OPPORTUNITY KNOCKING

IMPACT CAPITAL AS THE TRANSFORMATIVE AGENT TO TAKE EMPLOYEE OWNERSHIP TO SCALE

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INTRODUCTION: IMPACT CAPITAL AS AN AGENT FOR TRANSFORMATION AT SCALE

With more than half of small businesses predicting they may be forced to close as a result of the COVID-19 economic crisis, business owners face catastrophically bad choices as 2020 comes to a close.[1] A flood of businesses will be put up for sale for pennies on the dollar, with more shutting down permanently. An estimated 30 million unemployed workers, meanwhile, are struggling to keep their heads above water, lacking reserves that might buoy them up in tough times.[2] For workers of color it's far worse, with the U.S. Department of Labor reporting that fewer than half of Black workers were employed as of April 2020.[3]

Impact investors and other capital providers could be the agents that help resolve this vicious crisis—stepping in to turn the misfortune of small-business owners into a new start for employee-owners. Capital could be the agent that begins to take employee ownership to scale in this pivotal moment in our nation's history, stabilizing the local economies we all depend upon.

Absent strong action, wealth concentration—disturbingly extreme in the pre-COVID-19 world—is poised to become worse. Before the crisis, less than 1 percent of the world's population owned 50 percent of all wealth; in the United States, 84 percent of the stock market was held by the wealthiest 10 percent.[4] At the other extreme, fully 46 percent of Americans reported they could not put together $400 in an emergency.[5] The pandemic has accelerated these disparities, as evidenced by miles-long lines at food banks and a brewing eviction crisis.

If shares of company ownership for the 1 percent represent one more vacation home, for workers such assets can mean a down payment on a family home, a child going to college, or support for an aging parent. For low-wage workers—many of whom are people of color—gaining assets through employee ownership could narrow the racial wealth gap and lift families into the middle class.

As business owners and communities look to weather the economic crisis—and as impact investors look to remedy racism and inequality—employee ownership is a powerful, proven solution waiting to be deployed. What is needed is an agent capable of taking it rapidly to scale. *That agent is capital.*

Rather than standing by as a wave of corporate buyouts and consolidations undermine local economies, social impact investors could become the agents of a sweeping economic transformation anchored in broad-based employee ownership. Impact capital could become the lever directing wealth into the hands of average Americans—while generating attractive returns on investment. In this report, we propose that, with the right incentives, guardrails, and approaches to value engineering—and ultimately, the right support through policy—investors could help lead the way in substantially transforming our economy, creating out of the COVID-19 crisis a better world for all.

> By using their capital to grow employee ownership, investors could help lead the way in substantially transforming our economy, creating out of the COVID crisis a better world for all.

Employee Ownership Works

Decades of research, most recently showcased in a report from Project Equity, demonstrates the substantial benefits for workers, firms, and communities that result from employee ownership.[9] Among the highlights:

Business Performance: In comparing hundreds of companies that transitioned to Employee Stock Ownership Plans (ESOPs, the most common form of employee ownership in the United States), the National Center for Employee Ownership (NCEO) found that after becoming ESOPs, firms saw sales, employment, and productivity grow more than 2 percent faster per year than otherwise would have been expected. Other studies confirm similar increases in productivity at worker-owned cooperatives.

Other advantages multiply with a more participatory management culture, according to Douglas Kruse and Joseph Blasi of the Rutgers University Institute for the Study of Employee Ownership and Profit Sharing. They found that not only did companies that transitioned to participatory ESOPs grow in sales, employment, and productivity, but these firms were more likely than peer firms to survive downturns or other routine causes of business failure.[10]

Workers: Employee ownership enhances job security by reducing layoffs, improving wages and benefits, and significantly increasing wealth-building opportunities. Through profit sharing and share ownership, workers are able to build long-term economic security. According to the Institute for the Study of Employee Ownership and Profit Sharing, the average ESOP account in 2018 was valued at $134,000—a significant nest egg considering most Americans have no retirement savings at all.[11]

In a particularly interesting study, the NCEO found that employees aged 28 to 34 employed at ESOP firms enjoyed almost double the net worth, received 33 percent greater median pay, benefited from a wider array of fringe benefits, and reported 53 percent longer job tenure than their peers at firms with traditional (private or investor) ownership. For workers of color, household net worth was 79 percent higher, while median income was 30 percent higher.[12]

Structures of Employee Ownership

In the United States, close to 7,000 firms have at least some employee ownership. This mainly takes two forms:

Employee Stock Ownership Plans (ESOPs), through which company stock is held in an employee retirement trust. Workers receive their shares free, as a retirement benefit. According to the National Center for Employee Ownership, 6,416 firms have ESOPs, with 14 million retired and current employee participants.[6] Of these participants, nearly 2 million work for privately held companies, where it is common for the ESOP to hold over 50 percent of the companies' stock.[7]

Worker-owned cooperatives, which are employee-owned and democratically governed firms organized on a principle of one worker, one vote. Employees purchase shares, often at a nominal rate. According to a 2019 study by Democracy at Work Institute, the United States has 465 worker-owned cooperatives, employing 6,454 workers.[8]

Communities: As locally owned enterprises, employee-owned businesses are engines of community wealth building. When residents have better jobs and the ability to grow wealth, they pay more taxes and are less dependent on government funds. The NCEO estimates that in 2010 employee ownership saved the government $37 billion in the year following the financial crisis.[13]

Employee ownership benefits

- **Workers**, who gain a stake in the business, grow their assets, and enjoy greater financial security;[14]
- **Companies**, through a more engaged workforce, increased productivity, and reduced turnover;[15]
- **Communities**, through local and loyal ownership that keeps wealth local;[16] and
- **Retiring business owners**, who have the opportunity to ensure the legacy of companies they built.

The Failure to Scale

Despite these benefits, the growth of employee ownership in the United States has been largely stagnant over the last three decades. This is essentially a problem of agency. An agent capable of transitioning asset ownership at the necessary scale has not yet emerged.

In this report, we argue that risk capital is the agent most likely to bring about desired change in the employee ownership field, because it is already poised to capture firms as their ownership changes hands. Further, we argue that to compete with the traditional mergers and acquisitions market—and to prevent businesses from closing because buyers are not readily available—the employee ownership field needs capital models that provide the same "knock upon the door" that traditional acquirers offer: capital with agency to initiate, structure, and finance transitions to employee ownership. We report on more than a dozen funds emerging to operate in this way, the best of which are using employee-friendly value engineering approaches. If this nascent movement of capital is to reach sufficient scale, we argue, action by government will be needed, including direct government financing and the establishment of policies and risk-reduction strategies, such as loan guarantees, to facilitate private financing.

Finally, if a massive influx of capital does build and grow, we make the case that it must be appropriately channeled and restrained to prevent excess extraction, through the use of guardrails and protections, such as the *Guidelines for Equitable Employee Ownership Transitions* developed by our organization with others in the field. Also needed are social impact metrics, to ensure social impact is authentically achieved.

Through it all, we argue that social impact—not simply maximum benefit to exiting owners or investors—must guide investments in employee ownership, if the growing enthusiasm for broad-based ownership is to have the moral and political force to lift employee ownership out of the stagnation it has suffered for decades and deliver prosperity for many families now dispossessed.

Crisis and Opportunity: The Swelling Wave of Exiting Business Owners

We face an unprecedented opportunity to tip the scales of our economy toward greater equity. Most experts in the employee ownership field have concluded that converting existing businesses to employee ownership provides a more efficient path to scale than launching new employee-owned firms.[17] And the COVID-19 recession is forcing small businesses to close in communities all across the country.

The sale and closure of small businesses was already poised to accelerate with the retirement of the baby boomer generation. Before the current crisis, Project Equity predicted 1.2 million baby boomer-owned businesses with more than ten employees would come on the market over ten years, with most likely to close. [18]

The situation is now much more dire, with business owners facing "a daunting decision of whether to take on more debt or cut their losses and shut down," according

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The party best positioned to facilitate this generational ownership transfer is mission-driven risk capital.

to the ICA Group. Moreover, ICA predicts the crisis will have a disproportionate impact on "business owners and workers of color, women, and immigrant communities already suffering from less access to capital and disinvestment or displacement pressures."[19]

When firms are sold to a traditional strategic acquirer, such as a large competitor, the transfer increases the likelihood of downsizing and dislocation. Considering that baby boomer-owned businesses in 2012 employed 24.7 million people, generating $5.14 trillion in sales, a massive wave of corporate acquisitions and closures could be dire indeed. Yet this is what is likely to happen, without intervention.[20]

At the same time, the closure crisis represents a rare opportunity for catalyzing the democratization of ownership. If more of these businesses can be transitioned to employee ownership, society could bend the curve of history—creating access to wealth for thousands of families through a new norm of broad-based enterprise ownership. As we argue throughout this report, the key to getting there is mission-driven capital.

Mission-Driven Capital: The Missing Agent

It has never been likely that employee ownership would scale through the independent actions of either retiring entrepreneurs or their employees. Both face significant information barriers, and the transactional complexities required to execute a sale to employees are off-putting even to those familiar with the process. The party best positioned to facilitate this generational ownership transfer is mission-driven risk capital.

The challenge is that, though a sizable and growing number of investors are searching for ways to use their money for social impact, the impact investing infrastructure is not yet fully developed. In a 2020 report, the Global Impact Investing Network (GIIN) estimated the size of the total impact-investing universe (public and private markets) at $715 billion.[21] By contrast, traditional private equity firms held $3.9 trillion in assets in 2019—and early 2020 saw $1.5 trillion in private equity sitting on the sidelines, the highest levels of "dry powder" in recorded history.[22] With its deep pockets, traditional private equity executed 3,500 buyout deals in 2019, while the number of employee ownership conversions per year is a few hundred.[23]

To avoid seeing countless distressed yet viable firms snapped up by extractive private equity, the number of employee ownership conversions needs to grow dramatically and quickly. What is needed is the creation of new impact-investment products and intermediaries that would finance the conversion of businesses to employee ownership on a massive scale. These vehicles must deliver returns through *employee-friendly approaches to value engineering*. Rather than loading firms with excess debt, reducing personnel to cut costs, and flipping ownership quickly—as traditional private equity often does—an emerging new class of *impact private equity* can use employee engagement, existing tax incentives, and strategies to lower risk that together could create substantial value.

Investing in employee ownership conversions enables impact investors to build more equitable local economies, while also generating the kind of attractive returns largely unavailable to impact investors elsewhere. This is clearly an idea whose time has come, as a variety of prominent players have begun to explore the concept. In 2019, Transform Finance issued a seminal paper on how private equity funds can foster equitable conversions to employee ownership. Their report profiled a half-dozen pilot funds in formation or in operation, marking a critical milestone in the growing body of evidence that suggests financing employee ownership may well become the next major focus area in impact investing.[24]

Other innovative approaches to deploying catalytic capital for employee ownership are also needed to spur this transition to a more democratic economy. This includes action by community development financial institutions (CDFIs), employee ownership centers, and other mission-aligned groups. The shift will involve "blended capital," funds in which philanthropic and investment dollars are blended to facilitate ownership by marginalized communities. And it will include philanthropy and local multistakeholder collaboratives taking actions to scale employee ownership. Finally, it will require action by federal, state, and municipal governments—as well as the Federal Reserve and development finance entities—to directly fund or encourage and support the movement of private capital.

To build this capital ecosystem for employee ownership, we make four recommendations, discussed in more detail in the final section of this paper:

1. Develop new investment funds for employee ownership
2. Ensure employee benefit by developing and deploying common metrics and deal guidelines
3. Use employee-friendly approaches to value engineering
4. Support this developing ecosystem with philanthropy and take it to scale through government policy

Most immediately, progress will rely on first-mover, catalytic impact investors who recognize the opportunity to benefit from a surprisingly unexplored market niche, and who want, at the same time, to help build a future that works for all of us.

The Fund for Employee Ownership Focuses on Jobs for Low-Income Communities

Mission-driven capital positioned to build shared community wealth

The Fund for Employee Ownership (TFEO), affiliated with the Evergreen Cooperatives, a nationally recognized network of employee-owned companies based in Cleveland, Ohio, is testing the idea that mission-driven capital can drive significant growth in employee ownership. TFEO was one of several initiatives seeded by the Kendeda Fund's $24 million investment in employee ownership (see p. 35). Structured like a private equity fund, its goal is to acquire small and mid-size businesses from retiring owners and to convert them to employee ownership, while providing ongoing support to assure long-term success. By doing so, TFEO hopes to preserve and grow jobs for low-income workers and marginalized communities in Cleveland and throughout northeastern Ohio.

In late February 2020, TFEO made its first acquisition. It became the majority owner of Berry Insulation, a small business in Cleveland that provides energy audits and insulation for both commercial buildings and residences. Owner Martin Berry was considering how to exit the business when he heard about TFEO. With 15 employees and $2 million in revenue, he knew his business would not be attractive to a private equity buyer. Employee ownership appealed to him, because it would reward his workers and sustain his legacy in the community.

