invested “at risk” in various forms of securities – in the case of an ESOP in company specific securities. DB plans pay a defined cash benefit and are guaranteed, within limits, by the federal government.
leveraged his relationship with US Senator Russell Long — who was the chairman of the Senate Finance Committee — to include ESOP legislation in the 1974 Employee Retirement Income and Security Act (ERISA). Additional tax incentives and benefits were passed in the years that followed, such as the 1984 Tax Reform Act that allowed employers to deduct dividends paid in cash under a qualifying ESOP. In addition, Internal Revenue Code Section 133 was created to permit qualified financial institutions to exclude 50% of the interest on loans to ESOPs, which led to the formation of ESOP departments at large banks. While some of these tax benefits, like IRC 133 interest exemption, were ultimately eliminated, many remain in effect today.

The most potent of these tax benefits still in effect came with the Taxpayer Relief Act of 1997, which fully exempted 100% ESOP-owned S corporations from corporate income taxes, further spurring their growth.9

**WORKER COOPERATIVES**

Worker cooperatives are businesses that are owned and controlled by their workers, who are the members of the cooperative. Members share in the profits and control of the company under a “one worker, one vote” principle.

The International Cooperative Alliance Statement on the Cooperative Identity defines a cooperative as “an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise.”10

In the US, worker cooperatives have roots in a number of traditions, including African American cooperative economic practice, the Rochdale Society of Equitable Pioneers from the UK, as well as Latin American, Native American, and other traditions of mutualism and solidarity used by various communities including those facing various forms of marginalization. In the nineteenth century, worker cooperatives grew in number when the Knights of Labor and Cooperative Workers of America used them as a strategy for organizing labor. Another surge of interest in the US blossomed in the 1970s after Mondragon – the largest consortium of worker cooperatives in the world, based in the Basque region of Spain - began gaining traction as a community economic development strategy.

Worker cooperatives are the second most common form of employee ownership in the US. There are currently 450 worker cooperatives - all of which are majority employee-owned and have democratic governance structures - employing approximately 6,700 workers.11 Well-known worker cooperatives include Equal Exchange, Namaste Solar, Alvarado Street Bakery, and South Mountain Company. Many worker cooperatives identify as mission-driven organizations. Cooperative Home Care Associates, the largest worker cooperative in the United States with over 2,000 workers, was developed by a nonprofit organization in 1985 to employ low-wage women of color in the South Bronx, NY. The majority of worker cooperatives in the US today are of recent

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9 While the vast majority of that growth was new, legitimate ESOPs, the tax benefits also led to a wave of abuses. Over a thousand ESOPs were created between 1998 and 2001 for the sole purpose of tax avoidance. In 2001, Congress passed regulations that minimized the potential for such abuse. See Camille Kerr, Corey Rosen, and Nancy Wiefek, *The Changing World of Employee Ownership*, Oakland, National Center for Employee Ownership, 2014, 2.


vintage: 60% were formed since 2000 and 30% were formed since 2010.\textsuperscript{12}

**THE POSITIVE IMPACT OF EMPLOYEE OWNERSHIP**

Decades of studies have confirmed what advocates and practitioners in the field intuited: employee ownership yields measurable benefits for workers, the companies that implement it, and the communities where those companies are located.\textsuperscript{13}

In fact, employee ownership can play an especially important role in creating and preserving jobs of distressed communities and enhancing the economic base of those communities. More than 700 privately held ESOP companies – employing 155,000 people – have their headquarters in a distressed community.\textsuperscript{14}

A 2017 study found that employee owners have higher levels of income, wealth, and benefits than non-employee owners. Relative to non-employee owners, employee owners:

- have a 92% higher median household net wealth
- receive 33% higher median income from wages
- have access to a greater array of benefits, including flexible work schedules, retirement plans, parental leave, and tuition reimbursement
- have significantly greater access to childcare benefits (23% vs. 5% of non-employee owners)\textsuperscript{15}

The study indicated that these results were consistent for the vast majority of the demographic sub-groups analyzed, including single women, parents raising young children, non-college graduates, and workers of color. In fact, households that include young children (up to age 8) had double the median net worth of non-employee owners, and receive $10,000 more in annual wages. This confirms the results of previous studies; for example, a 1997 study in Washington State found that employee owners had wages 5% to 12% higher than their counterparts, as well as retirement assets that were 2.6 times greater.\textsuperscript{17}

Building on the evidence for wealth creation for workers overall, a 2019 study by the Rutgers Institute for the Study of Employee Ownership and Profit Sharing showed that ESOPs result in a significant but incomplete leveling of the racial wealth gap, with the median ESOP account value being at least 160 times that of the national median wealth for each of

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\begin{table}[h]
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\begin{tabular}{|l|c|c|}
\hline
 & MEDIAN WEALTH OF SINGLE WORKERS IN THE US & MEDIAN ESOP ACCOUNT OF LOW/ MODERATE-INCOME WORKERS IN SURVEY \\
\hline
African-American Women & $200 & $32,000 \\
\hline
African-American Men & $300 & $180,000 \\
\hline
Latina Women & $100 & $143,500 \\
\hline
Latino Men & $950 & $200,000 \\
\hline
White Women & $15,640 & $172,000 \\
\hline
White Men & $28,900 & $323,500 \\
\hline
\end{tabular}
\end{table}

Source: Study: Employee Ownership Narrows Gender and Racial Wealth Gaps\textsuperscript{16}

\textsuperscript{12} Ibid.
black women, black men, Latina women, and Latino men (compared to 11 times greater for white men and women). The report provides further evidence of higher incomes for women and workers of color, with 17% higher wages for women compared to the national average and 30% higher wages for workers of color.18

While the survey results clearly demonstrate that ESOPs are a powerful wealth building tool, the gap between African-American women and other subgroups is striking. This research serves as another reminder that much more work needs to be done in corporate settings – including with ESOP companies – to reduce the wealth gap in particular for Black women. It also underscores the fact that an ESOP structure per se, when used in a traditional returns-seeking context without consideration to specific benefits to workers, may perpetuate the racial wealth gap. This is a reason for the emphasis in the proposed impact guardrails on specifically seeking to address the needs of workers of color.

The momentum in the employee ownership field is palpable. Benefiting from a political climate that is hungry for viable mechanisms to build a more just economy, employee ownership is receiving unprecedented attention. Policy initiatives to spread employee ownership are growing nationwide. In August of 2018, the Main Street Employee Ownership Act became federal law. The provision embedded employee ownership into the Small Business Administration, making employee-owned companies eligible for SBA loans and charging the agency with spreading awareness about the model. According to Joseph Blasi, the director of the Institute for the Study of Employee Ownership and Profit Sharing at Rutgers University, the new measure is “the most significant policy change on employee share ownership in over two decades.”

At the local level, the New York City Council has invested over $12 million over the past five years into the Worker Cooperative Business Development Initiative, which “offers innovative ways for New Yorkers to overcome economic and social inequality.” New York City’s investment is the largest of multiple initiatives passed by municipalities nationwide to promote worker cooperatives, including in Madison, Miami, Philadelphia, and more. At the state level, Colorado, Massachusetts, and New York, among others, have passed recent legislation supporting employee ownership.

A recent report by the Next System Project outlines an overall policy framework for supporting employee ownership. These initiatives are combating the plateau that employee ownership has encountered. Other than a recent modest increase in the number of worker cooperatives, the number of employee-owned companies has been stagnant for over a decade. Employee ownership experts have attributed this lack of growth to a lack of awareness, a perception of complexity and costliness by business owners and their advisors, and a lack of capital. The current era may be witnessing a shift in these patterns. Indeed, the plateau is at odds with the remarkable interest in employee ownership in the United States. The 2018 General Social Survey reported in its national poll that among 1,500 working Americans “the vast majority of respondents (72 percent) said they prefer to work for an employee-owned company.

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over one owned by investors (19 percent) or the state (9 percent). A recent national poll from the Democracy Collaborative and YouGov Blue similarly found considerable support for “policy requiring business owners to allow their workers a chance to buy the business if it is being sold or closed,” indicating some public awareness and favor towards employee ownership transitions.

‘Employee ownership is also poised to play a significant role in the 2020 Presidential elections, with several candidates proposing policy that seeks to promote employee ownership of various forms.

**START-UPS OR CONVERSIONS?**

Creating more employee ownership can be accomplished in two ways: (1) promoting the development of new, start-up businesses that are structured as employee-owned in their initial formation, or (2) converting conventional, established business to employee ownership.

Initiatives like Start.coop – a Silicon Valley style incubator specific to cooperatives – and the newly formed Institute for the Cooperative Digital Economy at The New School are bringing a new, bold vision to start-up cooperative development. In many communities, start-up worker cooperative development is a growing part of the long-term vision for creating local self-reliance and fostering a solidarity economy. On the financing side, cooperative and employee ownership professionals are developing innovative new financing mechanisms to help start-ups capitalize and grow. Conversions, on the other hand, are benefiting from a major demographic shift: every day, 10,000 Baby Boomers are retiring. The retirement of the Baby Boomer generation, a phenomenon dubbed the “silver tsunami,” is both a threat to the economic stability of our communities and an opportunity to build a new paradigm of more distributed ownership of private businesses. In the US, there are over 1.2 million businesses with ten or more employees, which is the low-end size for a viable conversion; over 50% of businesses are currently owned by Baby Boomers. The estimated transfer in business assets from retiring Baby Boomers is $10 trillion. These businesses are also better established and have shown longevity – other things being equal, that is, these are less risky, more resilient businesses, as compared to younger ones. Upon their retirement, particularly if there is no succession plan in place, these hundreds of thousands of businesses may be forced to shut down – or be absorbed into larger conglomerates and relocat-

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ed - resulting in local jobs and services leaving communities, especially ones already economically challenged.\textsuperscript{33} A sale via a conversion to employee ownership offers the opportunity to retain these businesses – including the jobs and the services they provide – while also offering employees the opportunity to build assets on top of their annual income.

The model presented below focuses on the opportunity for ownership via conversion because of the lower risk it creates for workers (that is inherent in a start-up business) and the demonstrated possibility for scale.

Leaders in the employee ownership field have identified the lack of available and appropriately structured investment capital as a significant barrier to more companies becoming employee-owned. Combined with the recent momentum and visibility of the field in general, the opportunity for conversions has caught the attention of investment circles – both traditional buyout capital and impact-minded investors.

This provides a dual opportunity: to address that barrier, but also to leverage capital so as to ensure that succession-based conversions truly create positive impact for workers and communities. We have identified the following as core advantages of an impact-driven investment approach to conversions:

- **Providing impact guardrails:** There have been abuses of the employee ownership form as a financial engineering tool at the expense of workers in the past. Even upstanding ESOP financiers can fall short on impact by not explicitly focusing on industry, geography, and demographics of the workers, as well as the structural and cultural elements of the converted enterprise. By setting guardrails around the impact sought, first movers through worker-centric buyout funds have the opportunity to protect, center, and empower workers while avoiding those abuses. To do so, we propose five impact recommendations: 1) Long-term, broad-based employee ownership; 2) Centering POC and low-wage workers; 3) Measured impact; 4) Employee participation and power; and 5) Non-extractive deal structures. These recommendations are detailed later in this report.

- **Increasing the available market for conversions:** A conventional employee ownership transaction requires a significant commitment by the selling owner, who remains part of the capitalization of the company long after the decision to sell. Combining employee ownership and private equity creates greater liquidity for selling owners (lower reinvestment, faster timeline to exit), increasing the pipeline of sellers interested in employee ownership.

- **Activating investors:** Multiple fund managers and asset owners have expressed interest in financing businesses to become employee-owned, but are hesitant to take on the risk of a solo deal or want to move beyond the provision of debt capital. Creating a buyout vehicle specifically for this type of investment can increase the capital available for employee ownership transactions.
• **Replicating and scaling:** Investing in employee ownership conversions through a novel buyout fund model can create the proof of concept needed for replication at a scale that vastly exceeds the efforts to date. The market-sustainable, mission-driven approach is sufficiently appealing for a range of capital, and even a handful of funds using the buyout model can touch thousands of workers and build substantial accounts for those workers in a relatively short time.

**CURRENT FINANCING MODELS**

**THE SELLER FINANCING MODEL**

In a traditional employee ownership transaction in a succession context without outside equity financing, the selling owner remains tethered to the company long after the decision to sell. In many cases, the selling owner finances the entire transaction. In others, the transaction is financed by a combination of senior debt from a bank and junior debt from the selling owner, typically a minimum of 30% of the transaction and often priced below market. This model can provide more after-tax cash proceeds to the selling owner, as compared with a traditional private equity sale, allows the owner to retain control and reduces the culture change. However, it also means that the selling owner remains part of the capitalization of the company long after the decision to sell.

**OUTSIDE FINANCING: CDFIS AND PE + ESOP**

The current opportunities for outside investment in employee-ownership conversions are limited; this is one of the factors why we have not seen a more significant increase in conversions despite the overall appetite. In 2016, the Foundation for Enterprise Development published a report on the state employee ownership and impact investing as an outside source of financing. The report found two primary investment options: (1) a handful of community development finance institutions (CDFIs) with a focus on worker ownership and (2) private equity groups that use the ESOP model.\(^35\)

The CDFI and loan funds have used a pure debt model with an impact focus. They leverage grant capital to subsidize operating expenses and provide technical assistance beyond what a traditional lender can offer; they have generally not achieved market sustainability or scale. The financing products range from senior debt to equity-like subordinate capital, and investors receive concessionary returns. The existing PE + ESOP funds, on the other hand, use an equity-like model and target rates of returns comparable with the rest of private equity, making them attractive to institutional investors able to deploy bigger pools of capital, but mostly do not have an impact focus. They do not typically leverage grant or philanthropic capital.

The employee ownership CDFI or loan funds are all under $30M (and mostly under $10M), whereas the PE + ESOP funds are over $150M. This leaves a major gap for sizeable target companies that can be a natural fit for a PE + ESOP fund that has an impact focus.

The table below compares the core differentiating factors between CDFIs, PE + ESOP funds, and the fund model being proposed in this document.

### A Comparison of Financing Models

<table>
<thead>
<tr>
<th></th>
<th>CDFI</th>
<th>EXISTING PE + ESOP</th>
<th>WORKER CENTRIC PE + ESOP</th>
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<tbody>
<tr>
<td><strong>Use of Equity vs. Debt</strong></td>
<td>Primarily debt with some preferred share investments that have returns similar to debt</td>
<td>Mezzanine debt with paid in kind (PIK) interest and warrants</td>
<td>Mezzanine debt with warrants, potentially capped upside</td>
</tr>
<tr>
<td><strong>Deal Size</strong></td>
<td>Average in the six-figure range. Some deals have been as large as $5-$6MM</td>
<td>Target companies in the $3M-$10M EBITDA range</td>
<td>Expected to target, at the low end of fund size, companies in the $500K-$3M EBITDA range</td>
</tr>
<tr>
<td><strong>Impact Focus</strong></td>
<td>Must support economically disadvantaged communities to be a CDFI</td>
<td>No explicit impact focus</td>
<td>Focus on creating a positive impact on workers, especially low-wage workers and workers of color</td>
</tr>
<tr>
<td><strong>Return Target</strong></td>
<td>5-8% loan terms</td>
<td>12-18%</td>
<td>Low to mid-teens</td>
</tr>
<tr>
<td><strong>Operational Subsidy</strong></td>
<td>Between 30% and 80% subsidized based on size and operational model</td>
<td>No subsidy required</td>
<td>Some subsidy likely needed, along a continuum, as a potential function of depth of impact and assistance needed to create a culture of ownership and minimize overleverage and wealth extraction</td>
</tr>
</tbody>
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Source: The Authors
More broadly, one can think of a set of fund approaches along the axes of a continuum of capital (from concessionary to market rates) and a continuum of deal sizes (from very small enterprises to large cap companies).

The chart below maps the fund approaches in an indicative fashion along those axes, ranging from worker cooperatives to traditional, pure PE models without employee ownership exits.

**Indicative Landscape of Outside Financing Options for Conversions**

The chart below maps the fund approaches in an indicative fashion along those axes, ranging from worker cooperatives to traditional, pure PE models without employee ownership exits.

**Continuum of Deal Size**

- Worker-Centric PE + ESOP (Proposed Fund Approach)
- ESOP with Mezzanine Financing
- Worker Cooperative Financing
- Traditional Private Equity (No Employee Ownership)
- PE Using ESOP

**Continuum of Financial Returns Sought**

- Impact-First
- Exclusively Financial
In terms of combination of depth of impact and feasibility, the several fund approaches can be characterized as described in the summary table of pros and cons below. The following section will explore in more detail the existing PE + ESOP model and its worker-centric version.

### PROS AND CONS OF THE SEVERAL FINANCING APPROACHES

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<th></th>
<th>POSITIVE</th>
<th>NEGATIVE</th>
</tr>
</thead>
<tbody>
<tr>
<td>WORKER COOP FINANCING</td>
<td>Focused on democratic and equal ownership - very good on reducing inequality</td>
<td>Approach does not fit well in many sectors; often heavily reliant on concessionary capital</td>
</tr>
<tr>
<td>CDFI-FINANCED ESOP</td>
<td>Focused on significant employee ownership</td>
<td>Scaling appears to be limited by ability to acquire and then convert as well as potentially access to concessionary capital sufficient to scale deal sizes and sector</td>
</tr>
<tr>
<td>WORKER-CENTRIC PE + ESOP (Trust)</td>
<td>Focused on significant employee ownership; employees leaving firm does not create debt burden for the company and/or employees</td>
<td>Relative newness of employee trust or other alternative collective ownership models; yet to be determined if model is scalable</td>
</tr>
<tr>
<td>WORKER-CENTRIC PE + ESOP (Traditional ESOP)</td>
<td>Focused on significant individual employee ownership</td>
<td>Employees leaving the firm creates debt burden for company and/or employees; yet to be determined if model is scalable</td>
</tr>
<tr>
<td>PE + ESOP</td>
<td>Seemingly potential for additional scale and access to capital; potentially an alternative approach to higher risk-adjusted financial returns but only a couple groups doing this in past two decades</td>
<td>Reduction of inequality not a priority; objective is sale at maximum price; ESOP at best a tool in service of Fund Manager profit maximization (incentive of carried interest)</td>
</tr>
<tr>
<td>PURE PE</td>
<td>Scale and access to capital</td>
<td>Reduction of inequality not a priority; objective is sale at maximum price; ESOP at best a tool in service of Fund Manager profit maximization (incentive of carried interest)</td>
</tr>
</tbody>
</table>

Source: The Authors (based on conversations with Garth Davis)
FINANCING CONVERSIONS THROUGH A PE FUND MODEL

THE PE + ESOP MODEL

In a typical private equity leveraged buyout fund model, the private equity group (PEG) purchases a significant – often controlling – stake in multiple private businesses, using debt to finance a large percentage of each transaction. The PEG holds the companies for a period, typically between 3 and 8 years, during which time fund managers serve on the board with the intent of growing and improving the profitability of the business. The value creation may come, for example, through upgrading operational systems, cutting costs, pursuing new markets, increased tax efficiency, or putting in place better financial controls. The fund typically exits the investment through an IPO or by selling to a strategic buyer, an upstream investor, or another PE fund.

Adding employee ownership into the mix changes the structure, but not the basic model. The ESOP trust owns the company, purchased with financing from the PEG. The PEG receives a note for mezzanine capital and structured equity but, unlike in a traditional leveraged buyout, does not take outright ownership. Instead, the PEG gets warrants, which are similar to stock options and give the holder the right to buy shares at a negotiated price.

The tax-advantaged status of the ESOP, as well as increased profitability, allows the company to pay down the leverage quickly. At the end of the holding period, the business recapitalizes to finance the warrants as they are exercised or redeemed.

According to one of the major private equity groups deploying the ESOP strategy, ESOP structured equity is an attractive risk adjusted return security (“mezzanine-plus” - above the low- to mid-teens mezzanine returns and below private equity’s 20-30% returns) which may consist of:

- Closing fee of 2-3%
- Cash coupon of 10-14%
- 5-7 year put (ESOP valuation at fair market value)
- 2 out of 5 board seats
- Board leadership and committee representation
- 25-40% warrant position

We note that this return model leads to a very high equity return, which tends to be inconsistent with a balanced return expectation among the stakeholders. Indeed, some of the current funds on the market show a significantly overpriced approach – with expected returns at least as good as standard private equity funds, but with lower risk. An overly high return expectation at the inception of this growing industry can skew the market and crowd out fairly priced transactions. ESOPs can take on less debt, can be less risky: they tend to be mature companies and have greater cash flow. Because of this, market rate returns for equity investors could be sustainable at much lower levels. A “market rate” is currently hard to determine; given that so few investors are supporting employee ownership conversions, it is an open question what the proper risk-adjusted rate of return should be.

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36 Steve Buchanan and Dick May, remarks at the 2nd Annual Private Equity and Employee Share Ownership Symposium hosted by the Institute for the Study of Employee Ownership and Profit Sharing, Piscataway, NJ, March 25, 2019.
for these transactions. Funds could target equity- or debt-like returns based on how the deal is ultimately structured. Prior transactions appear to have delivered returns across the entire spectrum.

Optimal terms for a hypothetical dedicated employee ownership fund could differ from the expectations of traditional private equity. Given the nature of the exits, the fund could have a) a different form of incentive than carried interest and b) a longer fund life. Because the exit for the private equity investor is not predicated on a sale, but rather relies on cashflow to facilitate a refinancing, the incentives for the fund manager should be aligned with avoiding unnecessary pressure to make a premature exit. In particular, carried interest sometimes incentivizes managers to minimize reinvestment in the company in order to maximize debt repayment - a problematic situation for employee owners in the long term.  

While historically less customary, long-dated funds (exceeding the traditional ten-year term) have been on the rise and would not necessarily be off-market in this context.

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**SAMPLE PE + ESOP TRANSACTION STRUCTURE**

Source: Adapted from Private Equity and ESOPs: A Creative Combination.

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37 Impact-aligned investors, such as foundations, could support start-up fund managers with a different fee model by providing start-up concessionary capital to help fund managers establish themselves on more equitable terms.


FINANCING CONVERSIONS THROUGH A PE FUND MODEL

Pre-transaction, the selling shareholders hold 100% of the common stock. Upon the transaction, the selling shareholders sell all of the shares to the company in exchange for cash and reinvests a portion of that cash in the company (on terms similar to those of the PE fund investment – a combination of mezzanine debt and warrants).

The company purchases 100% of the shares from the selling shareholders. Now the company owns 100% of the shares, financed by three parties, exemplified below with indicative percentages:

- Senior debt provider (50% of transaction with a term loan at current interest rates)
- PE fund (30% of transaction, with a combination of mezzanine debt and warrants)
- Reinvesting seller (20% of transaction, with a combination of mezzanine debt and warrants)

The company contributes the shares - 100% of common stock - to the ESOP trust, in exchange for an internal loan. The ESOP trust now owns 100% of the common stock and repays the loan through the funds it receives from the company, as the company earns profits, through ESOP contributions.

The company uses these repayments from the ESOP trust to repay the external debt holders, which progressively reduces the company’s debt load. As the internal loan from the company to the ESOP trust is repaid, company shares held by the ESOP trust are released into employees’ accounts.

When the reinvesting seller and the PE fund are ready to exercise their warrants, the company typically calls the warrants, repurchasing them at the value of the exercise. The company often finances the transaction by recapitalizing with senior debt.

When using the PE + ESOP strategy, funds often target multi-generational family-owned businesses whose priorities include leaving a legacy and institutionalizing the business for the long-term. Several established PEGs have found that combining employee ownership and private equity can be a competitive advantage over other private equity firms. While admittedly a smaller opportunity set, sellers concerned with their legacy are offered the opportunity to maintain and reward existing management and employees who helped build the company without having to pay a financial penalty or unduly deferring their return. For a seller motivated to choose this path, the fund model can reduce the friction significantly through the combination of readily available capital for the transaction and the tax benefits from the ESOP conversion. Specifically, the selling shareholders may be eligible to defer

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**PE + ESOP TRANSACTION**

**SAMPLE SOURCES AND USES**

<table>
<thead>
<tr>
<th>SOURCES AND USES</th>
<th>AMOUNT</th>
<th>TERMS</th>
</tr>
</thead>
<tbody>
<tr>
<td>SENIOR DEBT</td>
<td>$42M</td>
<td>5%</td>
</tr>
<tr>
<td>PE NOTES AND WARRANTS</td>
<td>$26M</td>
<td>10% – 12%, 25% of diluted equity value</td>
</tr>
<tr>
<td>REINVESTMENT NOTES AND WARRANTS</td>
<td>$16M</td>
<td>10% – 12%, 15% of diluted equity value</td>
</tr>
<tr>
<td>TOTAL SOURCES</td>
<td>$84M</td>
<td></td>
</tr>
<tr>
<td>REINVESTMENT CAPITAL</td>
<td>$16M</td>
<td></td>
</tr>
<tr>
<td>CASH PURCHASE OF SELLER EQUITY</td>
<td>$64M</td>
<td></td>
</tr>
<tr>
<td>FEES AND EXPENSES</td>
<td>$4M</td>
<td></td>
</tr>
<tr>
<td>TOTAL USES</td>
<td>$84M</td>
<td></td>
</tr>
</tbody>
</table>

Source: Private Equity and ESOPs: A Creative Combination.41

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40 Ibid.
FINANCING CONVERSIONS THROUGH A PE FUND MODEL

By way of example, Long Point Capital started out as a traditional private equity firm. At the request of one of its portfolio companies, Sunbury Textile Mills, Long Point Capital explored its first private equity ESOP transaction in 2004. A few years later, the fund experimented with the model again with an investment in Atlantic Plywood. Both experiments were successful, leading to Long Point Capital embracing the strategy. Today, Long Point Capital offers what it calls “PE + ESOP recapitalization” as one of four standard transaction structures in its current $238 million dollar fund and has done seven ESOP transactions, for a total of 3,000 employee owners.

Mosaic, conversely, is an example of a Small Business Investment Corporation (SBIC) that has structured several deals using the PE + ESOP model. The fund is approximately $164 million, relying on significant SBIC leverage via the Small Business Administration. The SBIC program contributes up to $150 million into private funds that invest in small businesses, and typically matches the funds raised 2:1. For example, a fund that raises $75 million can be matched with $150 million of SBA leverage, resulting in a $225 million fund. SBICs offer investment options for small businesses that otherwise avoid private equity investments, because control investments by large funds can put their small business contractor status at risk. Conversely, because SBA funds can only be used with small businesses, the SBIC strategy is confined mostly to lower middle market transactions.

THE CURRENT LANDSCAPE OF PE + ESOP TRANSACTIONS

There are currently at least four PEGs that have used ESOPs in their transactions: Long Point Capital, Mosaic Capital Partners, Endeavour Capital, and New State Capital Partners.