In October 2020, TFEO announced the acquisition of Phoenix Coffee, a coffee roaster with a chain of cafes in the Cleveland area employing 37 workers. To ensure these businesses successfully transition to worker cooperatives, Berry Insulation and Phoenix Coffee will be integrated into the Evergreen Cooperative network, which will provide business support and ensure that the companies grow vibrant ownership cultures.

For Brett Jones, executive vice president at Evergreen and cofounder of TFEO, "The work of the Fund for Employee Ownership will be a vital way to keep quality jobs in the communities that depend on them, especially when so many business owners facing retirement lack a clear plan for succession."

PART I: SOLVING THE AGENCY PROBLEM

Workers and Owners Lack Agency Necessary to Propel Conversions

In the social sciences, “agency” is a concept that views social outcomes as a function of choices that individual people make to better themselves. These choices are not entirely free, but are constrained by laws, rules, and social factors, as well as by resources such as information or finances.

Research shows that employee ownership brings beneficial outcomes for workers and firms, and as we argue in this paper, society as a whole, but something is inhibiting its expansion. We attribute this to a problem of agency. The problem here is not the principal-agent problem commonly discussed in management theory, the notion that shareholder-owners, who are removed from daily operations, have difficulty holding managers to account despite the fact that the managers are acting as their agents.

The lack of growth of employee ownership involves a different agency problem. Walt Mayo, a former executive with Dell Computer who is a founding partner of the Blueprint Fund, put it this way: “The question is, why hasn’t employee ownership become a broader phenomenon? The answer is lack of agency. The primary beneficiary of employee ownership is the employees. But they lack the agency to effect the transaction.”[25]

American workers lack agency partly because they lack information. In the United States, employee ownership is not well understood or recognized as a competitive business structure. In most cases, employees lack the information necessary even to entertain the option of a direct buyout. Furthermore, they often lack the financial resources required for a successful transition to employee ownership. The average American household has $11,760 in savings, including retirement savings (far less among households headed by people of color), which means most workers lack the resources to buy even a relatively small business.[26] Raising debt financing is another hurdle. For example, in a direct purchase, as is typical for a cooperative conversion, lenders typically require one business partner to provide a personal loan guarantee. But this is not usually feasible in a transaction involving multiple buyers.[27]

This financing challenge is what has made the ESOP vehicle so attractive and explains why there are 17 times more ESOPs than worker cooperatives in the United States (see sidebar, p. 6). These transactions do not rely on worker mobilization nor do they require employees to raise a dollar of capital. ESOPs are typically initiated by private owners and use company credit to purchase ownership for employees, through debt paid back out of the earnings of the firm (see Appendix for details on ESOP financing). This form of financial engineering is similar to the leveraged buyout, a staple in the private equity toolkit, with one important difference: private equity deals usually benefit the few, while ESOPs benefit the many.

The number of ESOP buyouts compared to direct employee buyouts provides evidence that reducing the hurdles created by the agency problem can absolutely impact market adoption. But despite generous tax incentives (see sidebar, p. 11) and the relative ease of ESOP formation—and all the data indicating that employee ownership benefits firms—the number of ESOPs has barely budged over multiple decades. This suggests that ESOP formation, too, is hindered by an agency problem: one of seller agency. The same kind of information deficits that preclude employee agency also preclude seller agency. In a strategy that relies on sellers to initiate a transaction, these selling owners first need to know that employee ownership is an option. The problem: they don't.

Our thesis was confirmed when The Democracy Collaborative and the Democracy At Work Institute convened 34 employee ownership experts in 2016, almost all of whom agreed that low awareness and misconceptions hinder expansion of ESOPs and worker cooperatives. The group also noted that advocates lack the resources to communicate the value of employee ownership to business owners, employees, and other stakeholders.[28] Thomas Dudley, founder of Certified Employee-Owned, which works to develop and promote a brand identity for employee-owned firms, bluntly articulated the challenge: "The major hurdle to educating people about EO is that almost nobody is looking for information about employee ownership today. The fundamental problem is that we're not on the radar."

ESOP Tax Incentives

To promote ESOP formation, the federal government offers three tax incentives:

1. **Company contributions to an ESOP are tax deductible.** This means both principal and interest on a sale to an ESOP are deductible; in a non-ESOP transaction, only interest is deductible.
2. **An owner selling at least 30 percent to an ESOP can defer capital gains taxes,** by investing the proceeds in another US company. Capital gains from the sale are not taxed until that newly purchased stock is sold.
3. **S corporation ESOPs pay lower or no taxes on company income.** S corporations pass gains and losses through to shareholders. When an ESOP trust is a shareholder in an S corporation, income to the trust is not taxed until employee-owners cash in their shares upon leaving the company. If an S corporation is 100 percent owned by an ESOP trust, it pays no corporate income tax, a key reason for today's growth of S corporation ESOPs.[29]

A Limited Solution: Institutional Levers to Encourage the Exercise of Agency

Over several decades, an institutional approach has emerged to address the problems of employee and seller agency. Historically, state-level employee ownership centers, technical assistance (TA) providers (for-profit or nonprofit), and business services firms have promoted employee ownership, educating buyers and sellers, offering services such as legal counsel or tax advice, structuring ownership transitions, and providing gap loans to finance start-ups or conversions. This universe of experts, however, supports a relatively small number of employee ownership conversions annually as compared to the US market for small business sales, most recently estimated at 10,000 per year.[30]

One of the driving forces for conversions has been state employee ownership centers.[31] Building on the success of the model, the nonprofit Employee Ownership Expansion (EOX) Network launched in 2018 to bring employee ownership centers to more states.[32] With the support of EOX, the network of state centers has expanded from a handful to 15 centers serving 16 states—California, Colorado, Florida, Georgia, Indiana, Massachusetts, Michigan, Minnesota, New York/New Jersey (a combined center), North Carolina, Ohio, Pennsylvania, Vermont, Tennessee and Texas.

State centers, for the most part, focus on ESOP conversions. Employing one to three staff, they draw on the expertise of a large group of TA providers, including large ESOP specialty law firms, advisors, valuation service firms, and investment banks such as Blue Ridge ESOP Associates, the Menke Group, Verit Advisors, and Prairie Capital Advisors, among others. Several major financial institutions like Bank of America and Fifth Third Bank have special divisions for ESOP lending. Altogether, approximately 1,000 ESOP professional advisors serve the field. These skilled advisors are capable of working with large-scale companies, such as Recology, the 100 percent employee-owned waste hauling and recycling firm with $1.2 billion in revenue, which became fully employee owned back in 1986; or Clif Bar, the organic snack bar firm with revenues estimated to be close to $1 billion, which became partially employee owned in 2010.[33]

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The employee ownership field needs to provide the same “knock upon the door” that private equity offers: capital with agency to initiate, structure, and finance transitions to employee ownership.

A different universe of TA providers works to promote worker cooperatives; for instance, at least 47 TA providers (many of which are not-for-profit), 11 local government and economic development partners, and 14 affiliated service and capital providers participate in the Workers to Owners Collaborative, to spur conversions of businesses to democratic employee ownership (mainly worker cooperatives).[34]

As vital as this universe of TA providers is, it supports a modest number of employee ownership conversions—200 to 300 per year, according to Martin Staubus of the Beyster Institute.[35] Workers to Owners members handled 21 conversions in the group's first year. But these TA providers simply don't have the resources to promote employee ownership at a scale large enough to influence the market of selling owners.

James Steiker, ESOP attorney and principal with Steiker, Greenapple & Fusco, P.C., and SES Advisors, Inc., explained the field's longtime education and marketing dilemma this way:

> Marketing [of employee ownership] has been left to the professional community of TA providers. But people like me are not the right ones to [educate the universe of potential sellers]. The sales cycle is too long. If I'm out talking to a Chamber of Commerce, where no one has heard of ESOPs or knows how they work, it takes far too long for that to translate into any business for me. It's not cost-effective marketing for TA people.[36]

While nonprofit employee ownership advocates and TA providers are not as hindered by the long and uncertain sales cycle Steiker identifies, their efforts are constrained often by scarcity of funding. One reason is that many foundations have not seen a business approach to solving large-scale social problems, such as employee ownership, as appropriate for charitable dollars. Thus, the employee ownership field lacks sufficient allies, awareness, and agents to take employee ownership to scale.

The Knock Upon the Door: The Unique Role of Capital

What if, instead of waiting for owners to come to the employee ownership market, that market instead came to the owners? We posit that organized capital could make this happen. Capital is already positioned to continuously reconstitute ownership at a rapid scale and pace through mergers and acquisitions (M&A). *Flashwire US Monthly* reported that 14,247 US M&A deals were completed in the 12 months ending August 31, 2019, totaling more than $2 trillion.[37] The annual value of employee ownership financing, by contrast, amounts to roughly $8 billion—a ratio of 250-to-1.[38]

As the field ponders how to channel more buyout deals to employee ownership, it is important to note that the typical employee ownership deals done today are not necessarily inhibited by a lack of capital. For most ESOP deals, which represent the lion's share of employee ownership conversions, traditional bank and seller financing is available—once a deal is put together. Wells Fargo, Bank of America, and JPMorgan Chase are just three banks with ESOP lending or advisory groups. As previously noted, the total credit made available for ESOP financing is conservatively estimated at about $8 billion per year.[39] (To understand how these financial transactions work, see the Appendix, p. 44).

The challenge arises earlier, when the selling business owner begins to consider succession-planning options. These sellers, for the most part, are unaware that employee ownership is an option that is available to them—and if their business is likely to attract a buyer, they need only wait for the knock upon the door from private equity and strategic acquirers. Therein lies the problem: traditional capital with agency—organized capital with the incentives and capacity to make a deal—is ready and waiting, and vastly outweighs organized employee ownership capital.

To pursue an ESOP deal independently, the owner has to educate him or herself, find a consultant, find a bank, and put the deal together. In these situations, banks generally require the owner to remain on the hook with partial seller financing, carrying loans of 20 percent or so of the company's value. In today's markets, a seller has to be highly motivated to take the ESOP route.

To compete with the traditional mergers and acquisitions market—and to prevent businesses from closing because buyers are not readily available—the employee ownership field needs to provide the same "knock upon the door" that private equity offers: capital with agency to initiate, structure, and finance transitions to employee ownership. It is starting to happen, as Transform Finance documented in its 2019 report, *Investing in Employee Ownership: Financing Conversions through a Private Equity Model*.

The private equity model for stewarding employee ownership conversions has also been piloted and proven by pioneers such as Long Point Capital and Mosaic Capital Partners (see sidebar, p. 14). The mechanics of these deals are explained in more detail in the Transform Finance report. We summarize the approach below.

Private Equity: A Model for Growing Employee Ownership

Briefly, how does the model work? Private equity decouples the business sales process from seller initiative. The complications that come with selling a business are a challenge to sellers in any marketplace but, as we have outlined, pose a particular challenge to the growth of employee ownership. Private equity firms have staff, resources, and sophisticated methodologies to assemble capital; source, structure, and negotiate deals; and drive long-term firm performance—tools that are all needed to drive more employee buyouts.

Typically, private equity raises closed-end funds, which pool capital from multiple investors who agree on a common "investment thesis," or set of parameters that define the types of firms and transactions to be pursued. The funds also develop partnerships that provide access to a pipeline of potential opportunities. For example, a fund with an industry focus may engage with trade associations or industry experts within that sector. Likewise, a fund with a goal of benefiting particular communities of workers, such as low-income, rural, or immigrant workers, or workers of color, could develop pipeline strategies designed to similarly access target firms.

Opportunities are vetted through multiple stages of screening culminating in formal due diligence, which involves analyzing a firm's viability, future prospects, and risks. Private equity funds then go knocking on doors, whether or not target firms are for sale. Once a private equity firm acquires a business, the later stages of the process begin: driving firm performance through "value engineering" (i.e., making operational, governance, and financial changes to deliver a higher return for investors upon exit).[40] To support these goals, private equity fund managers engage with industry experts, consultants, and others to help firms succeed in complicated markets. This type of expertise is crucial to ensure that newly incorporated employee-owned firms can continue generating wealth for workers over the long term. However, agents capable of mobilizing such resources for employee ownership are uncommon in today's marketplace. It is unsurprising, then, that employee ownership is not advancing rapidly, particularly when you consider its competition.

Could the private equity model actually be deployed to create vastly more employee-owned firms? We argue that it can—and should—but that balancing the interests of investors with the interest of other stakeholders, particularly employees, is a twist on the private equity model that requires deliberate attention.