42 For a thorough review of the economics of the several tax advantages, see Pete Stavros, “Private Equity and ESOPs,” The Journal of Private Equity, Winter 2002, 6 (1) 42-58, https://jpe.pm-research.com/content/6/1/42.
44 Established by Congress through the Small Business Investment Company Act in 1958, the SBIC program has resulted in over $70 billion of funding to more than 100,000 businesses.
45 The SBIC “small” business designation is based on a standard that is an alternative to the SBA’s size standard for the industry in which it is primarily engaged. As of 2014, the SBIC alternative size standard is tangible net worth (total net worth minus goodwill) under $19.5 million and average net income after federal income taxes (excluding any carry-over losses) for the preceding two years under $6.5 million. Congressional Research Service, SBA Small Business Investment Company Program, p. 35, https://fas.org/sgp/crs/misc/R41436.pdf.
While ESOP transactions and worker cooperative conversions are often thought of as similar models, the financial structure for a worker cooperative conversion is meaningfully different. Worker cooperative conversions are typically financed with a combination of seller notes and senior debt. Most transactions are fully debt financed because most cooperatives do not allow investors to have voting rights and, as a result, investors owning common stock—or any voting stock—is not an option. However, some cooperatives have offered preferred, non-voting shares to finance a conversion.

**WORKER COOP CONVERSION**

**SAMPLE SOURCES AND USES**

<table>
<thead>
<tr>
<th>SOURCES AND USES</th>
<th>AMOUNT</th>
<th>TERMS</th>
</tr>
</thead>
<tbody>
<tr>
<td>SENIOR DEBT</td>
<td>$500,000</td>
<td>4-8%</td>
</tr>
<tr>
<td>SENIOR DEBT – LINE OF CREDIT</td>
<td>$150,000</td>
<td>6-8%</td>
</tr>
<tr>
<td>SUBORDINATED DEBT – SELLER FINANCING</td>
<td>$200,000</td>
<td>4-10%</td>
</tr>
<tr>
<td>WORKER OWNER EQUITY</td>
<td>$50,000</td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL SOURCES</strong></td>
<td><strong>$900,000</strong></td>
<td></td>
</tr>
<tr>
<td>CASH PURCHASE OF SELLER EQUITY</td>
<td>$700,000</td>
<td></td>
</tr>
<tr>
<td>WORKING CAPITAL</td>
<td>$200,000</td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL USES</strong></td>
<td><strong>$900,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

Source: The Lending Opportunity of a Generation: FAQs and Case Studies for Investing in Businesses Converting to Worker Ownership.

The outside debt in a worker cooperative conversion is often provided by a community development finance institution (CDFI) that specializes in lending to cooperative businesses. CDFIs that are actively developing a pipeline of worker cooperative conversions include the Cooperative Fund of New England, the Local Enterprise Assistance Fund, Shared Capital Cooperative, and The Working World. In addition, the Ohio Employee Ownership Center and the Vermont Employee Ownership Center – two nonprofit organizations that offer technical assistance to businesses interested in becoming employee-owned — have started loan funds to provide subordinate debt for the employee ownership transactions they facilitate.

With The Working World (TWW) as an early innovator in the space, many of these cooperative CDFIs are currently offering or exploring equity-like financing products in their worker cooperative transactions. TWW’s equity-like financing, combined with the long-term technical assistance they offer, resembles the PE + ESOP model discussed above. For example, like a private equity firm, TWW supports its portfolio companies with operational recommendations to improve productivity, including by identifying and onboarding new management. TWW has an explicit mission of serving low-wage workers and people of color and has pioneered the concept of non-extractive finance.
It must be noted that the CDFIs pursuing worker ownership conversions typically work with smaller companies with transaction values in the $300,000 – $1 million range, although they have played a role in financing deals up to $6 million. They also leverage a significant amount of grant funding to subsidize their operations, and their investors typically provide patient capital at below-market rates.
INVESTMENT OPPORTUNITIES THROUGH A DEDICATED FUND

Given the activity around financing conversions with a worker-centric impact thesis, there is currently a clear opportunity for the creation of a dedicated fund. Indeed, during the research period that led to this report, asset owners and fund managers have expressed increased interest in the establishment of dedicated funds.49 New funds have emerged and there are currently six mission-driven financial institutions focusing on conversions using a leveraged buyout model (see “Investing in Existing Dedicated Employee Ownership Financial Institutions,” page 29).

This section seeks to identify and advance new investment options focused on combining meaningful impact for workers with the spread of employee ownership at scale. While the dedicated, impact-centric fund concept has captured the attention of most investors interested in employee ownership, there are three complementary strategies or pathways, which can combine into a dedicated fund.

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Three Pathways to a Dedicated Fund

1. Establish a Bespoke Fund

Build the necessary elements for a fund by issuing an RFP for a fund manager and anchoring the fund. This process would require a large financial commitment, the identification of potential co-investors, and the running of an RFP process to assemble a team with a demonstrated commitment to the impact alongside fund management experience in an LBO private equity model.

Pros: The anchor investors would have significant control over the fund’s mission and approach.

Cons: It can be challenging to build fund capacity from scratch, and experienced fund managers may not be too eager to embrace a strategy that is relatively unproven and may present lower economics for the manager. Conversely, less experienced and first-time fund managers may have difficulty raising capital. Anchoring a fund may be a daunting commitment for investors, particularly if they have not previously done one-off conversions.

2. Catalyze Existing Early-Stage Employee Ownership Funds

Invest in emerging employee ownership funds and influence their impact practices. Some of the emerging funds have managers with significant employee ownership expertise, others are experts in social impact investing, and yet others have significant leveraged buyout experience. Few if any of the emerging funds have all three. An investment into such a fund would rely on the existing infrastructure and help build missing capacity.

Pros: By supplying early-stage capital to support the successful raise of one or more of these funds, an anchor LP would have influence over the fund’s impact criteria. Demonstrating one successful dedicated fund could catalyze additional funds to follow their practices.

Cons: Other elements of social impact are as complex as employee ownership, which fund managers without experience with might not understand or implement effectively.

3. Assemble a Special Purpose Vehicle for a Single Transaction as a Precursor to a Fund

Work with a buyout fund or fund manager to identify a deal that can successfully demonstrate the model, and invest in an SPV or similar vehicle for that deal.

Pros: It is relatively easy to assemble capital for a single transaction, less capital is needed, and investors can perform due diligence on the transaction in advance. The single transaction can serve as a model for replication and scaling, increases confidence in the viability of the model, creates a track record for subsequently raising a fund, and, if successful, can be rolled up into a fund.

Cons: A permanent fund capacity is not created and the capital is limited to the individual deal. Replication and scaling is limited to the individual deal, as opposed to the fund structure. Risk is not diversified across transactions and there are no synergies captured or economies of scale realized.
FINANCING CONVERSIONS THROUGH A PE FUND MODEL

BUILDING A DEDICATED EMPLOYEE OWNERSHIP FUND

For years, employee ownership advocates and aligned investors have contemplated the idea of an investment fund dedicated to transitioning healthy businesses to employee ownership. Such a fund would offer subordinated debt and structured equity, using the leveraged buyout model to transition healthy businesses to employee ownership, along the lines of the PE + ESOP model described above. The fund would generate returns though a combination of the ESOP tax benefits and improved profitability, including by implementing an employee ownership culture.50

Where the returns are driven by productivity increases, as opposed to value extraction, is highly dependent on the sector targeted. Investors driving for maximization of returns may focus on a subset of industries that may not correlate to the priorities from the perspective of the maximal impact on workers. For example, the focus on POC and low-wage workers may mean prioritizing a pipeline of companies with lower margins. Starting from the position that a dedicated fund would be foremost concerned with the impact, the impact recommendations laid out below may well affect the returns profile of the PE + ESOP business model. This is not a reason to shy away from the model. Rather, it is an invitation to reconsider who is in the best position to bear the financial hit of a fair conversion. For example, a fair conversion under the PE + ESOP model in lower-margin industries may require a willingness on the part of GPs and LPs to accept potentially lower returns in exchange for the additional impact. The lower GP/LP return model as a driver of non-extractive impact is currently being explored by Social Capital Partners. We hypothesize, based on our conversations and survey of the field, a continuum of capital, with impact-minded investors, such as foundations, being in a position to finance transactions (and funds) at the lower end of returns. This is not necessarily the case, however. Among the funds currently pursuing a PE + ESOP strategy discussed below, American Working Capital, for example, targets a combination of competitive margins and high impact on a diverse workforce.

FINANCING CONVERSIONS THROUGH A PE FUND MODEL

THREE APPROACHES TO BUILDING A FUND

1. MIRROR EXISTING FUNDS, ADDING IMPACT EMPHASIS

One approach to a dedicated fund is to mirror the PE + ESOP fund model used by Long Point Capital and Mosaic Capital Partners, mentioned above, adding an impact focus and adjusting return expectations as needed. This approach targets a fund size of $150-$200 million and companies in the $3M-$10M EBITDA range, which is understood to be sustainable without a philanthropic contribution. The approach is attractive because (1) it is a tested, market sustainable model and (2) it has the scale and replication potential to reach tens of thousands of employees. The primary drawback of this approach is the difficulty of raising a first-time fund of this size - as well as the existing incentive structure for the fund manager, which may be at constant odds with the impact emphasis.

2. BUILD A FUND IN THE MISSING RANGE

A second approach to a dedicated fund is to build a fund in the $30M-$75M range, currently overlooked in the PE + ESOP space. This range has the advantage of matching what many first-time funds in the social investment space have been able to raise. A smaller fund might target companies at the low-end of the ESOP range - that is, companies with $500K-$3M in EBITDA.

By way of contrast, Long Point and Mosaic focus on companies in the $3M-$10M EBITDA range. There are multiple private equity firms that focus exclusively on businesses in this size range, although none of them has an employee ownership focus. For example, Hadley Capital is a $40M fund that identifies as a patient, collaborative investor targeting companies with $1M-$3M EBITDA. Evolution Capital Partners also focuses on deals in the $500k-$2M EBITDA range. A fund that targeted this size range could leverage the tax advantages of the PE+ESOP model while raising a significantly smaller fund.

3. COMPETE DIRECTLY WITH MIDDLE MARKET PRIVATE EQUITY

There is also a third approach to a fund focused on employee ownership, which intentionally competes with private equity firms. Given that private equity transactions can often have negative impacts on consumers, workers, and communities, there is a strong impact thesis for redirecting firms that would have otherwise sold into private equity toward employee ownership. There is some flexibility on which segment of the private equity market this fund could target. However, given that there have averaged over 1,000 transactions annually in the central middle market ($100-500M Enterprise Value), where prices generally average around 10x EBITDA, this would be a large and addressable market for ESOP conversions.


There are a number of important considerations for a fund that would directly compete with private equity:

**Transaction structure:** Similar to the other funds contemplated, this fund could use mezzanine debt to support the conversion of a company into a 100% ESOP owned. On a transaction selling for 10x EBITDA, financing could come from bank debt (40-50% of transaction, equivalent to 4-5x EBITDA), mezzanine debt (30-40% of transaction, equivalent to 3-4x EBITDA), and the remainder financed by the seller through a subordinated seller note (10-30% of transaction).

**Tax advantages:** As described previously, a 100% ESOP-owned company does not pay corporate tax, which enhances its debt service capabilities. In addition, a seller is able to defer and possibly eliminate capital gains tax by selling to an ESOP. As a result, this fund could have a 1-2x EBITDA purchase price advantage over traditional private equity, depending on the seller’s cost basis.55

**Fund size:** In light of the transaction structure, where a fund would finance 30-40% of the purchase price, a $500M fund (admittedly atypical for a first-time fund) targeting 7-10 transactions would be well positioned to compete for the average middle market private equity deal. Limited Partner co-investment opportunities could enable the fund to pursue larger investments as well.

**Return expectations:** Should the seller roll significant proceeds from the sale (20-30%) back into the company as a subordinated seller note, there is a strong argument that the rate on the mezzanine investment be more aligned with market rates of 10-12%. Concessionary capital would enable the fund to pursue deals with sufficiently attractive returns to the fund, improve outcomes for employees, or improve incentives for the seller (i.e. higher interest rate on seller notes, or a smaller seller note).

While this is an ambitious concept, there are tangible benefits to using an ESOP conversion fund to crowd-out private equity. The fund would provide owners of large companies with a credible alternative to private equity that ensures a business remains independent and local. Most importantly, a successful fund could create over 3x the fund size, or $1.5B in wealth for employees while delivering acceptable returns (once all portfolio companies repay debt). Competing with private equity enables employee ownership to reach scale and stem the tide of companies getting consolidated by private equity firms to the detriment of workers and to the advantage of investors and fund managers. Also, proving that these conversions can occur in a very large fund can be a catalyst to unlock billions of dollars in impact capital toward employee ownership. There are so many mid-market buyouts in the United States as to provide an almost unlimited ability to absorb capital, and a successful fund could be a prototype for other, similar, funds.

At the other end of the spectrum, the team at the newly forming Legacy Business Fund has identified multiple potential benefits to the smaller fund approach. Businesses in this smaller size-range are not typically attractive to private equity firms, limiting competition. It is a well-documented trend that private equity firms are paying premiums for deals in the middle and upper middle market because of the extensive competition for deals. Because of this trend and other factors, companies that sell in this size-range typically go for much lower multiples.

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They also have substantial areas for growth and improvement through, for example, improving financial management and upgrading systems and technology.

Given the variables outlined above, this report intentionally stops short of outlining what a worker-centric PE + ESOP fund could look like in terms of size, target returns, number of deals, and similar parameters. A follow-on report ought to address these elements from the perspective of practitioners currently envisioning such funds.

**INVESTING IN EXISTING DEDICATED EMPLOYEE OWNERSHIP FINANCIAL INSTITUTIONS**

Given the relative novelty of the PE + ESOP concept, one can expect some challenges in fundraising for pioneering funds. Through early commitment and support to funds (and other financial institutions fulfilling similar roles) that are currently raising, impact aligned investors can demonstrate traction and help first-time funds to achieve their target raise, or lower operational subsidy levels, while de-risking the overall strategy for subsequent investors who are taking a wait-and-see approach.