Mosaic Capital Partners Finances ESOP Sales

A successful private equity approach

One leading example of a private equity fund approach to employee ownership is Mosaic Capital Partners, which has a $165 million fund focused exclusively on Employee Stock Ownership Plans (ESOPS). "When we first came to market with our ESOP strategy, no one had done it," said Keith Butcher, managing partner of Mosaic, based in Charlotte, North Carolina. Now the group has completed more than a dozen ESOP transactions, and the fund is on track to deliver investors competitive private equity returns.

Mosaic's strategy is to leverage investment capital and Small Business Administration incentives to finance the sale of private, often family-owned companies to employees. A fair number of its investments have been in rural manufacturing firms, where sellers often want to keep firms locally owned.

For example, Mosaic provided the capital for an ESOP trust to acquire 100 percent of shares in Galfab, a manufacturer of waste-hauling equipment in rural Indiana. Galfab CEO Jerry Samson said he was looking for a way to take care of the company's employees and keep the firm operating in Winamac, a town of 2,500.

"The desire to create an ownership opportunity in Galfab for our over 150 employees," said Samson, "was always the top priority for us. Our employees are the heart and soul of Galfab."

Mosaic didn't begin its strategy with a focus on social impact. In the future, however, the firm is considering a new approach targeting institutional impact investors. To demonstrate genuine impact to these investors, they aim to develop marketing messages, key performance indicators, and social impact metrics.

Says Butcher, "As ESOP participants, [employees] may end up with three times their annual salary in wealth." That wealth-building opportunity can be transformative for workers, and for the small communities in which they live.[41]

A Worker-Friendly Approach to Value Engineering

The private equity model brings complications: it is known for extracting maximum investor value from firms in ways that can negatively impact employees, who have traditionally been viewed as mere inputs to profit generation.

Private equity firms have earned the reputation of "corporate raiders" due to playbook strategies such as layoffs and downsizing to squeeze savings out of personnel costs.[42] Over-leveraging is a frequent tactic as well, with investors making a profitable exit while leaving behind the shell of a company so loaded with debt it cannot survive. As Transform Finance observes, this type of financial engineering, a strategy to "over-leverage the company with excessive warrants or debt," is detrimental to any deal intended to benefit workers."[43]

In the traditional private equity model, investors are the principal, while the private equity firm is the agent working on their behalf. Employee ownership puts a twist on this model. Investors remain the principal, but their support of employee ownership ultimately turns the employees of portfolio firms into a de facto *second principal*. Private equity firms, now beholden to more than one principal, engage in practices more beneficial to employees than would be typical in a private equity acquisition—and agents are held accountable to broader goals. This opens the door for alternative approaches to value engineering, such as building employee engagement through a participatory ownership culture, that yield positive results for both workers and investors.

Could the private equity model actually be deployed to create vastly more employee-owned firms?

Research shows that ESOP firms with more participatory structures grow, on average, at three- to-four times the rate of non-participatory firms.[44] These firms put into practice for employee-owners some combination of open communication, pass-through voting rights or board representation, inclusion in planning or budgeting, a say in manager and supervisor appointments, control over work, and a strong collaborative team culture. They drive firm performance by aligning incentives through profit sharing and empowering employees with tools and information they can use to contribute to the firm's success. By fostering these practices, instead of relying primarily on cost-cutting tools, private equity managers can deliver attractive value for both investors and employee-owners.

Private equity giant KKR is testing this hypothesis. To better align incentives between management and the rank and file, its industrials team has rolled out limited employee profit sharing across its portfolio. According to Peter Stavros, head of that unit:

> We use this ownership model as a mechanism by which to engage people beyond the management team as business partners. This allows us to have a dialogue with the employees about our value creation plan, what their individual contribution can be to that journey, how we will track progress and so on....
>
> The performance of these investments has been strong, both financially and operationally. We've invested nearly $4 billion of equity in investments utilizing this approach and the current value is worth more than three times that amount. From an operational standpoint, we've been able to meaningfully improve the performance of the businesses, oftentimes in a truly transformational manner.[45]

Stavros goes on to say that it is difficult to unpack how much of this performance gain is the result of implementing an ownership culture. To figure that out, KKR has engaged an academic team to try to isolate the culture change variable and measure the real impact of participatory employee ownership in the success of its industrials portfolio. If KKR can demonstrate a correlation between a strong ownership culture and performance to other investors, its model could contribute to scaling employee ownership.

Proof that Investing in Employee Ownership Yields Good Returns

Corey Rosen, founder of the National Center for Employee Ownership, makes a case for the attractiveness of employee ownership investments through the "Employee Ownership Index," which he launched in 2017 at the online trading platform Motif Investing. The index included 30 publicly traded companies with ESOPs that offer broad-based ownership. Significantly, to be included in Rosen's index, companies had to also demonstrate a high level of employee engagement, as evidenced by having won one of several national best-places-to-work or most-engaged-workforce awards.

From its inception in June 2017 through May 2020 (35 months), the index was up 52.1 percent, compared to 26.4 percent for the S&P 500.[46] These impressive results indicate that investors can in fact expect the best returns in the employee ownership sector when ownership is combined with quality jobs and a participatory ownership culture. Though the index is no longer available for investing through the Motif Platform, Infinite Equity is tracking the performance against the S&P 500 and Russell 2000.[47]

> **This opens the door for alternative approaches to value engineering, such as building employee engagement through a participatory ownership culture, that yield positive results for both workers and investors.**

We share the concern others have expressed that employee participation and profit sharing, if adopted by mainstream private equity, could be deployed only superficially, as a means of producing more investor return. But we believe in the potential of a more balanced model—one that organizes the right group of investors around a strong, pro-worker investment thesis, and puts guardrails in place to promote shared value and protect employees from financial abuses.

Such a model might employ risk-reduction strategies to make deals more attractive; for example, participatory practices to make firm performance more stable and reliable, or credit enhancements backed by public or philanthropic actors. We are optimistic that creative solutions are available that do not factor into most current private equity deals simply because the principals do not currently require them.

A balanced model can be advanced by investors who demand that social impact goals be prioritized along with financial goals. And these investors already exist: Large-scale impact investors—including in both family offices and institutions—are growing in number and assets under management (AUM). These could be the first movers, who lay the foundation for a larger-scale movement of capital into employee ownership.

PART II: ENSURING AUTHENTIC SOCIAL IMPACT

Impact investing aims to use capital across asset classes to "generate positive, measurable social and environmental impact alongside a financial return," explains the Global Impact Investing Network (GIIN). Values-driven as well as market-driven, impact investors see business as both responsible for and capable of resolving societal and environmental ills.[48]

Rapid Growth of Impact Investing

With a generational transfer of an estimated $59 trillion in wealth from baby boomers to their spouses and children, impact investing is expected to grow significantly in the coming years. Women and millennials, as demonstrated in a study by the Center on Wealth and Philanthropy at Boston College, are known to be disproportionately drawn to socially responsible investing.[49] Says Amit Bouri, CEO of GIIN, "Impact investing will become part of 'a new normal,' galvanizing capital markets to play a significant role in tackling or even solving big global challenges such as poverty, inequality, and environmental degradation."[50]

Today, major investment firms are launching impact-investment divisions to attract these values-driven investors. KKR, for example, recently announced its $1 billion Global Impact Fund, joining other major firms like Bain, TPG, BlackRock, and Goldman Sachs, which all operate impact divisions.[51] The entry of these global giants suggests the arrival of impact investing as an important market.

Employee Ownership: An Impact Investing Opportunity

Employee ownership is not yet a major part of impact investing, but indications suggest it could play a key role as the field continues to develop. In a 2020 GIIN survey, 69 percent of impact investors responded that the impact field is beyond its infancy and "growing steadily"; yet only 2 percent see the field as "established/mature." Moreover, there is room for far more impact investing in the US; only 20 percent of aggregate impact AUM currently are in the United States and Canada.

Scale of Impact Investments

In 2020, impact investors reported:

- $715 billion in impact assets under management
- 57 percent unlikely to change commitments due to pandemic
- 15 percent likely to commit additional capital

Global Impact Investing Network, "Annual Impact Investor Survey 2020." https://thegiin.org/research/publication/impinv-survey-2020

Investment infrastructure is also still lagging. GIIN respondents noted the following challenges: the industry lacks "appropriate capital across the risk-return spectrum" (56 percent); lacks "high-quality investment opportunities (fund or direct) with track record" (42 percent); and lacks "suitable exit options" (47 percent).[52]

In the current environment, impact investment opportunities tend to be concentrated at two ends of the spectrum. On the one end are high-risk impact investing opportunities focused on direct investment in individual enterprises—generally start-ups or early-stage businesses. At the other end of the spectrum are low-risk opportunities to invest, but these mostly fixed-income opportunities provide low returns.

The gap is in the underdeveloped middle in the risk-return spectrum. This gap in investment opportunities could be filled by emerging *impact private equity funds*. By investing in employee ownership conversions, which can occur in virtually any industry and offer access to investment in more mature firms, these funds could offer a natural answer to the challenge of providing diverse opportunities for impact investors. Employee ownership via ESOPs, by its nature, provides an exit option for investors. (Investors fund purchase by the employee ownership trust, and the firm itself over time pays back that investment.)

The relatively new category of impact private equity is gaining momentum. The 2020 GIIN Annual Impact Investor Survey found that among 294 respondents, 83—or 28 percent—allocated 75 percent or more of their impact AUM to private equity. The top three sources of capital for impact-oriented private equity products were pension funds (20 percent), development finance institutions (19 percent), and diversified financial institutions (13 percent).[53] Insurance companies are becoming players in this field as well, and fund managers also report that banks and sovereign wealth funds are beginning to consider investing for impact. Some investor groups, such as unions or municipal governments, would appear to have a natural affinity for products promoting the empowerment of workers.

Risk-Return Spectrum for Impact Investors

LOW

Impact Debt

Investments in Community Development Financial Institutions (CDFIs), microfinance, and loan funds that offer low fixed returns.

MEDIUM

UNDEVELOPED MIDDLE

Impact private equity funds could fill this space by offering investors significant social impact along with market rate returns of net IRR of 12 to 14 percent.

HIGH

Venture Capital

Through funds and direct investment in one or more enterprises, investors take on high risk for potentially high returns. Investments often target start-ups and emerging markets.

> Employee ownership via impact private equity funds could become the next big focus area for impact investors.

The Critical Role of Catalytic Capital

Employee ownership via impact private equity funds could become the next big focus area for impact investors, providing access to later-stage, middle risk-return investment opportunities. In the past few years, a number of new funds have formed, but these early entrants must overcome a heavy burden of proof. These funds most likely will need to rely, in the early stages, on what GIIN terms *catalytic capital,* which it defines as "investments that accept disproportionate risk and/or concessionary returns relative to conventional investment in order to generate positive impact and enable third-party investment that otherwise would not be possible." In the GIIN survey for 2020, 78 percent of respondents said they have either engaged in catalytic capital structures or plan to do so in the future. Those providing catalytic capital are primarily for-profit asset managers (27 percent of those providing catalytic capital), foundations (22 percent), and not-for-profit asset managers (20 percent).[54]

Impact capital can include debt, equity, and guarantees along with investment instruments. Most common is debt with flexible terms (72 percent of providers). Close to half of investors provide, via grant capital, equity in an "all catalytic capital structure" or subordinated debt. Catalytic capital is deployed for many reasons, most commonly to enable innovation and prove a novel business model, financing structure, or target market; to support early-stage businesses; and to reach underserved populations.[55]

To unlock broader capital for employee ownership, more intermediaries that can demonstrate results, both financial and social, will need to emerge. To convince investors of their authenticity, employee ownership private equity funds will need to demonstrate the achievement of measurable impact goals, consistent with attractive returns.

Catalytic capital is the agent that is needed to seed new intermediaries until the models and impacts are proven conclusively. Once these are demonstrated, a substantial new market could emerge.

Embedding Mission at the Heart of Employee Ownership Conversions

Employee ownership carries the potential for upending the prevailing capitalist logic, which reserves wealth and control for a narrow group of owners and top managers. However, such an upending is not automatic. As several knowledgeable experts in the field have noted, ESOP deals have at times focused too much on getting the best deal for the seller, while not focusing enough on employee impact. This, we argue, is a natural byproduct of a system that depends on seller agency to get deals done.