For asset owners seeking to drive a specific impact thesis, investing in an existing fund presents a disadvantage in terms of being able to bake the thesis into the fund pre-formation, or establish parameters, such as a focus on a geographic area or worker demographic. This is even more the case in the context of impact requirements such as the ones outlined in this document (see “Ensuring Impact,” page 37).
The table below presents a summary of six mission-driven financial institutions that are currently in various stages of development or deployment. Detailed descriptions of each are presented in the Appendix.

### MISSION-DRIVEN FINANCIAL INSTITUTIONS — CURRENT EFFORTS

<table>
<thead>
<tr>
<th>Name</th>
<th>Target Size</th>
<th>Ownership Culture Focus</th>
<th>Concessionary Capital</th>
<th>Impact Focus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inclusive Capitalism Fund</td>
<td>$100-$200M (raising now)</td>
<td>Yes, one member of the core team is an expert.</td>
<td>No – offering 12% – 18% gross IRR.</td>
<td>Employee ownership impact focus.</td>
</tr>
<tr>
<td>Fund for Employee Ownership</td>
<td>$20-$50M (raised $5M)</td>
<td>Yes, leveraging the experience of building worker engagement with the Evergreen Cooperatives</td>
<td>Yes, offering investors concessionary debt rates.</td>
<td>Employee ownership and low-wage worker / racial equity impact focus.</td>
</tr>
<tr>
<td>The Blueprint Fund</td>
<td>$150M (not yet raising)</td>
<td>Yes, one member of the core team is an expert.</td>
<td>No - offering 12 – 14% net IRR.</td>
<td>Employee ownership impact focus.</td>
</tr>
<tr>
<td>National Worker Ownership Impact Fund</td>
<td>$50M (not yet raising)</td>
<td>Prior experience with worker ownership.</td>
<td>TBD</td>
<td>Employee ownership and low-wage worker focus.</td>
</tr>
<tr>
<td>Legacy Business Fund</td>
<td>$30M (not yet raising)</td>
<td>Yes, one member of the core team is an expert and Democracy at Work Institute is a TA partner.</td>
<td>Yes, offering concessionary debt and equity rates.</td>
<td>Employee ownership and minority business ownership focus.</td>
</tr>
<tr>
<td>The Working World Fund</td>
<td>$50M evergreen/open-ended fund ($9M currently deployed)</td>
<td>Yes, long-term experience in cooperative incubation, already active with outstanding equity placements.</td>
<td>Yes, offering investors concessionary but performance based rates.</td>
<td>Employee ownership for low-wage and minority ownership.</td>
</tr>
</tbody>
</table>

Source: The Authors, based on conversations with the relevant financial institutions.
FINANCING INDIVIDUAL DEALS DIRECTLY

Several asset owners interested in conversions have expressed hesitation about investing in, let alone anchoring, a PE + ESOP fund strategy. An onboarding opportunity for such investors can be to offer subordinated debt or equity to facilitate individual deals that would otherwise not be possible. One method for identifying such deals would be to partner with employee ownership professionals and finance institutions that are actively building a pipeline of conversions. For larger deals, investors can assemble the necessary financing, for example, by creating a special purpose vehicle (SPV). The SPV would have similar economics to the underlying transaction highlighted above, even though the risk diversification elements of a fund would be foregone.

An alternative approach to the individual transaction lies, rather than with the asset owner, in the province of a private equity portfolio manager. Private equity groups can add employee ownership as a one-off or as a standard part of their portfolio — like Long Point Capital has — by providing capital to allow the owner(s) to generate liquidity when selling their company to an ESOP, selling a portfolio company to an ESOP, or offering financing to existing ESOPs to expand. From the portfolio manager’s perspective, this type of transaction has the additional advantage of providing a structured or certain exit in circumstances of limited M&A activity.

INDIVIDUAL DEALS VIA THE FUNDLESS MODEL: SEARCH FUNDS AND FUNDLESS SPONSORS

A relatively unknown option that sits between the fund model and the individual transaction lies in the “fundless model”, which can take the form of a search fund or fundless sponsor model. Fundless models do not rely on a capital commitment and can have a solid competitive position in lower middle market acquisitions. Fundless sponsor models are sometimes also referred to as “pledge” funds where transaction pipeline generated by the fundless sponsor is shared with a relatively small group (under 6) of investors who underwrite search efforts and enjoy the privilege of opting-in or opting out of specific investment opportunities. Membership in pledge fund groups can be for limited time periods such a one or two years, usually renewable. Pledge fund costs are variable for investors but are in the range of a few hundred thousand dollars per year.

Funds such as these look for acquisition targets without a prior capital commitment or obligation to invest. The deals that are found are brought to the investors who financed the search stage and the equity is raised for that specific transaction. While a search fund normally suits the circumstance of an entrepreneur who wants to acquire a company and run it, the structure can lend itself to the acquisition of companies in a succession context for purposes of conversion. Search funds have been used for lower middle market acquisitions in a succession context, but, to our knowledge, have not been combined with the PE + ESOP strategy.

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A fundless sponsor oftentimes adds transactions under a new strategy to an existing portfolio - making it more similar to the circumstance, such as Long Point, where conversion deals are being explored as a new strategy. Given the knowledge required of a PE + ESOP team and the variability in deal size, the fundless sponsor model can be a good fit for sizeable transactions without the requirement of committed capital. It can lessen some of the difficulties of raising a first-time fund with a novel strategy, redirecting the energy instead toward the search of the appropriate transaction.

Fundless models are also not subject to the time horizon of a traditional closed-end fund, which can provide more flexibility for a PE + ESOP conversion strategy, lessen the constraints around deal size, and open the possibility for different investors to participate in deals that specifically address their interests - a welcome feature where there may be different impact targets across different markets.

One weakness to the fundless model approach is it can encounter resistance from the seller because of the uncertainty about securing the capital for the deal, unlike a traditional fund with committed capital. That is where reliance on credible, experienced investment teams with a track record of successfully securing capital to finance similarly scaled transactions is critical to give a seller confidence the deal will close.

INVESTING IN EMPLOYEE OWNERSHIP CDFIS

Employee ownership and cooperative CDFIs are currently financing the largest number of values-driven employee ownership transactions and providing technical assistance (TA), especially around worker cooperative conversions. The Democracy at Work Institute has brought these groups together into the Workers to Owners Collaborative, with the purpose of catalyzing a “wave of business conversions to cooperative employee ownership.”

CDFIs participating in the Collaborative include Capital Impact Partners, the Cooperative Fund of New England, the Local Enterprise Assistance Fund, Shared Capital Cooperative, and The Working World.

Investing in these CDFIs – some of which have had a mission of converting businesses to employee ownership for decades – has the potential to spur more visibility and sustainability for the field. According to Brendan Martin, executive director of the Working World, “investing in those CDFIs with a business lending record, and especially a cooperative business lending record, could generate a significant uptick in capital available for business conversions to worker ownership and help steer the CDFI field in that direction as a whole.”

Additionally, greater investment in worker cooperative CDFIs could allow them to be market sustainable. At a size of $10M, which is normal for worker cooperative CDFIs, the typical fund relies on subsidy for approximately 50% of its operating budget. The subsidy level decreases as size increases. According to Amine Benali, managing director of strategy and development at the Local

Enterprise Assistance Fund, a fund size of around $30M would allow the fund to be sustainable.

For the investor who wishes to gain exposure to employee ownership conversions without significant direct involvement, an investment into a specialized CDFI can be an appealing avenue. Given the sustainability issues of CDFIs, we note that additional debt investments may be limited by the requirements around net asset ratios.
FINANCING CONVERSIONS THROUGH A PE FUND MODEL

WORKER GOVERNANCE AND OWNERSHIP CULTURE IN EMPLOYEE-OWNED COMPANIES

STAYING PRIVATE AND EMPLOYEE-OWNED

Employee ownership can offer a long-term or permanent structure for companies that wish to safeguard their services and impact as an alternative to the pressures on mission that can come from outside ownership. For example, King Arthur Flour – a company that was founded in 1790 – became employee-owned through an ESOP to create an enduring ownership structure following generations of family ownership. There are legal limits to setting up an ESOP as permanent, however. The fiduciary duty of the ESOP trustee is to act in the financial interest of employee-owners in their role as retirement plan participants (not in their role as employees). In some cases, these fiduciary obligations might warrant a sale of the company despite an intention by the board of directors to stay private and employee-owned. However, it is very uncommon for an employee-owned company to be sold against the wishes of the board. It is much more common for an ESOP to dissolve through a lack of buy-in from leadership, where the management team and board decide to wind down the plan without consulting employee-owners. This is a fundamental concern of the PE + ESOP model; to counterbalance it, we have proposed long-term, broad based employee ownership as a primary impact guardrail for such transactions.

The worker cooperative model of employee ownership, unlike the ESOP, is designed to be a permanent ownership structure and can only be sold or dissolved by a vote (usually a super-majority) of the worker-members. Some worker cooperatives create additional financial disincentives to a sale, such as requiring in the bylaws that some portion of the proceeds of the sale go to a charitable or membership organization.

The EOT structure further protects against sale by removing the right of employees to choose to sell. In an EOT, the trust document generally stipulates that the trustee cannot sell under any circumstances, with the only exception being if the company was going out of business.

DEMOCRATIC CONTROL BY EMPLOYEES

Democratic control by employees is most commonly seen in worker cooperatives. However, in the US, worker cooperatives are a small segment of employee ownership overall, and the US democratic...
employee ownership community likely has fewer than 10,000 employees total.\(^{59}\)

Outside of worker cooperatives, most employee-owned companies in the US do not give employees a vote for the board of directors or any meaningful governance role. The typical ESOP company only passes through to participants the mandatory minimum voting rights, which include the right to vote on major corporate events such as a merger, liquidation, or sale of substantially all major assets. These voting rights do not include the right to vote on a stock sale, however, which is how many ownership transitions take place.

There are, however, notable exceptions. A handful of ESOP companies have fully democratic governance, including Amsted Industries, Once Again Nut Butter, Sun Light and Power, and MBC Ventures. Other ESOPs, such as Homeland Stores, have negotiated worker participation in governance and management through a collective bargaining agreement. Because democratic governance provides structural accountability of the management team to the workers, and results in long-term alignment of the management with a pro-worker mission, ensuring employee participation and power is a primary impact guardrail of the model proposed in this paper.

**OWNERSHIP CULTURE**

Research has demonstrated that employee-owned companies outperform the competition if they have a strong ownership culture\(^{60}\) — that is, a corporate culture where employees are focused on driving the success of the company, not just their job security and paycheck. The fact that employees have a financial stake in the success of the business offers employee-owned companies a distinct advantage over conventional companies. Workers can also build social capital with greater opportunities for joint decision-making and social engagements. An ownership culture leads to “increased self-confidence, employability and optimism,” which “yields individual and group socio-economic gains through increased productivity, better quality services, better wages and negotiation skills.”\(^{61}\)

There is an ecosystem of consultants and advisors that help companies achieve an ownership culture. Some of the best practices for creating an ownership culture include:

- **Open book management:** At a company that practices open-book management, employees have access to the financials of the company, training on how to read the financials, and information about the company’s business model.

- **Formal channels for input and engagement:** Many ownership culture experts emphasize that an “open door policy” or “suggestion box” are insufficient to create an ownership culture. They suggest formal channels for employees to offer ideas and feedback and have their input meaningfully considered.

\(^{59}\) While considerations around the size of the democratic employee ownership landscape go beyond the purpose of this paper, we note that UK-based John Lewis Partnership, is by itself several times larger than all of the democratic employee ownership in the US combined, with 84,000 partners. In other countries, worker cooperatives are far more common than in the US. Italy has an estimated 25,000 worker cooperatives, there are several thousand in Spain, and approximately 2,000 in France. Argentina has also seen a rapid rise in worker cooperatives and now has an estimated 6,000 worker-owned companies employing approximately 300,000 people.


\(^{61}\) Wilson Majee and Ann Hoyt, “Are worker-owned cooperatives the brewing pots for social capital?”, Community Development 41, no. 4 (November 2010): 417-430.
One popular method of building an ownership culture at ESOP companies is a methodology laid out by the Great Game of Business, wherein companies track improvement on key performance indicators through interactive and visible games as a way to rally participation. It offers both support on open book management and on building the formal channels for input and engagement. Our PE + ESOP model proposes implementing these methods in order to build employee participation and power.

### WORKER GOVERNANCE AND OWNERSHIP CULTURE ACROSS DIFFERENT MODELS

<table>
<thead>
<tr>
<th>WORKER CO-OP</th>
<th>WORKER ROLE IN GOVERNANCE</th>
<th>CREATING A CULTURE OF OWNERSHIP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Worker members can sell company, but there may be financial disincentives depending on bylaws.</td>
<td>Structure is inherently democratic. Workers elect the board on a one-worker-one vote basis.</td>
<td>Worker-owners purchase a share, creating “skin in the game” and receive annual dividends, creating the conditions for a strong ownership culture. Worker cooperatives also often engage in open book management practices.</td>
</tr>
<tr>
<td>The trustee makes decisions, including whether to sell the company, based on financial interests of participants. However, it is uncommon for a company to sell without management approval. Management has the power to dissolve plan over time.</td>
<td>The trustee elects the board. Very few ESOP companies (fewer than 10) offer employees any role in selecting the board. ESOP companies can layer on democratic bylaws, but structure was not intended for worker control.</td>
<td>Many ESOPs invest in creating a strong ownership culture through open book management and practices that encourage employees to understand the concrete ways that they can increase the value of the company. As a retirement plan, ESOPs do not have immediate financial incentives, which some companies address by also offering profit sharing.</td>
</tr>
<tr>
<td>Company can be restricted from being sold, however fiduciary obligations of trustees and use of the EOT structure is relatively untested.</td>
<td>Trustee elects the board at worker-members’ direction.</td>
<td></td>
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</tbody>
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Source: The Authors
ENSURING IMPACT

IMPACT ON WORKERS

An investor should not presume that employee ownership transactions are driven by an impact thesis around the workers. In fact, there is a wide range of approaches and motivations, from purely financial ones to deeply intentional, impact-first investments.