A few high-profile employee buyouts, such as United Airlines, which used an ESOP but failed to deliver on promises to workers when the business experienced hardship, tarnished the field in the minds of some. Attorney Jared Kaplan, a longtime advisor to ESOPs, notes that the ESOP field would benefit from a return to the original social mission of ESOPs:

> ESOPs were conceived as a vehicle for addressing what we now call income and wealth inequality ("Kelso's Second Income Plan"), but with the passage of time and the enactment of tax benefits designed to stimulate ESOP formation, the focus shifted from the workers to the selling shareholders, lenders, investors and service providers. If ESOPs continue to be promoted primarily as a tax loophole for wealthy business owners seeking liquidity, they'll face an uncertain future. In my view, the key element in establishing the viability of the ESOP model is to assure that they

> **Investors can serve as stewards of a worker-centric mission through the entire lifecycle of a conversion deal, including sourcing, valuation, transition, ongoing management, and exit.**

provide [as much as possible] financial benefit for the workers, effectively addressing income and wealth inequality.[56]

Employee benefit needs to be baked into the structure of every employee ownership investment. This can be done via design features and processes that ensure that employee ownership will promote workers' rights and empowerment, while firms take on a level of risk and leverage appropriate to their social mission. The key is balancing the interests of sellers, employee-owners, investors, and the management team that will take forward the employee-owned company—aligning all stakeholders around a common goal of shared value creation.

Investors are uniquely positioned to insist deals be designed to do this. In this way, investors—such as impact-focused limited partners in a private equity fund—can serve as stewards of a worker-centric mission through the entire lifecycle of a conversion deal, including sourcing, valuation, transition, ongoing management, and exit. To fulfill this stewardship role, investors need clear guidelines mapped to measurable performance indicators.

The Importance of Employee Ownership Impact Metrics

As UK employee ownership advocate Graeme Nuttall advocated in his 2020 Gandhi lecture, social mission should not be conceived of as an add-on to employee-owned firms but the reason for their existence.[57] Employee ownership makes the producers of wealth—the workers—the beneficiaries of that wealth. It is an ownership structure that embodies a social mission in and of itself, and that mission can be deepened by additional commitments to improving the quality of jobs, reducing poverty, and limiting environmental impact.

Centering and communicating mission is likely the key to attracting the catalytic impact capital that could drive growth. But to do so, the field needs to be able to demonstrate impact for workers and their communities. That requires established, field-wide *employee ownership impact metrics.* Fortunately, there are many established frameworks to build upon.

Today's impact investors often look to global frameworks such as the Paris Agreement on Climate Change and the United Nations (UN) Sustainable Development Goals (SDGs) to align investments with worldwide impact goals and measure and report on performance.[58] The UN SDGs focus on 17 impact focus areas (see Figure 1, p. 21), as wide-ranging as poverty reduction, gender equality, climate action, biodiversity, good jobs, economic innovation, and growth. Because these goals are broad, standards bodies have broken them down into more specific business metrics.[59] For example, the SDG Compass Group (made up of the UN Global Compact and the World Business Council for Sustainable Development) developed a framework for translating the SDGs into measurable indicators such as the popular IRIS metrics developed by GIIN.[60]

GIIN reports that 73 percent of impact-investor respondents already use the SDGs, although managers focused on developed markets are less likely to think of performance in those terms.[61] Though no one has yet translated the SDGs into indicators specific to employee-owned firms in developed markets, the social benefits of employee ownership are consistent with some of the framework's key goals, such as "Decent Work and Economic Growth" (no. 8), which is a focus of investment for nearly three-quarters of GIIN survey respondents.[62] Other SDG goals aligned with the benefits of employee ownership are "No Poverty" (no. 1), "Reduced Inequalities" (no. 10), and "Sustainable Cities and Communities" (no. 11). So the connection is clear. It would be straightforward for advocates of employee ownership to create metrics that track directly to the goals impact investors across the globe already embrace.

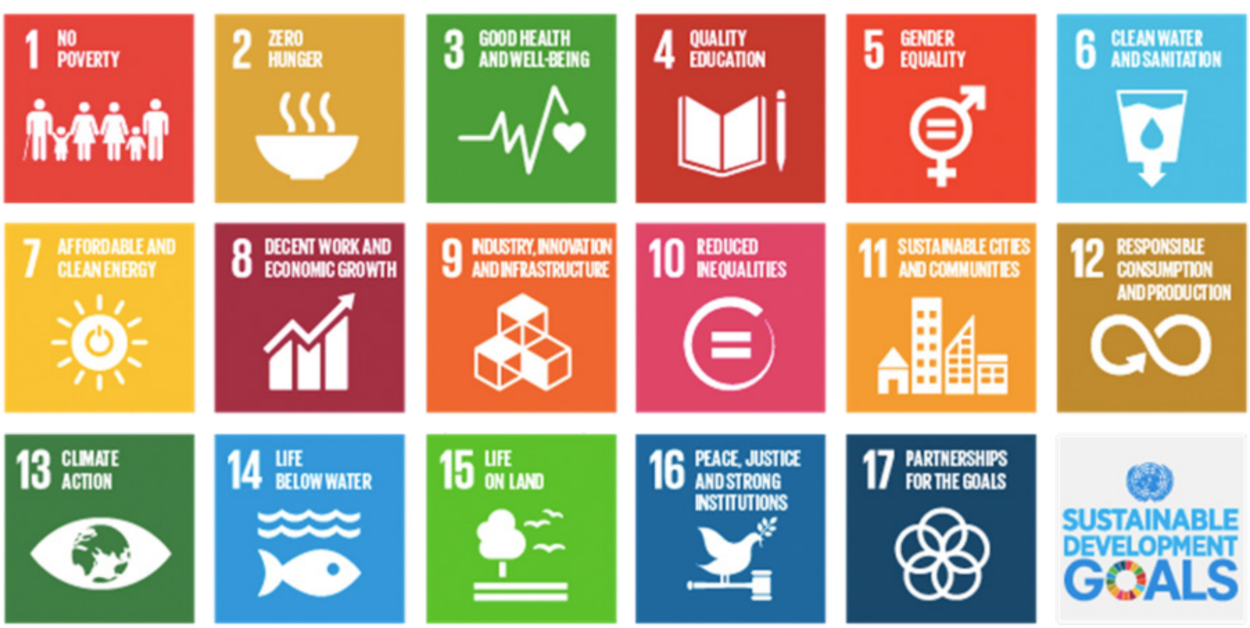
Three Recommended Themes for Impact Metrics

To ensure that investors recognize employee ownership investments as a tool to deliver on goals they embrace, the employee ownership field needs to develop appropriate impact metrics. A fully articulated set of measurements for employee ownership impact is beyond the scope of this paper; moreover, such metrics should be developed with participation from multiple stakeholders, including investors, technical advisors, and employees. Nonetheless, as a starting point, we suggest three core themes that employee ownership metrics should encompass: *wealth building*, *participatory ownership culture*, and *corporate social responsibility*.

Wealth building: The question of wealth is primary. In the United States, as elsewhere, lack of asset ownership is intricately linked with poverty and inequality, problems that the SDG goals target. Asset ownership provides protection from the kinds of stresses, strains, and personal crises that waylay people who do not have resources to fall back upon. These kinds of stresses are most pronounced for people in poverty but affect countless low- and middle-income families as well. A widely reported 2017 poll commissioned by CareerBuilder found that 80 percent of Americans were living paycheck to paycheck, including millions of working people—and that was before the economic shutdown due to coronavirus.[63]

Increasing the long-term financial security of workers through wealth building is the most fundamental goal of employee ownership. To measure wealth-building impact, metrics could include tracking gains in the size of the average ESOP savings account (or member capital account, in the case of a worker cooperative), or annual profit sharing per employee. Also important is assessing community wealth-building practices, which the best employee-owned firms prioritize by committing to practices that support racial equity, environmental health, local purchasing, or other community benefits.

Figure 1: United Nations Sustainable Development Goals



Downloaded from https://www.un.org/sustainabledevelopment/

> **We suggest three core themes that employee ownership metrics should encompass: wealth building, participatory ownership culture, and corporate social responsibility.**

Participatory ownership culture: Experts and thought leaders in the employee ownership field emphasize fostering a participatory workplace, which aligns with the SDG goal of "Decent Work and Economic Growth." Employee ownership literature strongly correlates participatory mechanisms with performance gains for companies and other gains for employees; a 1987 study, for example, found 8–11 percent higher company growth among ESOP firms with participatory cultures.[64] Beyond the business case, participation benefits workers by improving job quality, imparting a sense of dignity to workers, and fostering employee self-efficacy and improved morale. These psychosocial benefits can extend from the workplace into family and civic life, helping support the SDG goal of "Sustainable Cities and Communities."

Where wealth building is a built-in component of any ESOP, participatory cultures are not. Investors who wish to promote greater economic democracy, giving workers a voice in how their companies function, could ensure that participation-boosting practices are built into their investments and tracked across a portfolio. These might include providing regular updates from the board and management to employees regarding top-level decisions, strategy, and financial position; the use of open-book management; and giving employees new oversight powers, such as input in hiring or renewing managers, pass-through voting rights on key issues such as demutualization, and seats on governing boards or policy committees.

Corporate responsibility: Corporate responsibility, which includes accountability to employees, communities, and the environment, is a third area in which investors should expect impact from employee ownership. The best employee-owned firms are stewards of a broad social or environmental mission, but this commitment is not automatic or universal; it should be encouraged through measurement.[65]

Established environmental, social, and governance (ESG) frameworks have ratings that could be adapted by employee ownership investors. For private companies—which the vast majority of employee-owned firms are—B Corp certification, or benefit corporation incorporation, might be a proxy measure of corporate responsibility and an outcome advanced by investors.[66] (ESG goals of investors should not substitute for strong legal and regulatory requirements, which can drive social and environmental impact on a macro level).

Finally, it is important to note that employee ownership is an effective way to protect a company's commitments to people and planet beyond the initial leadership of a founder or charismatic CEO. In fact, research at The Democracy Collaborative has found that mission-led firms are well positioned to retain and enhance their social and ecological mission when they transition to substantial employee ownership.[67]

For example, Eileen Fisher is a leader in sustainability among clothing manufacturers. As the company website says, "Our vision is for an industry where human rights and sustainability are not the effect of a particular initiative, but the cause of a business well run. Where social and environmental injustices are not unfortunate outcomes, but reasons to do things differently."[68] When looking to the future of the company she founded, Fisher considered selling to another company, but realized, "People were interested in what they could get out of the company [i.e., profits], not what they could give to it."[69] To protect the company's mission, Fisher established an ESOP, with the expectation that when she retires the company will be owned by "the people who put their blood, sweat, and tears into it; the people who love it and care about it and think about it every day." The employee-owners, Fisher believes, will be better incentivized to make decisions based on the best interests of the company, its people, and the communities it impacts.

By setting goals in these three areas—wealth building, participatory ownership culture, and corporate responsibility—and holding management accountable to key impact metrics tracking employee and other social outcomes, impact investors can help reconcile the conflict between the extractive private equity business model and the goal of broad social benefit.

Guidelines for Equitable Employee Ownership Transitions

Achieving this alignment will take more than metrics. Also needed are practical guidelines for investing practices that—up front, including in the deal-structuring phase—effectively embed concern for optimal employee benefit and broader ESG impacts into buyouts. As Transform Finance and others have argued, the industry would be wise to establish guidelines that make it easy for capital entrants to determine how to deploy their capital for optimal worker benefit, while helping fund managers achieve this. Such guidelines could synthesize decades of knowledge to welcome new entrants while encouraging the employee ownership-investing field to pursue practices that authentically aim at worker benefit rather than solely focusing on maximum capital income.

The vital need for protecting social mission is illustrated by the dramatic rise and fall of the international microfinance sector. The shining public face of microcredit was Muhammad Yunus, who won the Nobel Peace Prize in 2006 for founding the Grameen Bank in Bangladesh, which pioneered the provision of small loans—as low as $10—to impoverished women, to help their families achieve self-sufficiency. Following Grameen's lead, other more extractive microcredit institutions entered the market, sometimes charging interest rates as high as 195 percent on loans in order to offer the highest returns to investors.[70] This led the field of microfinance to mushroom, internationally, in the 1990s, with these institutions attracting a flood of capital in the hundreds of millions of dollars. Claims that microcredit loans benefited the poor, however, ultimately were challenged, as many alleged that the industry had shifted into abusive practices.

Continued on page 26

Guidelines for Equitable Employee Ownership Transitions

As employee ownership emerges as a major focus area for impact investors, it is important to ensure that this type of investment properly balances worker benefits with financial gains. In 2019, The Democracy Collaborative's Fifty by Fifty initiative worked in partnership with Soros Fund Management and many leading experts in the field to arrive at the industry's first draft of *Guidelines for Equitable Employee Ownership Transitions*, which articulates the following five goals:

1. **Design equitable deal structures**: Balance the interests of sellers, investors, and employee-owners by setting a fair price and ensuring each deal is structured to sustain employee ownership for the long run. Importantly, this means ensuring investors don't leave a firm over-leveraged with excess debt upon exit.
2. **Embed broad-based ownership and support employee participation**: Create substantial—at least 30 percent—employee ownership and ensure it reaches throughout the organization, from executives to frontline employees. Then build a participatory culture by sharing information and supporting employees in developing financial and business skills.
3. **Promote quality jobs and working conditions**: Improve job quality by ensuring that every employee earns a living wage, has access to meaningful benefits, works in a safe environment, and is supported to grow professionally.
4. **Consider prioritizing deals that impact marginalized communities and workers**: Whenever possible, look for firms where employee ownership would benefit low-wage workers, people of color, women, immigrants, or others without meaningful access to good jobs or asset ownership.
5. **Measure and report on employee impact**: Establish goals and metrics to measure outcomes for employees alongside company and investor performance—and then report progress to a wide group of stakeholders.

Table 1: Highlights of the Guidelines by Deal Stage and Goal

	GOAL				
DEAL STAGE	**1. Design Equitable Deal Structures**	**2. Embed Broad-Based Ownership and Support Employee Participation**	**3. Promote Quality Jobs and Working Conditions**	**4. Consider Prioritizing Impacted Populations**	**5. Measure and Report on Employee Impact**
Stage One: Sourcing/ Selection	• Select companies that have potential for long-term viability and adequate wealth-building for employees • Select companies whose free cash flow can support debt required to finance conversion to an employee ownership structure as well as investments in growth and participatory culture • Select companies with viable succession leadership and culture fit	• Select companies that have sufficient free cash flow to support investments in participatory culture • Screen company culture for risks/opportunities related to employee participation goals	• Select companies that have sufficient free cash flow to support investments in job quality	• Recognize the potential of employee ownership to correct systemic wealth and income inequality and consider naming benefit to marginalized workers as an explicit goal • Develop capacities, pipeline strategies, and networks to select target companies whose conversion to employee ownership will benefit the target populations or communities • Consider diverse viewpoints and seek community input in investment decisions	• Establish job quality, asset-building, and other employee impact goals for the conversion
Stage Two: Due Diligence & Valuation	• Ensure appraisals are balanced and reflect true market terms • Ensure no premium is paid above fair market value for the interest being acquired • Consider leverage required to support valuation • Select trustees, fiduciaries, or other worker representatives who are independent, ethical, and able to advocate for employee interests throughout deal cycle • Provide trustee/representative complete, accurate information • Require trustee/representative to evaluate reasonableness of any data or projections used to determine valuation • Be transparent about selection of trustee/representative and other advisors, as appropriate • When considering competitiveness of offer, factor seller tax benefits into price negotiations as appropriate	• Ensure employee job quality and wealth-building outcomes are actively considered during negotiations	• Evaluate baseline job quality data, such as employee compensation and benefits during due diligence and consider opportunities for future improvement	• Establish baseline demographic data on impacted populations during due diligence and consider opportunities for future improvement • Assess baseline asset-building readiness for disadvantaged employees and consider opportunities for future improvement	• Model estimated gains for employees alongside valuation and investor return, to fully evaluate opportunity for employee-owners

DEAL STAGE	GOAL 1. Design Equitable Deal Structures	2. Embed Broad-Based Ownership and Support Employee Participation	3. Promote Quality Jobs and Working Conditions	4. Consider Prioritizing Impacted Populations	5. Measure and Report on Employee Impact
Stage Three: Deal Structuring to Closing	• Protect independence of trustees, fiduciaries, or other worker representatives • Structure capital to preserve the potential for long-term employee ownership • Target no more than a reasonable market-rate return for risk and duration of investment • Limit influence of short-term investor time horizons • Ensure capital structure adequately considers costs associated with any ESOP administration or repurchase obligations • Encourage trustees or representatives to apply broadest legal definition of worker benefit • Consider structuring as a benefit corporation • Incorporate mechanisms to ensure any future investment will not create undue burden to company (i.e., over-leverage)	• Allocate the greatest amount reasonable, but at least 30%, company ownership to employee ownership group • Distribute ownership clearly and fairly and memorialize in organizing documents • Clarify employee involvement at time of deal; memorialize in organizing documents • Consider embedding post-transaction pass-through voting to employee-owners on issues of trustee selection or demutualization • Factor cost of financial education and investments in ownership culture into deal structure • Ensure take-forward management team can drive both company performance and worker participation and align incentives accordingly	• Factor cost of job quality improvements into capital structure • Ensure employee outcomes are actively considered during deal structuring	• Consider partnering with capital providers who serve target communities or populations • Consider partnering with financial capacity, education, workforce development, or similar organizations that serve priority communities	• Establish impact metrics and reporting protocol, which include job quality metrics and impacted population metrics, alongside financial metrics
Stage Four: Post-Transaction Operations	• Maintain up-to-date employee ownership documents and structures • Ensure that cash flow management strategy adequately considers costs associated with repurchase obligation to prevent demutualization pressure • Develop systems that ensure adequate employee representation during key decisions	• Deliver financial and business education and hold management accountable for building a participatory culture for workers • Ensure regular, transparent communication with employee-owners on finance and strategy • Utilize participatory management practices, such as open-book management • Involve employees in management and/or governance decisions as appropriate • Ensure employee input on any outside acquisition offers	• Adopt policies that promote high job quality • Uphold workers' right to collective bargaining • Promote appropriate diversification to mitigate single-stock concentration risk for employee-owners • Hold management accountable to job quality goals and other employee outcomes	• Hold management accountable to goals regarding impacted populations or communities • Adopt HR policies that encourage diversity and/or prioritize impacted populations • Partner with organizations that can offer benefits and services to support target populations or target communities • Consider cooperating with national initiatives focused on expanding employee ownership, especially for impacted populations	• Develop impact data collection systems and reporting protocol • Consider adopting broader environmental or social impact goals and pursuing B-Corp certification • Measure and report progress to stakeholders on key impact metrics

“

If traditional private equity dollars flood into employee ownership, excessively extractive practices could arise, unless proactive measures are put in place.

As the economist and critic of microfinance Milford Bateman observed, “Excessively extractive practices can too easily arise when capital floods into a new area, as happened with microfinance.”[71] If traditional private equity dollars flood into employee ownership finance a similar outcome might occur, unless proactive measures (e.g., impact metrics and investing guidelines) are put into place.

In 2019 a group of experts in employee ownership and employee ownership finance came together to draft the first employee ownership conversion guidelines, with these kinds of guardrails in mind. Led by Soros Fund Management (SFM) and The Democracy Collaborative’s Fifty by Fifty initiative, the group convened to prepare a set of technical guidelines to prevent abusive practices and illustrate how mission-aligned investors (and other third-parties structuring employee buyouts) could act as stewards, ensuring employee-owners optimally benefit. SFM and others plan to pilot test and refine these guidelines in the coming months.

The *Guidelines for Equitable Employee Ownership Transitions*—arranged according to deal stage—are organized around five goals that incorporate the pioneering work of Transform Finance, one of several leaders in the employee ownership field that participated in the convening. The five goals are broken down into actions relevant to each stage of a transaction: sourcing/selection, due diligence and valuation, deal structuring through closing, and post-transaction operations (see Table 1, p. 24–25). This makes the document an important how-to guide for social investors, asset managers, foundations, family offices, and any other party helping to structure employee ownership transitions.

The goals—excerpted in summary in the sidebar on page 23—aim to accomplish ends such as limiting over-leverage, encouraging employee-oriented practices by trustees, and avoiding excessively high valuations that benefit sellers but overburden employee-owners. The guidelines also aim to support structures that give employees an effective voice in decision making, ensure a living wage, and prioritize measuring and reporting outcomes.

With these guidelines and a set of impact metrics in place, we believe impact private equity could become the proverbial knock upon the door that is needed, offering a real opportunity to scale employee ownership while also ensuring reasonable returns to investors and positive outcomes for workers.

PART III: BUILDING AN EMPLOYEE OWNERSHIP CAPITAL ECOSYSTEM

As we have argued, the introduction of private equity that deploys impact capital for employee ownership conversions—pursuing standardized impact goals while respecting appropriate guardrails—directly addresses all known barriers that have so far prevented growth in the field. It is a strategy that carries the tremendous promise of taking employee ownership to scale in the near term.

That this has not so far occurred is both a classic market failure and a societal failure to recognize both the need and the opportunity for broad-based ownership. A society with widely shared prosperity and financial security is a healthier society, consistent with the founding ideals of the United States.

Early Market Innovators

Some impact investors have begun to step into this new focus area. For example, Impact Engine, a firm raising a $100 million fund of funds focused on economic opportunity, is exploring opportunities to invest in employee ownership-focused private equity funds or other vehicles. Soros Fund Management is exploring making direct placements to finance large-scale employee buyouts. But both have found that the universe of investable deals is not well organized and few products exist that can channel capital into mid- or high- risk–return deals. This is, in essence, a market failure.

Despite various investor groups with apparent affinities for employee ownership products, the financial services sector is just beginning to take notice of employee ownership and channel capital into it. Mary Ann Beyster of the Beyster Foundation for Enterprise Development confirmed this in the field's first landscape study, published by The Democracy Collaborative in 2017. As Beyster shared in her report, she herself is an impact investor interested in investing in employee ownership, yet at the time of her writing she was able to find few products available.[72]

Beyster's findings revealed an underdeveloped investment landscape with opportunities for investors clustered at the extreme ends of the risk-return spectrum. On one end were low-return, fixed-income opportunities provided by the National Cooperative Bank—a conventional bank that finances cooperative businesses, including worker cooperatives—and several community development financial institutions (CDFIs). As investment opportunities, CDFIs are limited. Most focus solely on cooperatives and returns are often between 0 and 2 percent, below the threshold that might be competitive for the asset class, generally.[73]

At the other end of the spectrum, Beyster found a small number of private equity groups, including Mosaic Capital Partners (see p. 14) and Long Point Capital, dedicated to ESOP finance and providing market-rate returns. Beyster

> **Apis & Heritage plans to address the racial wealth gap by converting businesses with workforces of color to employee ownership.**

concluded that, with the investment options clustered at the two ends of the risk-return spectrum, significant room existed for the financial services industry to develop strategies that "address the large, non-public market, including closely held ESOPs and worker cooperatives, and the public stock and bond market."[74] Her study showed that, numerically, the finance sector had not yielded enough products to engage investors in this space.

New Employee Ownership Funds Emerging

Since the Beyster study, a number of new employee ownership-focused funds have begun to enter the market. Endeavor Capital and New State Capital Partners use the private equity approach as a niche strategy. American Working Capital (AWC), a merchant bank with substantial experience investing in new and mature ESOPs, partnered with employee-owned Air Tractor, Inc., of Olney, Texas, to create OT 1 Investco, LLC, in 2018, which invests, in part, in ESOP financing.[75] Additionally, AWC has in formation the new Inclusive Capitalism Fund, aiming at a gross internal rate of return (IRR) of 12 to 18 percent through financing ESOP transitions.[76]

Transform Finance's 2019 report profiles these and four other emerging employee ownership funds.[77] Among them is Middle Bridge Capital's planned Blueprint Fund, which has been put on hold, according to principal Walt Mayo. Middle Bridge remains committed to what it calls the "ELBO" model—i.e., employee-led buyouts. The aim is to expand employee ownership as a bridge to broader wealth for employees, in turn strengthening their communities. The fund will acquire companies, giving sellers immediate liquidity, then, during a holding period, generate value by boosting employee engagement and creating an ownership culture. As MBC's website says, "Within three or four years, the employees will be ready to re-finance the company and take full control of the enterprise—and their own futures."[78]

Also profiled in Transform Finance's paper were three deep-impact focused funds; we update progress on these in Table 2 on page 31–34. Among the funds identified by Transform Finance was the National Worker Ownership Impact Fund. The Community Development Venture Capital Alliance plans to launch the $50 million fund in 2021; target returns are in the low teens. Another fund, originally called the Legacy Business Fund, is now the A&H Legacy Fund I, being developed by Apis & Heritage Capital Partners in partnership with the Democracy at Work Institute and with the support of Middle Bridge partners Walt Mayo and Michael Brownrigg. Apis & Heritage is a minority-led firm focused on the business closure crisis in Black and brown communities. The fund plans to address the racial wealth gap by converting businesses with workforces of color to employee ownership. It will seek a target net IRR of 15 percent.

The Fund for Employee Ownership at the Evergreen Cooperatives (see sidebar, p. 9), a Northeast Ohio fund, seeks to operate as concessionary private equity. Launched in 2018 at Evergreen Cooperatives of Cleveland, for which The Democracy Collaborative has been a strategic advisor, it uses an acquire-convert-support approach, while planning to exit some or all firms into the Evergreen Cooperative network of worker-owned companies.

Since the publication of Transform Finance's paper, additional deep-impact funds have launched. Project Equity has partnered with the CDFI Shared Capital Cooperative to launch Accelerate Employee Ownership (see sidebar, p. 29), an initiative to finance employee ownership conversions in ten regions across the country. And a new industry-focused fund, the Fund for Jobs Worth Owning, is being developed by Massachusetts-based ICA Group to create opportunities for low-income workers in the childcare and home health care industries. Focused on smaller firms, these funds are not likely to compete with mainstream private equity.