At the Second Annual Private Equity and Employee Share Ownership Symposium, Ira Starr of Long Point Capital remarked, “Our investors are not really interested in impact. We have completed seven 100% S Corp ESOP transactions. We like them. We invest in them because we can get a market rate return for our investors. That’s important because we have endowments and pension plans; they’re looking for market rate investments. We generate an appropriate return for the risk we’re taking.” That is to say, the PE + ESOP model can be used in a “PE-first” manner that is independent of an impact thesis.

At the other end of the spectrum, the Fund for Employee Ownership (F4EO) focuses its work on creating job opportunities for individuals with high barriers to employment and limited opportunities for wealth building. Similarly, The Working World’s mission is to create cooperative businesses in low-income communities. For these organizations, an intentional approach is critical to addressing the growing trends of wealth concentration and the racial wealth gap, with an emphasis on asset building opportunities resting with workers and not solely with capital.

In between, private equity groups like Endeavour Capital include environmental, social, and governance (ESG) factors and have as part of their mission enhancing local employment, but stop short of centering workers, in particular low-wage workers or people of color. Famously, KKR, the global private equity firm, has begun introducing employee profit sharing into some deal structures within its KKR Industrials portfolio using broad-based stock option plans that every employee participates in. KKR Industrials is by no means an impact-driven investor, yet it sees the alignment between company value creation and employee ownership. Pete Stavros of KKR discusses the use of employee ownership in terms of worker relations and employee engagement: “Within a manufacturing company, the majority of the workforce are blue collar and paid an hourly wage. In fact, that is usually the vast majority of the employee base. And despite the fact that that group of employees is so large and so important, what we find time and time again is that the relationship between the blue-collar workers and the people they work for is not a positive one. And often times it’s outright contentious and of course that impacts performance.” The employee ownership plans they offer are meant to align workers and owners and provide financial benefits to blue collar workers.

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Impact considerations are not limited to the investor side of the transaction, however. Retiring business owners may have an interest in preserving their legacy through employee ownership in light of the negative consequences on the community that could be wrought by a sale or a closure. Some are motivated directly by the notion of sharing with the workers the value that they contributed to create.64

**IMPACT ON CORPORATE CONCENTRATION AND WEALTH INEQUALITY**

A complementary approach to impact looks beyond asset building for workers, zeroing in on the negative effect that private equity has had on economic concentration and wealth inequality. A strategy around this thesis would seek to compete directly with traditional private equity, in the attempt to crowd it out and win deals through a combination of the PE + ESOP economics, a commitment by the seller to preserve the jobs, and potentially on lower return expectations from the LPs into the fund (as well as its GP) that can make the numbers work for ensuring a comparable return to the seller without burdening the workers in the quest for higher returns.65

This approach taps into the current wave of discomfort by asset owners such as pension funds, as well as others, with the financial extraction that takes place through the fees and carried interest compensation models of traditional private equity.66

At the moment there is a dearth of options to invest in private companies with an impact strategy that goes beyond the portfolio companies’ underlying product or service. That is to say, the thematic approach tends to lack an analysis of who among the various stakeholders (workers, business owners, and investors) captures the value created by the enterprise. Given the existing – and growing – private equity allocations of institutional investors who are concerned with wealth inequality, an approach that provides worker-friendly options within the $5 trillion asset class is promising.

64 Bob Moore of Bob’s Red Mill had turned down several acquisition offers before exiting via an ESOP transaction with the purpose of recognizing the workers’ contribution to the business: “I don’t think there’s anybody worthy to run this company but the people who built it. I have employees with me right now that have been with me for 30 years. They just were committed to staying with me now and they’re going to own the company.” (Christine Brozyna, “American Heart: Owner of Multi-Million Dollar Company Hands Over Business to Employees,” ABC News, February 18, 2010, https://abcnews.go.com/WN/owner-multi-million-dollar-company-hands-business-employees/story?id=9875038.) More recently the founder of Chobani, Hamdi Ulukaya, awarded 10 percent of the value of the company’s shares in 2016 to over 2,000 full-time workers. “I’ve built something I never thought would be such a success, but I cannot think of Chobani being built without all these people,” he said in an interview at the time of the award. He described the award as being based on “a mutual promise to work together with a shared purpose and responsibility… How we built this company matters to me, but how we grow it matters even more. I want you to be part of this growth — I want you to be the driving force of it.” (Jena McGregor, “Chobani’s CEO is giving up to 10 percent of his company to employees,” The Washington Post, April 27, 2016, https://www.washingtonpost.com/news/on-leadership/wp/2016/04/27/chobanis-ceo-is-giving-up-to-10-percent-of-his-company-to-employees/).

65 This section was informed by conversations with Social Capital Partners (www.socialcapitalpartners.ca), a Toronto, Canada based non-profit focused on wealth inequality building a model along these lines.

IMPACT RECOMMENDATIONS

Executing an employee ownership transaction does not, by itself, ensure a positive impact on workers overall. Over-leveraging can place undue risk on the workers, while additional elements that go beyond ownership per se, such as worker voice and a focus on marginalized communities, can strengthen the overall impact.

The following set of recommendations aims to address both the impact guardrails to avoid negative impacts on workers and some best practices to maximize the positive impact.

Of particular relevance are the issues of worker voice and democratic governance, non-extractiveness on the part of the investors, and fairness in the risk allocation to the workers.67

We recommend the following practices for socially driven investors in employee ownership, described more fully below.

1. **LONG-TERM, BROAD-BASED EMPLOYEE OWNERSHIP:**
   Investments are structured to create long-term, broad-based employee ownership

2. **CENTERING POC AND LOW-WAGE WORKERS:**
   Investors build a pipeline of companies where employee ownership would generate wealth and agency for low-wage workers and people of color

3. **MEASURED IMPACT:**
   Investors develop and track a set of metrics to measure wealth building, employee social capital, job quality, and other key impact areas

4. **EMPLOYEE PARTICIPATION AND POWER:**
   Transactions are structured to build an ownership culture, engage workers in governance, and implement other pro-worker practices

5. **NON-EXTRACTIVE DEAL STRUCTURES:**
   Investments are based on a fair valuation and are structured to protect workers from harm, by avoiding practices that, for example, reduce wages and benefits, decertify a union, over-leverage the company with excessive warrants or debt, or otherwise use financial engineering to shift the value of the company to selling owners or management

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67 These overarching considerations are based on the Transform Finance principles: 1) Projects are primarily designed, governed, and where feasible owned by the affected group, 2) Investments add more value than they extract, 3) The financial relationship fairly balances risks and returns among all stakeholders.
LOCKING IN BROAD-BASED EMPLOYEE OWNERSHIP

For an investment to be transformative, we recommend that the employee ownership stake constitutes a majority of the company stock and is broad-based (open to all employees who meet basic eligibility requirements). These requirements are met in a typical majority ESOP transaction. In addition, the employee ownership stake should be structured to be long term, not temporary or a mere financing mechanism.

Structuring for long-term employee ownership requires a thoughtful approach to exiting the investment. At the end of the investment period, the company must be in the position to recapitalize with lower levels of cheaper debt.

The long-term nature of the employee ownership plan should be codified through adjustments to the company’s bylaws and trust documents. These provisions would require the ESOP trustee to vote in accordance with participant votes on key issues, such as the decision to dilute or dissolve the ESOP, or to sell the company. On these matters, participants would vote on a one-person-one-vote basis.

CENTERING POC AND LOW-WAGE WORKERS

Employee ownership has the potential to address wealth inequality and the racial wealth gap. However, this requires an intentional approach to many aspects of the investment approach, including pipeline building, deal selection, and employee training opportunities. And, to be transformative, it also requires centering the voices of affected individuals and communities in the design of the transaction.

There are various paths to ensuring that employee ownership investors build wealth for low-wage workers and people of color. The Legacy Business Fund is using their managers’ current connections in the Black-owned business community in the Mid-Atlantic area to build a referral network to help identify minority-owned businesses exploring succession planning options. The network will include business owners, advisors, and other stakeholders with existing relationships to Black-owned businesses.

The Fund for Employee Ownership is using a geographic approach to build community wealth in under-resourced areas of Cleveland and surrounding areas. A geographic approach may also increase access to new investment sources, tax benefits, and government incentives at the federal and local levels intended to spur economic development in low-income areas. For example, the federal Tax Cuts and Jobs Act of 2017 created the Opportunity Zone program, which offers tax incentives for investments in economically distressed communities. Recently the Aspen Institute hosted a discussion and released a report on how the new Opportunity Zone investment can be used to facilitate transitions to employee ownership.68

Another method is to target industries based on demographics and wealth building potential. We recommend intentional pipeline development in industries that have a significant workforce of low-wage workers and people of color69 coupled


69 To determine which industries fit these criteria, national business census data is available by industry on occupations and wage rates and the percentage of African-American, Latinx, and other ethnic and racial groups in those occupations. See “Survey of Business Owners (SBO) - Survey Results: 2012,” United States Census Bureau, accessed June 17, 2019, https://www.census.gov/library/publications/2012/econ/2012-sbo.html.
with sufficient margins to build wealth for workers. Many industries with a significant segment of low-wage workers and people of color—such as grocery, staffing, landscaping, construction, specialty manufacturing, home health, food production, and waste management—have a proven track record in employee ownership.

Furthermore, unions are exploring employee ownership as a strategy to retain or create aligned employers in the industries they organize. An employee ownership fund with portfolio companies in these industries may be an attractive investment for labor-affiliated asset managers. Already, multiple labor organizations have resourced initiatives to develop or convert worker-owned companies as an innovative pathway to sustaining and growing their membership base.

It should be noted, though, that multiple fund managers interviewed questioned the feasibility of limiting the pipeline of deals to low-wage industries and, furthermore, the fund managers’ experience and relationships in an industry are a critical factor in determining which companies to invest in. Additionally, many low-wage industries are also low-margin industries, which may not be feasible or desirable for conversion because they have (1) minimal wealth building potential for workers, (2) insufficient capacity to take on significant debt, (3) minimal capital available from workers, and (4) unattractive returns for investors. However, this is not the case with all industries that have low-wage occupations, many of which have significant, proven wealth building potential.

MEASURING, MANAGING, AND REWARDING IMPACT

Investors should track a set of metrics that measure the benefits of employee ownership transactions for workers and the communities where they live. The field would benefit from a standardized set of metrics that is applicable to any employee ownership investment. Metrics include, by way of example:

- Demographics of workers, including age, gender, race, and current income level
- Number of companies converted
- Number of employee-owners created
- Amount of wealth created per worker through the employee ownership stake
- Annual income of workers
- Job tenure of workers
- Total business assets preserved

For an example of the metrics applicable to quality jobs and employee ownership, see the work of Mark Popovich of the Good Companies/Good Jobs Initiative at the Aspen Institute and Larry Schlang at Working Metrics:


FINANCING CONVERSIONS THROUGH A PE FUND MODEL

There is a natural connection between employee ownership and the quest for quality jobs. Employee ownership is not per se a guarantee of a quality job. Given the interest of investors in seeking quality job metrics and approaches in private equity more broadly, investors ought to explore the current efforts in defining and measuring quality jobs beyond ownership—such as benefits and opportunities for advancement—and the ways to address the structural barriers to quality jobs.

In addition to the impact areas outlined above, a fund may consider the underlying social and environmental impact of its portfolio companies. Such impact considerations can be enshrined through the social purpose statutes that protect the mission of the company:

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70 For an example of the metrics applicable to quality jobs and employee ownership, see the work of Mark Popovich of the Good Companies/Good Jobs Initiative at the Aspen Institute and Larry Schlang at Working Metrics:
• **Benefit Corporations**: Benefit corporation legislation is available in 34 states and pending in 6 more. It is a corporate election that gives the board of directors the right to consider social purpose alongside profits. It also creates reporting and impact measurement obligations. A benefit corporation can also be an employee-owned company, like King Arthur Flour. In addition, B Lab’s impact measurement — which is one of the third parties that benefit corporations can use to measure their social impact — includes employee ownership as a major factor.71

• **Other Social Purpose Corporations**: Additional legislation has been passed in a handful of states that are similar to benefit corporation status but more flexible — such as the social purpose corporation and the flexible purpose corporation. Like with Benefit Corporations, you can combine employee ownership and social purpose corporate status.

“Impact Management” is the notion that the data around impact that is collected in measurement should, as is the case for financial measurement, be used in order to manage that impact. In the case of an investment that is concerned with the creation of asset building opportunities for workers of color, impact measurement would provide the number of new worker owners; impact measurement would use that information to evaluate how to improve on the impact.

Just as what gets measured gets managed, what gets rewarded gets managed. Traditional fund management incentive structures for private equity reward the managers based solely on the financial performance of the fund. Where the fund manager undertakes to pursue a social impact, the fund manager’s incentives should be aligned with that pursuit also and not be solely determined on the financial returns. A best practice is to divide the carried interest into a combination of financial performance and impact performance.72

**EMPLOYEE PARTICIPATION AND POWER**

Employee ownership investments should consider a democratic structure — where workers nominate and elect the board of directors — for each transaction. Democratic governance provides structural accountability of the management team to the workers, and results in long-term alignment of the management with a pro-worker mission. As described in the appendix, there are multiple ESOPs in the US that have democratic governance.

Investors should also proactively build an ownership culture in its portfolio companies. Building a strong ownership culture is a critical factor in a successful ESOP transaction. Workers also build social capital with greater opportunities for joint decision-making and social engagements. An ownership culture leads “to increased self-confidence, employability and optimism,” which “yields individual and group socio-economic gains through increased productivity, better quality services, better wages and negotiation skills.”73 This work includes creating culturally relevant, accessible tools for capacity building with workers.


73 Wilson Majee and Ann Hoyt, “Are worker-owned cooperatives the brewing pots for social capital?”, Community Development 41, no. 4 (November 2010): 417-430.
Furthermore, investors should examine whether being an organized workforce would benefit workers by increasing their agency in the workplace and/or creating more favorable policy conditions for workers industry-wide.\(^\text{74}\)

**NON-EXTRACTIVE DEAL STRUCTURES**

The principles of non-extractive finance, developed and popularized by The Working World, aim to ensure that investors add more financial value for the affected stakeholders than what they take out as compensation for the investment. In its simplest definition, non-extraction requires that the cost of capital not exceed the internal rate of return generated by that capital. This precludes, for example, the kind of debt financing that is repaid by removing capital or future income streams from the enterprise as many traditional leveraged buy-outs in the 80s and 90s were charged with doing. An even stronger version of non-extraction holds that the cost of capital should not exceed half of the internal rate of return, so as to leave more of the surplus generated from economic activity in the enterprise rather than being taken out by capital providers. A sophisticated interpretation adheres to the ceiling of the simple definition while balancing practically the return to the enterprise and the investors depending on the specifics of the deal, how capital intensive it is, and what the absolute return to the enterprise is projected to result in. Specifically in deal structuring, non-extraction can take the form, for example, of establishing ceilings for investor returns that are commensurate with their risk, of not structuring collateral in ways that could leave the investee worse off in case of default, and in ensuring that the financial benefits to workers are not overshadowed by those to capital providers.

While non-extraction at first glance implies a lower rate of return for investors by definition, there are countervailing forces: by leaving more return in the enterprise, a well-structured deal can create greater incentive for the workers or others running the business to carry it to success, and this can mean that risk is lower for non-extractive deals by virtue of the agency it generates within the enterprise. The potential for lower return can, in the best cases, be balanced by the lower risk that well designed non-extractive deals can create.

Given that non-extractive deals implicate the whole relationship between the capital and the enterprise and the ability to have an impact rather than have all value extracted by the investors, non-extraction is foundational for creating the possibility for all the other impact recommendations. If the investors take all the returns, there is no impact to measure, no surplus to have power over, no benefit to the new POC owners, no significance to being long-term employee owned. It is only by leaving some value on the table through non-extraction that all the other impact recommendations materialize in additional impact.

In the context of the historical imbalance of power between workers and investors, additional protections in the case of PE + ESOP transactions aim to prevent (1) over-leveraging the company's assets in order to maximize payment to the selling owner through, for example, over-valuation of the company or the excessive use of warrants, (2) reducing benefits or wages as a result of the transaction, (3) decertifying an existing union.

\(^\text{74}\) For a review of worker participation models, see Paul Bernstein, “Essential Components in Workplace Democracy,” [https://www.academia.edu/12112718/ESSENTIAL_COMPONENTS_in_WORKPLACE_DEMOCRACY](https://www.academia.edu/12112718/ESSENTIAL_COMPONENTS_in_WORKPLACE_DEMOCRACY), excerpted from Journal of Economic Issues (Vol. 10 No. 2).
as part of the transaction, or otherwise creating profitability at the expense of ensuring quality jobs for the workers.

In the majority of employee ownership transactions, the employees who are to become owners of the company have neither knowledge of the transaction nor any decision-making role in its terms. In an ESOP transaction, the employees are represented by a trustee who has the fiduciary obligation to represent participant’s financial interests and protect their retirement assets. However, despite this protection, ESOPs have at times been abused and, including in some very high-profile cases, devastating to the financial well-being of workers. An often cited, if controversial, example, is the implementation by United Airlines of an ESOP in 1995. The airline’s pilots and machinists accepted 55% ownership in the company in lieu of up to $5 billion in wages and benefits. Although the results at first were promising, the tides turned for United Airlines and the company filed for bankruptcy in 2002, losing the value of that investment. Additional examples of high-profile ESOPs that adversely affected workers include Enron and the Chicago Tribune.

While the instances of companies that have used ESOPs to benefit workers far outnumber the cases of abuses, these notorious examples provide valuable lessons on how to ensure we do not replicate the same mistakes.

While there is no consensus on how to best provide these additional protections, ideas include:

- **Employee Involvement:** Involving employees directly in the deal negotiations for example through an employee committee. Worker cooperative conversions are typically negotiated between a worker committee and the selling owner(s).

- **Redefined fiduciary obligations for trustees:** Administrative or policy changes that broaden the fiduciary responsibility of trustees to take into account workers well-being as a whole, not just retirement account value.

- **Worker advocates:** Having a worker-advocate negotiating on behalf of worker interests alongside the trustee and selling owners.

**AN IMPACT/RETURN TRADE-OFF?**

We anticipate that these recommendations may affect the return on investment, requiring some level of patient or otherwise concessionary capital. This is not a novel circumstance in the context of investing with an explicit impact goal. Traditional financial returns are often predicated on allocating risk to non-investor parties, using financial engineering to maximize investor returns, and treating workers as a liability rather than an asset: they should not constitute the benchmark for the returns a fund can expect while explicitly addressing issues of wealth inequality, seeking to create asset building opportunities, and centering marginalized workers.

While there are opportunities to match market

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rates of return via employee ownership transactions, there is, as explored in this report, a range of deeper impacts that may warrant a different, more holistic approach to financial returns considerations. The trade-offs that may be incurred in doing so can be addressed by investors along a continuum of flexibility of capital - something that is not foreign to a variety of actors in the impact space, from foundations to family offices. And similarly, as is often the case in innovative structures or approaches, the amount of subsidy or concession that is required at first will steadily decrease as the model becomes more common and scale increases.

It is true that any limitations on how to structure a transaction, which types of companies to work with, or what returns to expect may reduce investor interest and therefore limit the scalability of the model. We contend that these impact recommendations are necessary for capital to be a force for good and trump the desire to reach scale at any cost to other parties.
THE ROLE OF PHILANTHROPY

Philanthropy has already been catalyzing employee ownership through strategic grantmaking. Multiple foundations and corporate funders – Open Society Foundations, the W.K. Kellogg Foundation, Citi Community Development, the Cooperative Development Fund, Kendeda Fund, the Catholic Campaign for Human Development, the Surdna Foundation, and more – have invested in employee ownership initiatives. These initiatives are led by academic institutions, community organizations, and national field building and technical assistance nonprofits. They typically fall into one of the following categories:

- **Research**: Impact research on the wealth building effect of employee ownership for low to moderate income workers and people of color, as well as market research on current conversion activity, what those transactions look like, and the market for conversions by geography and industry.

- **Awareness building**: Initiatives to spread the word about employee ownership and its benefits for selling owners, workers, and the communities these businesses serve. Activities include informational events, press strategies, and stakeholder education and outreach.

- **Ecosystem development**: Initiatives to convene and train practitioners, build supportive institutions, and advocate for favorable policy.

- **Capitalization**: Initiatives to increase access to capital on terms that allow for more conversions to employee ownership at scale and on terms favorable to workers.

- **Technical Assistance**: Subsidized support for businesses becoming employee-owned, which often focuses on a particular industry, demographic population, and/or geography.

By funding worker ownership initiatives, foundations are advancing their missions related to creating economic security for low-wage workers and their families, bridging the racial wealth gap, stabilizing small business ownership and stemming displacement in rapidly changing communities.

In the context of for-profit funds, philanthropy has an important role to play in ensuring that mission-related activities are adequately resourced. Whether through nonprofit partnerships or direct support, philanthropic dollars can be used for myriad activities related to the five impact recommendations. These might include researching and building a pipeline for conversions that will create wealth for low-wage workers and people of color, creating tools for capacity building with low-wage workers, defining metrics and measuring impact, creating financial products and tools that address the unique needs of minority-owned businesses affected by structural racism, and de-risking a novel fund model that is poised for wider adoption once it is proven to work.

The role of labor unions, which were historically active in the ESOP context and are currently exploring new models to benefit workers, falls beyond the purview of this paper.
Transformative investing in employee ownership is an emerging, rapidly changing field that requires significant additional exploration. Areas we recommend for further work include:

- Convening practitioners to workshop deal models and help substantiate the financial calculations to the various parties, including the effect on sale price, the amount of concessionary capital required, and the assumptions behind a 5-7 year window for recapitalization.

- Examining how existing employee ownership legal structures encourage or discourage investment in worker-centric employee ownership and whether new legal structures are needed.

- Developing a comprehensive set of impact metrics around employee ownership conversions and pathways for impact management, as well as comprehensive recommendations as to how to adequately protect worker interests in the conversion process.

- Documenting case studies of transformative investments in employee ownership using the private equity leveraged buyout model, including the type of capital deployed, the terms, and the role (if any) of concessionary capital. In particular, it will be helpful to document a comparison between 1) companies that converted to ESOP with outside financing from a non impact-minded investor, 2) companies that converted to ESOP without a fund and incurred difficulties in structuring the transaction or relied heavily on seller financing, 3) companies (real or hypothetical) that effected an impact-driven conversion using the PE + ESOP model, with a focus on whether the transaction was more impactful than (1) and more easily executed than (2).

- Exploring the role of unions in helping to facilitate and finance employee ownership transactions, as unions innovate on models to benefit workers and employee ownership has re-emerged as a possible tool.

- Considering the intersection of employee ownership with the circumstance of an increasingly contingent workforce.

- Creating a report that addresses specific variables of a worker-centric PE + ESOP fund, such as size, target returns, and number of deals from the perspective of practitioners currently envisioning such funds.
ACKNOWLEDGMENTS

The support of the Open Society Foundations made this report possible.

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Cover photo and report design by Dustin O’Neal
EMPLOYEE OWNERSHIP MECHANICS

EMPLOYEE OWNERSHIP FORMS

The common thread among employee-owned companies is that workers at every level are eligible to have an ownership stake in the business and, together, they own a significant percentage of company stock. Employee ownership can be structured in a variety of ways, falling into two main categories: (1) **direct ownership**, where individual employees hold shares and (2) **trust ownership**, where a separate legal entity holds the shares on behalf of employees. The main forms of employee ownership in the US are:

- **Employee stock ownership plan (ESOP):** A federally regulated benefit plan — similar to a 401(k) — that holds employer stock in a trust on behalf of employees.

- **Employee ownership trust (EOT):** An unregulated, non-charitable purpose trust that holds employer stock on behalf of tenured employees.

- **Worker cooperative:** A membership-based corporate structure where membership is limited to workers and the financial value of the company is based on a system of internal capital accounts, not a market valuation.

- **Broad-based equity compensation plan:** A stock plan that includes a broad base of workers, which may offer direct stock grants, purchase plans, stock options, restricted stock, etc.

The table below provides an overview of the economic reach of the several forms.

<table>
<thead>
<tr>
<th>FORM OF OWNERSHIP</th>
<th># OF COMPANIES</th>
<th># OF WORKERS</th>
<th>% CONVERSIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee stock owner-ship plan (ESOP)</td>
<td>2,500</td>
<td>750,000</td>
<td>100%</td>
</tr>
<tr>
<td>Employee ownership trust (EOT)</td>
<td>At least 4</td>
<td>At least 1,200</td>
<td>100%</td>
</tr>
<tr>
<td>Worker cooperative</td>
<td>450</td>
<td>6,700</td>
<td>25%</td>
</tr>
<tr>
<td>Broad-based equity compensation plan</td>
<td>At least 2</td>
<td>At least 11,900</td>
<td>Unknown</td>
</tr>
</tbody>
</table>

The numbers of companies and employees are approximations and reflect businesses where at

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76 Department of Labor data for ESOPs does not include whether the plans own a majority or minority of company stock, and no other reliable source of data exists on the number of majority ESOP-owned companies. This estimate is based on a minimum 580,000 workers at majority ESOP companies as reported by the NCEO in the Employee Ownership 100 (see **"The Employee Ownership 100: America’s Largest Majority Employee-Owned Companies,"** National Center for Employee Ownership, accessed June 17, 2019, [https://www.nceo.org/articles/employee-ownership-100](https://www.nceo.org/articles/employee-ownership-100), and an upper limit of 855,000, based on estimates by experts in the field that at most 45% of the 1.9M employees at privately held ESOPs work at majority ESOP companies. The number of employees at privately held ESOPs is from the Douglas Kruse and Joseph Blasi, **"Analysis of ESOP Data from 2001-2014 by Douglas Kruse and Joseph Blasi,"** Rutgers University Institute for the Study of Employee Ownership and Profit Sharing, 2017, accessed June 17, 2019, [https://smlr.rutgers.edu/content/shared-capitalism](https://smlr.rutgers.edu/content/shared-capitalism).

77 Employee ownership trust statistics are based on a count made on January 26, 2019 of the four majority employee ownership trusts known by the authors to exist in the US: WATG with a reported 365 employees (see [https://www.fieldfisher.com/publications/2016/04/watg-employee-owned-through-a-perpetual-trust](https://www.fieldfisher.com/publications/2016/04/watg-employee-owned-through-a-perpetual-trust)), California Harvesters with approximately 800 employees (see [https://medium.com/@theworkerslab/happy-new-year-from-the-workers-lab-54251eaa1798](https://medium.com/@theworkerslab/happy-new-year-from-the-workers-lab-54251eaa1798)), Metis Construction with 33 employees (see [https://metisconstructioninc.com/about/employees](https://metisconstructioninc.com/about/employees)), and Arbor Assays with approximately 10 employees (see [https://drive.google.com/file/d/0Bzn8LnYwl56ta2lHVTVlajM3UmM/view?usp=sharing](https://drive.google.com/file/d/0Bzn8LnYwl56ta2lHVTVlajM3UmM/view?usp=sharing)).


least 50% of the company is owned by workers.