Other CDFIs, loan funds, and new initiatives to finance employee ownership conversions, particularly cooperatives, include the Cooperative Fund of New England, The Working World and SEED Commons. Most recently, Co-op Cincy, a Cincinnati co-op developer, announced the Business Legacy Fund, a new partnership with SEED Commons, a national network of locally rooted, non-extractive loan funds, to finance business acquisitions in Southwest Ohio with the purpose of converting these businesses to worker ownership.

Accelerate Employee Ownership Joins Two Organizations

Project Equity partners with a capital fund

Project Equity, based in Oakland, California, is a national leader in the effort to grow employee ownership. The organization has long worried that insufficient financing could become a barrier to conversions. To address that concern, Project Equity partnered with Shared Capital Cooperative, a lender in St. Paul, Minnesota, that has been funding cooperative development for 40 years, to establish the Accelerate Employee Ownership initiative.

With a large grant from the Kendeda Fund and a $5 million investment from the Quality Jobs Fund—a collaboration between the New World Foundation and the Federal Home Loan Bank of San Francisco—to seed the program, the two are providing affordable and flexible financing for co-op conversions spurred by Project Equity's outreach to retiring business owners. Accelerate Employee Ownership obviates the need for each pipeline firm to search for financing.

Alison Lingane, president of Project Equity, says the organization chose Shared Capital as a partner because, as a for-profit business (as opposed to a nonprofit community loan fund), it can accept equity and place equity, and because of its decades of experience structuring deals. For Accelerate Employee Ownership, Shared Capital performs due diligence and structures the financing, while Project Equity builds the pipeline and provides technical support for the conversion.

The financing initiative was established in 2019, and thus far, has been tapped for three conversions: Adams & Chittenden, a Berkeley, California, scientific-glass-blowing business; Cal Solar, a solar installation company; and Happy Earth Cleaning, a Twin Cities cleaning company supported by Project Equity's Twin Cities partner, Nexus Community Partners. All of these deals involved traditional loans. But under the right circumstances, the Accelerate Employee Ownership project may also make equity investments.

Says Lingane, "We are truly excited about this partnership, because our work is about creating a pipeline of businesses ready to convert to employee ownership. But what happens if there isn't sufficient capital to convert these businesses? That bottleneck had to be eased."

"

A substantial opportunity exists for more new products to fill the missing middle of high impact investments yielding attractive mid-range returns.

Torana Group is a Chicago-based impact firm developing an independent-sponsor model to finance employee ownership transitions in middle-market firms, using a range of structures, including employee-owned trusts. The target net IRR is 10–13 percent.

The interest in this emerging impact area has also inspired some larger, more established players to explore impact strategies. For example, Mosaic Capital Partners (see sidebar, p. 14), which manages a $165 million middle-market, ESOP-focused fund, is now considering building social impact outcomes more intentionally into its deals. Their model has already produced scores of employee-owners as a natural by-product of exiting to ESOPs, but now the group is investigating strategies for deeper employee benefit that could be adopted and measured at the portfolio level. Mosaic also plans to pilot the *Guidelines for Equitable Employee Ownership Transitions* (see p. 23).

With pent up demand for mid-range risk-return deals in impact investing—combined with the inherent ability of employee ownership to achieve its social goals—a substantial opportunity exists for more new products to fill the missing middle of high-impact investments yielding attractive mid-range returns. In these examples of new and emerging funds, we see the market beginning to develop products that could answer this demand. But new funds that have not yet developed a track record are not ideal for institutional investors with strict fiduciary requirements. As with any new industry, the field needs early adopters: committed investors willing to take a risk on an unproven approach and support new entrants as they refine their models.

Table 2: Sample Funds Investing in Employee Ownership

Fund and Organization	Target Fund Size	Target Returns	Overall Strategy	Target Investments
A & H Legacy Fund I—Apis & Heritage Capital Partners: Apis & Heritage is a minority-led firm, with founding partners Todd Leverette and Philip Reeves. They are launching their first fund, aimed at addressing the racial wealth gap by converting businesses with workforces of color to employee ownership. Democracy at Work Institute will support portfolio firms in building strong ownership cultures.	Target fund size is \$25–\$40 million; ten-year closed-end fund.	Target returns are net IRR of 15%.	The Legacy Fund is focused on the business-closure crisis in Black and brown communities, aiming to create more wealth within these communities and to provide attractive, predictable returns for investors. It plans to develop a portfolio of eight to ten companies with 500-plus jobs, providing mezzanine financing to convert firms to ESOPs and building strong ownership cultures.	The fund will target SMEs and lower-middle-market firms (EBITDA >\$750K) with strong cashflow and large minority/immigrant workforces (>30 workers).
Accelerate Employee Ownership—Shared Capital Cooperative: A national loan fund and CDFI, Shared Capital Cooperative provides financing to cooperative businesses and housing throughout the US. In 2019, it launched a new cooperative conversion initiative, Accelerate Employee Ownership, in partnership with Project Equity.	Currently at \$14 million, the fund aims to raise \$25 million.	Shared Capital offers two investment options through private offering: (1) fixed-rate, fixed-term investment notes (private debt) with returns of 2–4.5%, depending on the amount and term, with a minimum investment of \$1,000; and (2) preferred shares (private equity) with a target annual return of 3–6% with a minimum investment of \$5,000.	Through Accelerate Employee Ownership, Shared Capital, in partnership with Project Equity, brings together financing with technical assistance to enable successful businesses to transition to employee ownership. Shared Capital also provides financing to worker co-op start-ups and expansions, and to a range of other community-owned enterprises and cooperatively owned affordable housing.	Shared Capital provides financing nationally to micro and small cooperative businesses, typically ranging from 5 to 250 employees. Shared Capital is primarily focused on serving cooperatives organized by marginalized communities, including communities of color, women, LGBTQ, and low-income communities.
Business Legacy Fund—Co-op Cincy with Seed Commons: A nonprofit co-op developer in Cincinnati, Co-op Cincy is building a network of cooperatives on the model of Mondragon. Seed Commons is a network of non-extractive locally based loan funds financing cooperative businesses.	SEED Commons has provided seed funding to launch this multimillion dollar business continuity fund. Conversions will be financed through debt instruments, but will be designed as patient capital similar to equity.	Institutional and individual investors can earn 0 to 5% returns over three- to ten-year terms.	Co-op Cincy hopes to grow employee ownership in Southwest Ohio by providing initial \$20,000 grants to consider the feasibility of employee ownership, and then financing the deals through the Business Legacy Fund.	The Business Legacy Fund will focus on successful sectors in Southwest Ohio—manufacturing, logistics, and industrial services—though the program is open to any business that could successfully convert to employee ownership. The fund is looking at small and mid-sized enterprises that can support jobs in the region.

Fund and Organization	Target Fund Size	Target Returns	Overall Strategy	Target Investments
Co-op Launch Loans—The Cooperative Fund of New England (CFNE): CFNE is a community-development loan fund that facilitates socially responsible investing in cooperatives, community-oriented nonprofits, and worker-owned businesses in New England and New York, with the goal of promoting economic, social, and racial justice. It has sponsored 21 co-op conversions since 2011 and has a designated fund to support start-ups and conversions.	In its 45-year history, CFNE has loaned $60 million to support co-op businesses grow and thrive. At the end of 2019, it had a loan portfolio of $23 million. It has sponsored five start-ups with co-op launch loans, which cap out at $50,000.	Individuals and institutions make loans to CFNE for one year or more with interest rates up to 2%.	CFNE works to promote economic, social, and racial justice by advancing community-based, cooperative, and democratically owned or managed enterprises, with a preference given to cooperatives in low-income communities. It provides financial products at reasonable rates, helps borrowers develop business skills, and offers an investment opportunity that promotes socially conscious enterprise.	CFNE makes secured loans of $1,000 to $1 million over five- to seven-year terms, with interest rates of 5–7 percent. Co-op launch loans finance predevelopment expenses to help get borrowers to the point where the fund's conventional products apply. CFNE finances co-ops throughout New England and in eastern upstate New York.
Fund for Employee Ownership—Evergreen Cooperative Corporation (ECC): A network of worker-owned firms, including a commercial laundry and large urban greenhouse, Evergreen Cooperative Corporation is supported by contracts from anchor institutions like the Cleveland Clinic and University Hospitals. ECC provides management and financing support, and houses and manages the Fund for Employee Ownership (TFEO). ECC CEO is John McMicken; senior vice president is Brett Jones.	To date TFEO has raised $11 million in capital. Two-year goal is a $20 million debt fund. Three-year goal is a $30 million private equity fund.	Initial investments received thus far have been via forgivable debt or philanthropic capital grants. Two-year goal is to raise market-rate debt. Longer term strategy is to offer investors concessionary private equity returns. The fund seeks to deploy mission-driven capital, delivering both social and financial returns.	This new mission-driven, nonprofit fund launched in November 2018 aims to create quality jobs through employee ownership, anchor wealth in Northeast Ohio, and generate value for investors. It will be a closed-end fund, acquiring companies, converting them to employee ownership, and supporting them through the Evergreen Cooperatives' network of firms. The fund could later go national.	The fund will acquire successful companies, providing quality jobs in Northeast Ohio. Fair valuation—an acquisition price fair to both exiting owner and employees—is the cornerstone of this mission-driven fund. Its first acquisition, closed February 2020, is Berry Insulation, an 11-year-old Cleveland firm with 15 employees that provides insulation services and energy assessments to residential and commercial clients in Northeast Ohio.
Fund for Jobs Worth Owning—ICA Group: The Fund for Jobs Worth Owning is a new fund administered by the ICA Group, the oldest national organization dedicated to the development of worker cooperatives. Since 1977, ICA has launched dozens of worker cooperatives and helped dozens of companies convert to worker ownership. David Hammer is the executive director.	The Fund for Jobs Worth Owning was seeded with a grant from the Kendeda Fund. The fund expects to raise patient capital from impact and traditional investors. Recognizing the enormous need for higher-risk mezzanine financing in employee ownership transitions, the fund intends to grow significantly over time to fill this gap.	The Fund for Jobs Worth Owning will offer a variety of financial products and have sub-funds with different risk profiles. Returns will be based on the risk of the individual fund and nature of the borrowers, providing opportunities for both patient investors and those seeking market-rate returns. To mitigate risk, the fund works in partnership with the ICA Group and other technical-assistance providers to support businesses.	The Fund for Jobs Worth Owning supports the growth and development of employee-owned businesses with jobs worth owning. The fund designs capital solutions both for existing employee-owned businesses and for those transitioning to employee ownership.	The Fund for Jobs Worth Owning targets sectors that employ large numbers of women and people of color. Its initial focus is financing caregiver cooperatives in the childcare and home care industries, but its investments are not limited to these industries or to a particular geographic region.

Fund and Organization	Target Fund Size	Target Returns	Overall Strategy	Target Investments
Inclusive Capitalism Fund—American Working Capital (AWC): This Chicago-based merchant bank focuses on private middle-market U.S. firms, providing both direct investment and co-investment capital. AWC has particular expertise in ESOPs. Managing partner, Richard May. In 2018 AWC launched OT 1 Investco, LLC, a co-investment platform formed by Air Tractor, Inc. of Olney, Texas, an ESOP firm.	The planned Inclusive Capitalism Fund (ICF) is in formation. Target capitalization is $300 million for a closed-end fund.	Expectation for ICF is gross IRR of 15% over the life of the closed-end fund.	The ICF will focus on creating positive social impact via broad-based employee ownership while generating attractive current returns and substantial capital gains, utilizing AWC's established reputation in ESOP financing and co-investing with family offices and institutional investors.	The ICF will invest in ESOP buyouts and growth transactions, as well as ESOP recapitalizations and acquisitions. The focus is making direct investments of $5 million to $50 million in companies with EBITDA of $5 million to $25 million.
Long Point Capital: Long Point is a private equity firm that invests in firms with highly capable management teams and strong growth prospects. A portion of their portfolio includes junior capital investments in ESOP transactions, including six companies owned 100% by ESOP trusts.	Information not availalable.	Target returns are competitive for the private-equity asset class.	Long Point provides junior capital for new ESOP formation (partial or 100%) and mature ESOPs. They call their private-equity-backed ESOP transactions a PE+ESOP Recap.	Long Point targets middle-market firms with highly capable management teams and strong growth prospects.
Middle Bridge Capital (MBC): Headquartered in Providence, RI, MBC aims to reinvent the standard private equity leveraged buyout (LBO) model. Its approach is to invest "purpose equity" to bring about employee-led buyouts, in what they call the ELBO model. Founding partners are Walt Mayo and Michael Brownrigg.	Plans to raise a fund of $150 million are on hold, as of December 2020. Middle Bridge is supporting Apis & Heritage's launch of its Legacy Fund.	N.A.	Middle Bridge aims to overcome key obstacles to employee ownership: complexity and liquidity. The firm provides financing for company buyouts, often sources new leadership internally, and works to build an ownership culture. All exits are to ESOPs.	The industry focus is value-added manufacturing, but will include other sectors proven successful in employee ownership.
Mosaic Capital Partners: Founded in 2013, Mosaic was the first private equity firm with an exclusive focus on employee-ownership buyouts. Principals include Steve Buchanan, Keith Butcher, Bill Hayes, and Ian Mohler.	First fund closed at $165 million.	Target returns are competitive for the private equity asset class.	With its inaugural fund of $165 million, Mosaic created or supported over 3,000 employee-owners through 13 sponsored leveraged ESOP buyouts. The deals spanned a range of industries, including manufacturing, business services, retail, food and beverage, industrials, and health care.	Mosaic focuses on lower middle-market companies with EBITDA of $3 to $12 million.