While the four forms described here currently dominate the employee ownership landscape, new innovations and hybrid models are emerging to address unmet needs. For example, as the percentage of contingent workers rises, purchasing and marketing cooperatives are being used to aggregate independent contractors in order to give them access to economies of scale and workplace benefits that are typically only available with traditional employment. More research is needed on the full range of potential employee ownership models available for worker-centered businesses under US law.

**EMPLOYEE STOCK OWNERSHIP PLANS**

An ESOP is a defined contribution retirement plan (like a 401(k) or profit sharing plan) which is designed to primarily invest in employer securities. ESOPs can be used to transfer partial or full ownership of a company to employees. Companies with an ESOP must share ownership broadly. That is, every employee who meets certain minimum requirements, including having one year of tenure and being 21 years or older, must be included in the plan. Employees do not pay for the shares – participation in the plan is a benefit offered by the company.

In an ESOP, the employee ownership stake is held in a trust, called an employee stock ownership trust or ESOT. The ESOT is administered by the trustee(s) for the participants’ financial benefit. The trustee may be an internal employee or committee, or an outside institution.

Federal laws – specifically the Employee Retirement Income Securities Act (ERISA) and the Internal Revenue Code (IRC) – govern many aspects of how the plan is administered, including who is eligible to participate, how shares are allocated and how they vest, the fiduciary duties of the trustee, how distributions are made, and more. The Department of Labor closely monitors ESOPs to ensure that they are created and maintained in participant-employees’ financial interest.

ESOPs are highly tax-advantaged. The most potent tax benefit is for 100% ESOP-owned S corporations, which pay no federal corporate income tax and, in many states, avoid state-level tax as well. Companies structured as C corporations also receive tax benefits, including the deductibility of both principal and interest payments on any loan used to finance the transaction.

More information about ESOPs and how they work is available on the website of the National Center for Employee Ownership.

**EMPLOYEE OWNERSHIP TRUSTS**

The employee ownership trust (EOT) is a way to structure a multi-generational, worker-owned business using favorable trust law. In the United Kingdom, EOTs are recognized and tax-advantaged. The largest EOT in the UK is the John Lewis Partnership, a well-known department store employing over 90,000 workers that has a democratic governance system outlined in their “constitution.”

In the United States, employee ownership trusts do not have enabling legislation or tax-advantaged
status. However, in many states, EOTs may be structured under current trust law as perpetual, non-charitable purpose trusts with a stated purpose of multi-generational worker benefit, and if desirable, provisions for workers to elect the board of directors and vote on shareholder-level issues. Additionally, EOTs can be structured in the US using UK trust law.80

EOTs are a very new form of employee ownership in the US, and only a few companies have adopted it.

WORKER COOPERATIVES

Worker cooperatives are part of the family of cooperative businesses, which are businesses owned and run by and for their members.81 Other cooperative forms include consumer cooperatives, producer cooperatives, purchasing cooperatives, housing cooperatives, and multi-stakeholder models that have attributes from one or more of these types. In a consumer cooperative, the members are individuals who purchase goods, such as outdoor equipment in the case of REI (Recreational Equipment, Inc.). In a producer cooperative, the members are small businesses that come together to jointly market and process their product, like small dairy farms in the case of Organic Valley.

In the case of a worker cooperative, the purpose of the business is to meet the needs of its workers. Worker cooperatives are recognized in the law at both the state and federal level. Some states have passed legislation authorizing a specific worker cooperative corporate form. These statutes codify the worker cooperative corporation model and may provide securities exemptions, tax benefits, or other special preferences. In many states with cooperative statutes, only a company filed under the statute may use the word cooperative in its legal name, although other companies operating with worker cooperative principles may identify as worker cooperatives.

These statutes are also designed such that worker cooperatives incorporated under the statute are eligible for tax deductions under Subchapter T of the IRC, which provides tax-advantaged status (similar to pass-through taxation) to corporations that maintain core cooperative attributes or, in the language of the tax law, “operate on a cooperative basis.”82

As members – each with one voting share – workers select the board of directors on a one-person-one-vote basis. Often, non-management workers serve on the board alongside management and any external board members. While some worker cooperatives operate with distributed management structures or engage in collective decision-making, worker cooperatives can and often do operate with traditional management structures.

BROAD-BASED EQUITY COMPENSATION PLANS

Employee ownership through an equity compensation plan can be structured using a wide range of stock-based compensation vehicles, including stock options, restricted stock, restricted stock units, and more. Typically, equity compensation is used as a vehicle to compensate high level management and key technical staff. Aside from small start-ups, the known examples of a broad-based, majority employee-owned stock


compensation plans are Graybar Electric, which has 8,500 employees and the employee stock purchase plan (ESPP) at Robert W. Baird & Co.83

HOW THE FORMS COMPARE

In an employee ownership transaction, there are legal, tax, governance, and regulatory implications that vary based on which form is used. The primary financial considerations include tax efficiency, transaction and ongoing administrative costs, and the financial burden associated with providing liquidity to employees.

**TAX EFFICIENCY**

Employee ownership can be very tax efficient for selling owners and the employee-owned company. Selling owners to either an ESOP or worker cooperative can access a tax deferral on the sale of stock if at least 30% of the business is transferred to employees and the proceeds are reinvested into US stock or other qualified replacement property. Furthermore, as mentioned above, a 100% ESOP-owned S corporation pays no corporate income tax, which is particularly attractive for profitable companies, and can save millions of dollars per year. The tax benefits for worker cooperatives, in comparison, are modest. There are no tax benefits for employee ownership trusts.

**TRANSACTION AND ONGOING ADMINISTRATIVE COSTS**

Because they are highly regulated, ESOP transactions tend to cost significantly more than worker cooperative or EOT conversions. For profitable companies, the tax benefits can easily outweigh the transaction costs. However, for smaller or less profitable companies, the administrative and transaction costs may not make financial sense.

**PROVIDING LIQUIDITY TO EMPLOYEES**

In most employee-owned companies – including both ESOPs and worker cooperatives – employees receive liquidity for their ownership stake after they leave the company or retire. In an ESOP, the company stock is valued annually and employees have the right to sell the shares upon leaving the company or retirement at that year’s valuation. Depending on the circumstances of the employee leaving, the company has one to five years to begin repayment, and can pay the account balance over a five year period. Without proper planning, or for companies with cash flow issues, the repurchase obligation can be a major financial burden. At worker cooperatives, share value is static, not based on the market, and the account balance is based on annual profit share distributions retained in the company through employee capital accounts. As a result, distribution amounts are more predictable.
## Comparing the Forms

<table>
<thead>
<tr>
<th>Worker Co-Op</th>
<th>ESOP</th>
<th>EOT</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax Efficiency</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Somewhat tax efficient: tax deferral on the stock sale, corporate tax treatment similar to pass-through entities.</td>
<td>Very tax efficient: tax deferral on the stock sale; S corp ESOP pays no corporate income tax on percentage owned by ESOT; C corp ESOPs can deduct both principal and loan payments.</td>
<td>No tax benefits.</td>
</tr>
<tr>
<td><strong>Transaction and Ongoing Administrative Costs</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$25,000–$50,000 for the transaction. No hard ongoing costs, but suggested investment in ownership culture.</td>
<td>$60,000–$200,000+ for the transaction. $30,000–$80,000 annually for valuation, trustee, administration, etc. plus suggested investment in ownership culture.</td>
<td>Transaction costs similar to worker cooperative: $25,000–$50,000. Ongoing costs include annual trustee fees plus suggested investment in ownership culture.</td>
</tr>
<tr>
<td><strong>Providing Liquidity to Employees</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No regulation on distribution policy, shares value is not market-based.</td>
<td>Must pay back accounts on a timeline established under federal law, share value is determined by an annual third party valuation process.</td>
<td>No buy back or repurchase obligation.</td>
</tr>
</tbody>
</table>
In an employee ownership transaction, the company often maintains the existing management structure with minimal shifts in the business or operational model, except to fill the exiting owners’ capacity if their role in the company is changing.

Like any sale or merger of a mid-sized business, an employee ownership transaction is a process that requires time and the support of qualified advisors. Typically, becoming employee owned takes anywhere from six to eighteen months, or more if the groundwork has not yet been laid for a successful transition.

The process involves four key stages:

1. **THE ASSESSMENT PHASE**
   In this phase, the selling owners and other key stakeholders determine if employee ownership is a good fit for their goals and the company’s current finances, life cycle, and culture. This phase includes exit planning with the selling owner(s) to determine their financial and non-financial goals for the transaction, an initial valuation of the company and an assessment of its cash flow, financial health, and debt capacity.

2. **THE PLAN DESIGN PHASE**
   In this phase, the selling owners have chosen to proceed with employee ownership, and are now designing the transaction. It involves identifying key stakeholders in the process and determining their roles, as well as assembling the advisors for the transition. For example, in an ESOP transaction, that includes the lawyer(s), trustee, valuation firm, and more. It is in this phase that the legal, governance, and financial design of the transaction are determined.

3. **THE TRANSACTION PHASE**
   In this phase, the process moves from design to completion. Advisors draft the relevant documents, a valuation for purposes of the transaction takes place, and a closing date is set for the transfer of stock to employees. This phase is complete when the ownership of the company is transferred to the employees.

4. **THE IMPLEMENTATION PHASE**
   In this phase, the company and its advisors provide education and implement new policies in line with the employee ownership structure. This may include, for example, a series of trainings on what it means to be an employee-owner.
FINANCING CONVERSIONS THROUGH A PE FUND MODEL

While the overall structure of an employee ownership transaction is similar across forms, there are meaningful differences between a worker cooperative conversion and an ESOP transaction (the two most common types of conversions).

Worker cooperative conversions⁴⁴ are typically small transactions and are few in number. ESOP transactions, which are more frequent (with approximately 200 new ESOPs created each year), typically involve middle market companies: forty-two percent of ESOP transactions are in the $10M–$50M range, and sixteen percent of ESOP transactions are over $100M.⁴⁵

DIFFERENCES IN CONVERSION MECHANICS

<table>
<thead>
<tr>
<th>WORKER CO-OP</th>
<th>ESOP</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADVISORS</td>
<td>ESOP advisors typically are employed by professional services firms, including large, well-known consultancies like Principal Financial and Morgan Stanley.</td>
</tr>
<tr>
<td>VALUATION</td>
<td>Independent valuation by an accredited firm is required by federal regulatory guidelines. Generally there is an initial, informal valuation and then a formal one.</td>
</tr>
<tr>
<td>BUY-IN</td>
<td>Employees rarely contribute their own capital in an ESOP transaction. Instead, it is treated more like an employee benefit. However, 401(k) accounts can be used to finance the transaction with employees’ consent.</td>
</tr>
<tr>
<td>ROLE OF RANK-AND-FILE WORKERS</td>
<td>Employees only need to know about the transaction beforehand if their 401(k) accounts will be used to fund the deal. Often, employees do not know about the transaction until it is over.</td>
</tr>
<tr>
<td>FINANCING</td>
<td>Most transactions include both seller financing and senior debt from an outside lender. Many major banks have an ESOP lending department.</td>
</tr>
<tr>
<td>Transactions are typically financed through a combination of seller notes and loans from cooperative-specific lenders. Many deals are 100% seller financed.</td>
<td></td>
</tr>
</tbody>
</table>

⁴⁴ About 25% of all worker cooperatives today were started as a traditional business, then converted. The Democracy at Work Institute reported that between 2016 and Q3 of 2017, 21 cooperative conversions were completed, with an average transaction size of $380,000 and an average of ten new employee-owners per company. Workers to Owners: 2017 Annual Impact Report, Democracy at Work Institute, 2018, https://institute.coop/2017-workers-owners-impact-report.

APPENDIX III
SAMPLE EXISTING FUNDS 
AND FUND CONCEPTS

THE INCLUSIVE CAPITALISM FUND 
(AMERICAN WORKING CAPITAL)

TARGET FUND SIZE
$200M closed-end fund | $20M pledge fund

TARGET RETURNS
Gross IRR of 12%-18%

CAPITAL DEPLOYMENT
Annual current rate of interest between 6-10% and accretion of face value on subordinated notes through PIK features. Additional scheduled return of capital based upon investment amortization schedule and capital appreciation of warrants.

PIPELINE CRITERIA
Target Firm Size: $5M-$15M EBITDA
Industry: Opportunistic, but will proactively focus on industry subsets where partners have deep expertise, including retail, specialty manufacturing, and business and government services.
Geography: National (US)

The Inclusive Capitalism Fund is being formed to provide structured equity capital to the lower middle market of privately-held, US-based businesses to (1) promote the predistribution of ownership through recapitalizations or buyouts and (2) to support business growth and expansion with a focus on broad based management and employee ownership. AWC is also raising a co-investment “pledge” fund with the same mission, which has a target capitalization of $20 million.

The investment objectives of the Fund are threefold: (1) to generate attractive current returns; (2) to realize substantial capital gains; and (3) to generate significant positive impact on income and wealth inequality through inclusive, broad-based ownership structures. Including both current returns and capital gains, the fund expects its investments to generate a gross internal rate of return of approximately 15% over the life of the Fund. The Fund will be focused on making $5 million to $50 million direct, privately negotiated investments (making use of a long-established network of scaled family office and institutional co-investors) in businesses with annual EBITDA typically between $5 million and $15 million.