Fund and Organization	Target Fund Size	Target Returns	Overall Strategy	Target Investments
National Worker Ownership Impact Fund—Community Development Venture Capital Alliance (CDVCA): CDVCA is a 25-year-old mission-driven, not-for-profit fund manager and CDFI. It is managing $250 million in various equity funds that focus on quality jobs for low-income workers. President Kerwin Tesdell began his career in worker ownership with groups like ICA and the precursor to Cooperative Home Care Associates.	Target fund size is $50 million.	Target returns in the low teens.	CDVCA is in discussion with investors about a worker-ownership fund to be launched in 2021. CDVCA's strategy is to invest in companies and then work with management to improve job quality and employment opportunities for low-income people. In addition to managing capital, CDVCA supports the field through training for fund managers, technical assistance, and policy work.	For all funds run by CDVCA, investments made in enterprises range from $100,000 to $8 million. The aim of the National Worker Ownership Impact Fund is creating and retaining good jobs for low-income workers.
Torana Group: Torana invests in middle-market businesses to help them grow responsibly and transition ownership in meaningful ways. Torana uses an independent sponsor model to finance employee ownership transitions through a range of structures, including employee-owned trusts (EOTs). The managing director is Malini Ram Moraghan, whose experience includes positions with McKinsey, JPMorgan & Chase, and private family offices.	Torana puts together deal-specific special purpose vehicles capitalized at up to $25 million.	Target returns are net IRR of 10–13%.	Torana invests in companies where frontline employees are essential to creating enterprise value, operating in the sectors that predominantly employ women and people of color. The firm recognizes employee ownership as a meaningful form of ESG-driven risk mitigation. Torana's strategy is to engage employees as owners to both reduce financial volatility and benefit workers.	Target companies range from $10 million to $100 million in revenue in the food and agriculture and senior care sectors. Characteristics of target businesses include positive EBITDA, available debt capacity, and opportunities for measurable improvements to employee wages, wealth, and working conditions while preserving enterprise value.
Working World Fund—The Working World: Launched in 2012, this fund seeks to benefit low-income workers and people of color through converting firms to employee ownership. The Working World was founded in Argentina in 2004, where it financed more than 250 worker cooperatives. Argentina has the largest concentration of enterprises converted to employee ownership in the world.	Target is a $50 million evergreen-style fund. Since 2012, $17 million has been raised and deployed. The fund is working with the New York City's Office of the Mayor and city council to raise capital to reach a sustainable capacity of $30 million.	Impact-rate debt with performance upside.	The Working World Fund structures non-extractive deals with priority given to deals with significant benefits for workers after conversion. Capital is deployed primarily through acquisition of equity held temporarily, before converting firms to employee ownership. The fund provides operational support and "value engineering" to develop a strong ownership culture.	The fund targets firms with $1 million to $5 million EBITDA in sectors that employ large numbers of low-income workers and people of color, including light manufacturing, caregiving, and other service industries. The fund is national but focuses on the New York City area.

The field of employee ownership investing needs a catalyst to correct the market's failure to recognize this investment opportunity and develop products. That catalyst, at least in the initial stage, is philanthropy.

The Role of Philanthropy in Seeding New Models

To fully capitalize on this critical moment—with millions of businesses at risk in the pandemic shutdown, growing concern over inequality and racial equity, and the greatest transfer of wealth in generations—the field of employee ownership investing needs a catalyst to correct the market's failure to recognize this investment opportunity and develop products. That catalyst, at least in the initial stage, is philanthropy.

Most (if not all) of the institutional or technical assistance-focused programs supporting employee ownership and cooperatives today have been underwritten by philanthropy for decades. But, as we have argued, the next and more deeply catalytic role for philanthropy is in seeding investment intermediaries. This funding has begun to materialize. All funds featured by Transform Finance, for example, benefited from some level of philanthropic subsidy during development or early operations. And, over the past 18 months, philanthropy has begun stepping up in even more bold new ways.

Kendeda Fund Invests $24 Million in Growing Employee Ownership

Philanthropy leading the way by demonstrating social impact

In 2019, The Kendeda Fund made one of its largest philanthropic commitments ever: $24 million to be invested over five years by way of grants to four organizations—the Fund for Employee Ownership, The ICA Group, Nexus Community Partners, and Project Equity—each of which works to expand democratic employee ownership. The majority of the funding has gone to launching employee ownership investment funds. Nexus Community Partners does not have a fund, but received investment to support direct conversions, focused on industries with high numbers of works of color, including manufacturing, construction, and health care services.

A private, Atlanta-based grant maker, the Kendeda Fund has three primary goals for its $24 million investment:

- Make communities more vibrant by retaining more businesses and preserving local ownership
- Improve job quality and confront the racial wealth gap that has long divided American communities and inhibited economic growth
- Inspire the philanthropic and impact investment communities to invest in democratic ownership as a means to grow a more equitable economy

The grantees have been leaders in reframing the COVID-19 small-business crisis as an opportunity to grow a more democratic economy. With the Kendeda Fund investment, these organizations are positioned to finance and support more than 100 business transitions. If successful, these transitions could serve as a visible model for tens of thousands of business owners searching for an exit plan.

Kendeda hopes that its gift will keep on giving, proving that employee ownership is a path to a just and fair economy that benefits everyone, not just a few at the top.

Perhaps the largest catalytic philanthropic contribution to date was made by the Kendeda Fund, which in August 2019 announced it was providing $24 million in grant capital to four employee ownership funds or initiatives, each piloting a new approach to scaling democratic employee ownership (see sidebar, p. 35).

Philanthropy is increasingly finding its way to the employee ownership field. The New World Foundation's Quality Jobs Fund has invested millions of dollars into employee ownership funds.[79] Meanwhile, Citi Community Development has invested in research and education to promote employee ownership investments through the 1,000 CDFIs currently operating in the United States.

Foundations can also begin offering credit enhancements as a way to support the growth of employee ownership investing. The Rockefeller Foundation, which has done much to advance impact investing, recommends a number of strategies for foundations wishing to accelerate it. One such strategy is to provide loan guarantees for social enterprises that would not otherwise qualify for loans.[80]

In these and other ways, philanthropy is stepping up to demonstrate capital's role in catalyzing employee ownership transitions. As Diane Ives of Kendeda put it, with its grants, Kendeda hopes to "inspire the philanthropic and impact investment communities to see democratic employee ownership as a necessary—and profitable—strategy for business growth."[81]

Policy Strategies to Catalyze Capital at Scale

In addition to the launch of private equity-like funds, supported in part by philanthropic dollars and catalytic capital, innovative public funding and policy is needed to attract private capital into the employee ownership space and incentivize the formation of more intermediaries. Mosaic Capital Partners, for example, enhanced its first ESOP-focused private equity fund through use of lower cost financing from the Small Business Investment Company (SBIC) program of the U.S. Small Business Administration. The SBIC leverages private equity fundraising up to three times the private commitments to a fund and, therefore, helps the favorability of lower middle-market deals.[82]

The federal government directly operates dozens of revolving loan funds, banks, and other investment vehicles. And at the state level, several massive sovereign wealth funds (state-owned investment funds, including those run by development finance institutions) directly invest in numerous economic activities and approaches. One policy approach for government would be to redirect existing funds or set up new public funds that invest in employee ownership conversions. In 2019, for example, Senators Bernie Sanders, Kirsten Gillibrand and others introduced a bill to create the U.S. Employee Ownership Bank to provide $500 million in low-interest loans and other financial assistance for workers who wish to purchase businesses through an Employee Stock Ownership Plan or a worker-owned cooperative.[83]

Senator Gillibrand was also the driving force behind the Main Street Employee Ownership Act (MSEOA), signed into law in 2018. That legislation bolstered federal support of ESOPs and worker cooperatives, in part, through financing mechanisms. In addition to mandating that Small Business Development Centers promote employee ownership through outreach and education efforts, the law aimed to increase funding for employee ownership conversions through SBA 7(a) lending. (The 7[a] program offers federal loan guarantees equal to 80 percent of loans up to $2 million, as a way to make lenders more willing to lend to small businesses with weaknesses in their loan applications.[84]) The MSEOA streamlines SBA 7(a) lending provisions as they pertain to ESOPs, allowing ESOPs to access loans under the Preferred Lenders Program. The new standards were intended to increase access to lending for both ESOPs and cooperatives, though subsequent SBA rulemaking on cooperative lending has disappointed the cooperative community.[85]

State and city governments have used loan guarantees or other credit enhancements to direct investment for employee ownership as well. One example is the Indiana ESOP Initiative (IEI), created in 2007 by then-Treasurer Richard Mourdock. His resume included a stint as an employee-owner, and that positive experience led him to create a $50 million linked-deposit program meant to incentivize ESOPs. In its first two years, IEI helped to create more than 900 new employee-owners.[86] The city of Madison, Wisconsin, seeded a revolving loan fund, which is now managed by the local community development authority. It makes loans between $50,000 and $250,000 for cooperative development.[87] Additionally, the city of Berkeley, California, recently amended its loan-fund practices to include funding of cooperative conversions (see sidebar, p. 37).

Credit enhancements could attract private capital to funds that otherwise might have above-market risk or below-market returns. Employee ownership funds can, and should, tap into existing government credit enhancements in order to lower the costs of initiating products. These approaches, along with direct funding, could provide significant momentum to the growth of employee ownership investing.

The largest and most expansive policy idea—widely endorsed by employee ownership experts and the authors—for dramatically growing employee ownership finance involves the use of loan guarantees at a large scale by state and federal government. Investment banker Dick May of American Working Capital, along with colleagues Robert Hockett and Christopher Mackin, has drafted a model policy called the Employee Equity Loan Act, suggesting that $100 billion in federal loan guarantees for employee ownership finance could create 13 million new employee-owners in a decade, add one million new jobs to the US economy, and generate more than $1.7 trillion in new wealth for workers.[88] Such guarantees would function by attracting private equity at scale. If these guarantees were accompanied by equitable investing guidelines, the movement of capital into the employee ownership space would optimally benefit both employees and investors—and a whole new sector of impact private equity might take shape.

Berkeley, California, Expands Small Business Lending to Worker Cooperatives

Municipal loan funds can ease barriers to lending

Across the country, 520-plus municipal revolving loan funds, seeded with grants from the U.S. Department of Commerce Economic Development Administration (EDA), support small businesses that are unable to access traditional capital. Berkeley received a $500,000 EDA grant in 1987 and has since provided financing to minority- and women-owned businesses unable to access conventional bank loans.

Until recently, the City of Berkeley Revolving Loan Fund required all business owners to provide a personal guarantee to secure a loan. Generally, this meant the business owner had to put up sufficient collateral (often, a home) that could be liquidated to pay off the loan should their business fail. The personal loan guarantee model excluded cooperatives, which are collectively owned businesses—one of multiple business owners could not take responsibility for backing the loan, and the rules did not allow for owners to take on that responsibility together.

In order to promote the expansion of cooperative businesses, the Berkeley City Council directed the Loan Fund Administration Board to take another look at the rules. Working with the Sustainable Economies Law Center, the board came up with a solution: a "limited guarantee."

In the limited guarantee model, a cooperative applying for a loan decides on a panel of owners who represent at least a 50 percent stake in the business to guarantee the loan. Each member of the panel is responsible for an equal share of the loan amount. If one of the panelists leaves the co-op, then another member must join the panel and accept responsibility for her share of the loan guarantee.

With a further revision of the rules, the fund can now finance the acquisition of a business by its workers. This aligns with efforts by the city to encourage retiring business owners to sell to their employees.

There are more than 500 EDA loan funds around the country, and all are free to replicate the Berkeley model, according to Kieron Slaughter of the Berkeley Office of Economic Development. The EDA did not consider the changes significant enough to require a federal approval process.