The Fund will invest in ownership transition and growth capital transactions, including ESOP buyouts, ESOP recapitalizations, and ESOP acquisition financings.

The Fund will be focused on creating positive social impact (primarily defined by broad-based employee participation in ownership and wealth creation over and above traditional benefit structures for all classes of employees).
FINANCING CONVERSIONS THROUGH A PE FUND MODEL

THE INCLUSIVE CAPITALISM FUND AT AMERICAN WORKING CAPITAL

SAMPLE DEALS

HOMELAND STORES

Business description: HAC, the parent of Homeland Stores, is a 95 year-old supermarket chain headquartered in Oklahoma City, OK. Retail operations consist of 74 stores serving Oklahoma (primarily) as well as Kansas, Texas and Georgia. Homeland’s 2018 sales were approximately $622M.

Transaction description: Homeland’s management team led the purchase of HAC from its parent company, Associated Wholesale Grocers (“AWG”), for $145M, utilizing a 100% S Corp. ESOP structure. AWG provided attractive financing to facilitate the purchase of Homeland. The transaction created more than 3,000 new union and non-union employee owners.

Employee Statistics:

- Over 3,000 employees
- Approximately $61m payroll base
- Average wage of $12.74
- Continued participation in Defined Benefit plan in addition to ESOP

ALUMINUM PRECISION PRODUCTS

Business description: Aluminum Precision Products (“APP”) is a producer and manufacturer of aluminum and titanium conventional and precision forgings, assemblies and open-die (hand) forgings with plants located in California and Virginia. 2016 sales were approximately $200M.

Transaction description: In 2016, a significant minority interest in APP was acquired by the Company’s existing ESOP through a leveraged recapitalization. Prior to this transaction, the ESOP owned 7.68% of the company’s stock. The transaction resulted in the ESOP acquiring additional stock for a post-transaction ownership of approximately 32%. The transaction structure allowed the owners to gain liquidity on their shares while retaining a meaningful role in the business, leaving open the possibility of the future expansion of the ESOP. The deal had $160.0M total capitalization with $25.5M investment from sellers in the form of seller notes.

Employee Statistics:

- Number of employees: 900
- Large percentage people of color, primarily Latino
- Payroll base: Approximately $40 million
- Average annual employee salary $42,500
- Estimated average employee balance in the ESOP of $82,000 after 10 years
The Fund for Employee Ownership is housed within the Evergreen Cooperative Corporation, a network of mutually supportive worker-owned enterprises in Cleveland, which together employ 212 workers. The worker-cooperatives in the Evergreen family of firms are supported by business development infrastructure that includes a shared back-offices services company (Evergreen Business Services), a financial arm (The Evergreen Cooperative Development Fund), and a 501c3 non-profit parent (The Evergreen Cooperative Corporation), which governs and provides oversight to the entire network.

Launched in 2008, Evergreen expands economic opportunity and creates quality jobs through a network of community-based, employee-owned enterprises. Evergreen’s workers earn a living wage, have the opportunity to become owners who participate in profit-sharing and governance, and can access valuable wraparound services such as training and a home-ownership program. Most of these employees previously faced incredibly high barriers to employment and limited opportunities for wealth building. Fifty-five percent of Evergreen’s employees are formerly incarcerated and eighty-five percent are people of color.

Though the existing portfolio of Evergreen firms were grown from start-up, Evergreen is now shifting its strategy to convert existing privately held firms to employee ownership to achieve scale and stability. The newly launched Fund for Employee Ownership is designed to catalyze those conversions by leveraging patient capital to acquire small and medium sized business, convert them to employee-ownership, and support them over the long term as members in the network of Cleveland social enterprises.

Evergreen describes this approach as the Acquire, Convert, Support (ACS) strategy. ACS creates a
Financing Conversions Through a PE Fund Model

Legacy plan for retiring business owners, roots quality jobs in local communities, and helps low- and moderate-income families build wealth. The Fund is drawing its strategy from known international best practices in employee ownership development, including:

- The mutually supportive, networked democratic business model of The Mondragon Cooperatives;
- The investor-driven acquire and convert strategy of Mosaic Capital Partners (advisors to TFEO);
- The use of public, philanthropic, and impact capital to catalyze employee buyouts, like The Working World and Italy’s Cooperazione Finanza Impresa.
The mission of Middle Bridge Capital's Blueprint Fund is to expand employee ownership as a bridge to broader wealth and stronger communities. The Fund aims to generate attractive risk-adjusted returns for investors, provide a simpler and more liquid exit for owners to sell to employees, and expand the number of employee-owned businesses where workers share in the value they create.

The Blueprint Fund will target privately owned, lower middle market firms and offer a flexible capital investment approach that best meets the needs of the stakeholders and the long-term health of the company while generating net IRR’s of 12-15% for its LP’s. This will include direct leveraged buy-outs, a shared Fund and ESOP buy-out, and subordinated debt with warrant financing of a 100% ESOP conversion.

The Fund, according to its thesis, allows owner/founders to overcome two key obstacles to selling to their employees – complexity and liquidity. By providing an upfront buy-out and a path to employee ownership, the Fund will enable sellers to realize fair value and immediate liquidity while taking the complexity out of ESOP transactions. It aims to generate value during the hold period through a proven playbook and deep engagement with acquired companies for the adoption of ownership culture practices that generate superior business performance and ensure the long-term success of the company under employee ownership. Middle Bridge Capital’s operating partner has more than 30 years of experience implementing ownership culture practices as part of employee-owned companies.

Middle Bridge Capital also aims to create awareness, identify opportunities, align investors, and generate mission-aligned returns. This will include creating a mentor corps of experienced ESOP and non-ESOP executives who will work to drive growth with portfolio companies, targeting acquisitions towards areas identified of interest to investors, creating a network to promote awareness broadly in employee ownership, and practicing open-book management with all stakeholders.

While generating target returns, three core and inter-related principles guide the firm’s execution: 1) all exits are to ESOPs, 2) the long-term health of the...
company is paramount to ensure employee-owners can build on its success, and 3) the General Partners will operate transparently with all stakeholders and especially employees. The General Partners will reinvest a substantial portion of profits toward the mission of broader employee ownership by promoting awareness and interest in employee ownership as part of its overall deal flow efforts with a longer-term intent to prove the viability and attractiveness of the model to investors and catalyze the development of other similar funds.
FINANCING CONVERSIONS THROUGH A PE FUND MODEL

NATIONAL WORKER OWNERSHIP IMPACT FUND
(COMMUNITY DEVELOPMENT VENTURE CAPITAL ALLIANCE)

CDVCA is a 24-year-old mission-driven, not-for-profit fund manager, certified by the Department of the Treasury as a Community Development Financial Institution (CDFI). Its mission is to promote the availability of flexible equity capital for businesses that provide high quality employment opportunities for lower income people. CDVCA currently manages $183 million in a variety of investment vehicles, including traditionally-structured equity funds and various special purpose investment vehicles. Once CDVCA invests in a company it works with management to improve job quality and to encourage development of employment opportunities accessible to low income people. In addition to managing capital, CDVCA contributes to the field through training programs for fund managers, technical assistance, and public policy work.

CDVCA has raised capital from and manages money for a broad range of investors, from foundations to insurance funds, through bespoke funds that achieve the financial and social impact objectives of a diverse group of market-focused and impact-focused investors. CDVCA is the managing general partner of such funds as the Puerto Fund for Growth and the InnovateNY Fund. It has established a number of state-focused funds and special purpose investment vehicles.

CDVCA offers the following investment products: market rate equity (typically participating preferred stock) and mezzanine debt (convertible debt, debt with warrants, and debt with royalties) for businesses; market rate equity investments in limited partnership interests in social impact equity investment funds; and market rate and concessionary special purpose vehicles for tailored social investments in businesses. The investment sizes currently range from $100,000 to $8M.

<table>
<thead>
<tr>
<th>CURRENT CDVCA FUNDS</th>
<th>SIZE (IN MILLIONS)</th>
<th>YEAR FOUNDED</th>
</tr>
</thead>
<tbody>
<tr>
<td>CDVCA Central Fund</td>
<td>$7.3</td>
<td>2001</td>
</tr>
<tr>
<td>National Impact Fund</td>
<td>$22</td>
<td>2011</td>
</tr>
<tr>
<td>InnovateNY Fund</td>
<td>$46</td>
<td>2012</td>
</tr>
<tr>
<td>Arkansas Impact Fund</td>
<td>$19.3</td>
<td>2013</td>
</tr>
<tr>
<td>Florida Impact Fund</td>
<td>$6.4</td>
<td>2014</td>
</tr>
<tr>
<td>Illinois Impact Fund</td>
<td>$8.8</td>
<td>2015</td>
</tr>
<tr>
<td>Puerto Rico Fund for Growth</td>
<td>$45</td>
<td>2016</td>
</tr>
<tr>
<td>Kentucky Impact Fund</td>
<td>$8.5</td>
<td>2016</td>
</tr>
<tr>
<td>Mississippi Impact Fund</td>
<td>$5.0</td>
<td>2017</td>
</tr>
<tr>
<td>Nebraska Impact Fund</td>
<td>$14.8</td>
<td>2017</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$183.1</strong></td>
<td></td>
</tr>
<tr>
<td>PLANNED FUND</td>
<td></td>
<td></td>
</tr>
<tr>
<td>National Worker Ownership Impact Fund</td>
<td>$50.0</td>
<td>2020</td>
</tr>
</tbody>
</table>

CDVCA has been in discussions about the possibility of managing a worker ownership-focused fund for the past year with a variety of investors and possible partners. In addition, individual CDVCA staff members...
have deep roots in worker ownership. CDVCA’s president, Kerwin Tesdell, began his career in worker ownership with such organizations as the Industrial Cooperative Association (now the ICA Group) and the precursor of Cooperative Home Care Associates. He drafted the New York State worker cooperative incorporation statute, enacted as Article 5-a of the NY Cooperative Corporation Law. CDVCA managing director Alan Bernstein, as a partner at the Wall Street law firm of Carter Ledyard & Milburn, began work on developing a focus on ESOP conversions.

**CDVCA**

**SAMPLE DEAL**

**OUTDOOR VENTURE CORPORATION**

OVC is a manufacturer of tents and other shelters. It began 45 years ago making tents for the recreational market, moved on to manufacturing airbags for cars, and now focuses primarily on shelters for the military. It has a strong track record of creating high quality, permanent jobs in the heart of Appalachian coal country. OVC is by far the largest private employer in a rural area of McCreary County, Kentucky, one of the poorest counties in the nation, where only 39.2% of the labor force is working and the area median income is under $9,900 per year.

The company currently employs 225 full-time workers and is anticipating hiring another 250 after winning a major new multi-year contract for sophisticated new shelter systems. The founder and current owner of OVC is quite interested in converting the company to worker ownership. He has had extensive discussions about these plans with the board chair of CDVCA, who has acted as a financier and financial advisor to the company for over 25 years.
The Legacy Business Fund in partnership with the Democracy at Work Institute is currently in the R&D stage for a values-driven, closed-end private equity fund focused on buying and transitioning successful minority-owned businesses and potentially minority-owned businesses (those with majority minority workforces) in the mid-Atlantic region. The fund will target healthy businesses of color that are ripe for transition and continued growth. The fund is proactively building solutions that are designed, for example, to create access to lower-cost debt for businesses at the smaller end of the market.
THE WORKING WORLD FUND
(THE WORKING WORLD)

TARGET FUND SIZE
$50M fund (debt with performance upside)
$9M raised and currently deployed
Evergreen open-ended raise

TARGET RETURNS
Impact rate debt with performance upside

CAPITAL DEPLOYMENT
Non-extractive equity structures and subordinated debt, exiting owner debt and equity

PIPELINE CRITERIA
Target Firm Size: $500K–$1.5M EBITDA
Industry: Light manufacturing or service businesses that employ primarily low/moderate income workers with a focus on minority workers
Geography: Washington, DC to Boston Corridor (US)

The Working World Fund is housed in and managed by The Working World, Inc. Launched in 2012, the Fund was created by the same team who started the first office of The Working World in Argentina in 2004. With Argentina having the largest concentration of enterprises converted to worker-ownership in the world, The Working World assisted and financed over 250 worker-owned cooperative businesses and gained considerable experience in the challenges and opportunities faced by worker-centered conversions.

The Working World is focused on worker impact, particularly for low-income and minority workers and specializes in non-extractive deal structures that leave significant investor returns on the table for worker benefit and incentive and it uses criteria that prioritize deals that could have a significant economic benefit for workers after conversion. Over 90% of The Working World’s deployed dollars to date have gone to minority and low-income workers, and the goal as the fund grows is to continue this track record with larger and increasingly economically impactful deals.

Since the launch of the U.S.-only fund in 2012, The Working World has raised $9M in an evergreen style fund that deploys as it grows, gaining experience with over ten small and medium-sized conversion deals in the U.S by 2018. Through partnerships in its base of New York City with the mayor’s office and City Council, The Working World is now focused on an additional raise of capital to reach a sustainability level of $30M and hit its resting target of $50M to deploy in $1M – $10M business conversion deals in the greater NY and Eastern seaboard area.

For conversion deals, The Working World deploys capital mostly through acquisition of equity that is held temporarily and converts to employee-ownership in a structured process. This intermediary model puts The Working World in the position of operational support and value engineering for the enterprise as the development of ownership culture and the conversion to worker-ownership progresses, which makes The Working World an active, PE-style investor. The Working World also deploys subordinated or equity-like risk-bearing capital that combines the possibility for investor upside with
worker ownership and control.

The Working World focuses on light and custom/local manufacturing and the caring industries with a secondary focus on broader service provision in stable industries. These industries offer the mix of the target population, large workforces, and the potential for meaningful economic upside for workers upon conversion.