Whatever the approaches used, government must ultimately play a role in advancing employee ownership by shaping the road for capital, public and private, to flow. It is a well-trod path to scale: the private sector innovates, developing models, and the government boosts the best of these models to scale through policy. This happened with finance for widespread home ownership, for example, with the development of institutions like Fannie Mae and Freddie Mac. And it happened with Social Security, which began as an experiment in giving aid to elders at the state level and was taken to scale through federal action. In the case of employee ownership finance, guardrails that channel large new flows of capital toward optimal employee benefit, modeled along the lines of the *Guidelines for Equitable Employee Ownership Transitions,* are also needed. But rather than codifying them in legislation or rulemaking—which Rutgers professor Joseph Blasi cautions against—the guidelines could be implemented as incentives, or through a certification program to reward the best players.

Growing the Market: Envisioning a Fully Developed Capital Ecosystem

Catalytic philanthropy and public financing vehicles, along with credit enhancements, can shape the infrastructure for beneficial flows of capital to employee ownership. On this foundation, impact private equity and the finance sector can build the infrastructure necessary to serve the new demand arising from communities, institutions, governments, and individuals discovering the power of employee ownership. Ideally, the public and private sectors will continue, singly and together, to round out a funding infrastructure, wherein:

1. The cheapest sources of financing, like publicly financed investment funds, SBIC loans, CDFI loans, or below-market or program-related investments (PRIs) are directed at riskier and higher social impact conversions, such as employee ownership deals aimed at benefiting marginalized communities;
2. Commercial bank loans continue to be available for creditworthy borrowers such as larger scale businesses converting to ESOPs;
3. Impact private equity funds and other models are incentivized via preferences, certification, guarantees, or other approaches that position them to successfully compete with commercial banks and traditional private equity to generate increased deal flow and close deals that create employee-owners; and
4. New institutions and policies emerge—such as an Employee Ownership Bank or state-level development finance entities—that institutionalize broad employee ownership in a major national commitment to shared economic security.

A diversified funding stream minimizing competition for the cheapest sources of capital would indicate a functioning market, at multiple scales and levels, able to reconcile the supply and demand for employee ownership investments in a way that most fully supports broad-based employee ownership.

One can envision how various players and financing vehicles might combine, over time, to take employee ownership to scale—with impact private equity funds playing a key intermediary role. The process of scaling employee ownership via capital begins with philanthropic support, paving the way for impact investors such as family offices, foundations, and high-net-worth individuals in a position to make personally driven investment decisions. As the market of intermediaries becomes more developed, institutional investors more remote from individual decision-making become more involved—including church and foundation endowments, insurance firms, as well as public pension funds governed tightly by the Employee Retirement Income Security Act (ERISA). With leading investors and funds demonstrating proof of concept, the asset class of employee ownership impact capital will be ready for scale.

This process would be helped along by the increased visibility of employee ownership, by way of marketing and media outreach. Cities and states would become more involved through centers for employee ownership, small business development center advising, and the promotion of anchor collaboratives seeking to grow employee ownership locally. Economic development players, concerned with keeping firms locally rooted and thriving, would become involved through using public loan funds or other forms of financing for employee ownership conversions.

Building the Investment Ecosystem To Take Employee Ownership to Scale

1. ***FOUNDATIONS PROVIDE PHILANTHROPIC DOLLARS TO SEED NEW EMPLOYEE OWNERSHIP FUNDS.***

   By seeding new investment funds, foundations provide proof of concept, demonstrating that these funds can generate social and financial returns through their support of employee ownership transitions. No return on investment is expected.

2. ***FAMILY OFFICES, FOUNDATIONS, HIGH-NET-WORTH INDIVIDUALS ENTER THE SPACE WITH CATALYTIC CAPITAL.***

   Investment decisions are personally influenced, with the goal of helping projects/funds demonstrate proof of concept—i.e., employee ownership transitions have proven impact. Returns may be concessionary or higher.

3. ***LARGER INSTITUTIONAL INVESTORS CHOOSE EMPLOYEE OWNERSHIP.***

   As the landscape develops, churches, foundations and university endowments, and insurance firms enter the space. Funds offer a moderate risk profile and solid returns.

4. ***STATE AND LOCAL GOVERNMENTS INVEST IN MARKETING AND TECHNICAL ASSISTANCE.***

   Governments support ancillary institutions such as employee ownership centers, small business development centers, and anchor collaboratives to provide outreach, education, and technical assistance.

5. ***ECONOMIC DEVELOPMENT FINANCIAL AUTHORITIES CREATE FINANCING MECHANISMS.***

   By creating public loan funds or other financing opportunities, economic development authorities support employee ownership transitions to keep local businesses thriving.

6. ***FEDERAL GOVERNMENT PROVIDES CREDIT ENHANCEMENTS.***

   Using credit enhancements such as loan guarantees, tax incentives, direct financing (e.g., Employee Ownership Bank) or other approaches, government encourages the flow of capital to employee ownership.

7. ***EMPLOYEE OWNERSHIP BECOMES A NORMAL PART OF THE INVESTMENT LANDSCAPE.***

   Across asset classes, employee ownership becomes a substantial part of the investment landscape, attracting capital from mainstream institutional investors, including pension funds.

> **A ripple effect across the larger financial market could be created, resulting in a proliferation of investment products delivering capital for employee ownership.**

A still higher phase of scale could be achieved with credit enhancements such as loan guarantees, offered initially by foundations or municipal economic development entities, along with other innovative financing models and funds, all designed to attract capital. Certain approaches might prove themselves, such as corporate spinoffs frequently moving into employee ownership, an idea proposed by the Quinsigamond Group.[89]

Thus a ripple effect across the larger financial market could be created, resulting in a proliferation of investment products across asset classes and risk ratings that could deliver capital for employee ownership. The beneficiaries would be investors, working people, local economies, and the economy at large. Eventually, a national commitment to employee ownership of enterprise could become a new norm.

CONCLUSION: FOUR RECOMMENDATIONS FOR SCALING EMPLOYEE OWNERSHIP THROUGH FINANCE

Communities, governments, and even Wall Street recognize that capitalism as usual is unsustainable in the twenty-first century: it has exacerbated the wealth divide to the point where even the Federal Reserve has warned that inequality is the nation's biggest challenge.[90] And that was before the COVID-19 pandemic. The public is beginning to see that employee ownership could be one of the keys to a more workable economy, and communities are mobilizing to save locally owned businesses by converting them to employee ownership.

As we have shown, capital has the agency, plus the institutional and financial power, to create innovative investment products that could scale this effort and transfer business ownership to employees in a massive way, while generating attractive financial returns. However, the market is failing to pick up on signals indicating increased demand for transformed enterprise—and increased need, given the economic fallout from the pandemic. With the right catalytic interventions, the market could correct and become the key agent to scale employee ownership. In the process, impact investors could achieve good returns, while also becoming key players in solving the social and environmental dislocations stemming from the hyper-concentration of wealth.

This report argues for a set of approaches that could drive significant momentum for employee ownership in the near term. Summarized here as a set of recommendations, the approach combines supply-side (expanding opportunities to invest) and demand-side (strategies that make investments more attractive) features in order to create a range of employee ownership investment products aligned along the full risk-return-impact spectrum.

We focus on impact private equity funds as the vehicle most likely to facilitate employee ownership transitions. At the same time, we recognize that government intervention will be needed to catalyze action at large scale through the creation of incentives, ecosystems, and new institutions for capital.

Innovation brings considerable risk, and much depends on savvy and visionary investors who recognize new opportunities that others have missed. Our recommendations are intended to incentivize investors whom we believe will reap rewards, social and financial, from being early adopters.

1. **Develop new investment funds for employee ownership**.
   New opportunities for employee ownership investing must be created. To create the ease of investment that investors require—and the ease of ownership transition that sellers need—depends on the continued creation of new intermediary funds targeting employee ownership conversions. Many of these intermediaries will resemble today's private equity funds but will be designed to attract impact investors and generate beneficial, authentic social impact. In addition to developing new investment funds, existing lenders and other players could also deploy capital toward more "knock on the door" investments.

2. **Ensure employee benefit through common metrics and deal guidelines.**
   A flood of capital into a new area can promote excessive capital extraction, as happened with microfinance. To guard against this and attract impact investors, new employee ownership–focused funds will need robust deal guidelines and metrics. The *Guidelines for Equitable Employee Ownership Transitions* provide a pilot version of impact metrics and guidelines for constructing beneficial conversion deals. It will be up to the employee ownership field to refine and further develop common metrics for impact and deploy them consistently to demonstrate social impact.

3. **Use employee-friendly approaches to value engineering.**
   Rather than creating investor value through traditional private equity practices such as downsizing, impact private equity can create value through employee-friendly practices, such as profit sharing, open communication, open-book management, participatory governance, inclusive planning and budgeting, and the solicitation of input in the appointment of managers or supervisors. These practices contribute to building a strong, collaborative team culture, which has been shown to increase productivity.

4. **Grow the market by supporting this developing ecosystem with catalytic capital and take it to scale through government policy.**
   To find its place in a competitive market, this new field of employee ownership investing needs philanthropy to catalyze early-stage activity. As proof of concept is demonstrated and scaling begins, approaches like credit enhancements (for funds, firms, and senior lenders) can continue to point capital in the direction of employee ownership. Ultimately, government action will be needed to fully develop this capital ecosystem and take the field to scale, via direct public funding, the provision of incentives, the de-risking of investment, and the encouragement of new institutions.

Toward a Beneficial Future

Widespread employee ownership is uniquely positioned to tackle inequality and significantly contribute to economic recovery from the COVID-19 pandemic in the United States. Yet, although impact capital is poised to enter the field and take it to scale—enjoying attractive returns, to boot—a supply of investment products geared to deploying capital for employee ownership has been, until recently, virtually nonexistent. Thankfully, that is beginning to change.

One day, we expect to see a fully developed investment landscape for employee ownership impact. For now, we urge the field to focus on impact private equity funds, which we believe can best catalyze this market. Though widening wealth inequality creates conditions of increasing urgency, we recommend cautious entry, since the trajectory of other innovative impact sectors, like microfinance, suggests there are risks involved with rapid growth.[91] Innovative finance is not immune from bubble dynamics nor from mission creep, and the field must be mindful of structurally safeguarding its employee-led objectives as a new market is built. That is why we have emphasized the need for appropriate guardrails, worker-friendly value engineering, and the development and deployment of impact measurements.

Ultimately, we envision many dozens of private equity funds forming to finance and accomplish employee buyouts. Private equity is already organized to effect the transfer of ownership at scale. Until now, that transfer has been from owner to owner, or owner to shareholders, but changing the equation from owner to employees does not fundamentally change the actions or expertise required for success. It does change the value creation and exit opportunities. And it potentially promises a massive reduction in wealth inequality and secures previously unattainable prosperity for millions of Americans.

Now is a propitious time to connect employee ownership to the emerging impact investment field, using impact investors' strong sense of social and environmental mission to preserve small businesses and drive broad wealth building.

Tens of thousands of companies in the lower middle market are candidates for ownership conversions—and many of these businesses are at risk of being lost as a result of the current pandemic crisis. Now is a propitious time to connect employee ownership to the emerging impact investment field, using impact investors' strong sense of social and environmental mission to preserve small businesses and drive broad wealth building, the democratization of the workplace, and a new era of corporate and investor responsibility.

Employee ownership today presents an unprecedented opportunity for visionary and catalytic investors to step forward and enjoy attractive returns while paving a new path for others to follow. The time has come to share ownership more broadly through ESOPs and worker cooperatives. Impact capital, organized to provide the proverbial knock on the door, is the agent that can take this vital process to scale.

APPENDIX

Traditional Financing for Employee Ownership Conversions

As discussed above, ESOP financing is readily available from traditional creditors, for viable firms with motivated sellers. Importantly, employees receive their shares for free as a retirement benefit. By contrast, worker cooperatives require an equity contribution from worker-owners. Worker cooperatives have far less access to traditional financing because of the standard requirement that a single person guarantee the loan for a collectively owned business.

ESOP Financing

To provide more detail on ESOP financing, the following is excerpted from Strategies for Financing the Inclusive Economy: Financing strategies that support broad-based ownership models in creating jobs and building community wealth *(The Democracy Collaborative 2016).*

Companies generally transition ownership into an Employee Stock Ownership Plan (ESOP) using debt of various kinds. ESOP trusts enjoy a special privilege as the only benefits plan that can legally borrow money.

Leveraged ESOP: A large majority of conversions to employee ownership are accomplished through a leveraged ESOP, in which an ESOP borrows money and buys the owner's stock, repaying the loan over time out of cash flow. According to a 2015 survey by the National Center for Employee Ownership, 72 percent of ESOP transactions are leveraged. Because lenders generally prefer to loan directly to the company (since its assets can better secure the loan), the transaction is often accomplished by the company borrowing money and then relending it to the ESOP plan.[92]

A leveraged ESOP sounds simple enough, but the actual transaction is a bit complex. The company must first set up the ESOP trust and then take out a loan from a bank (this is called an outside loan). Next the company relends the funds directly to the ESOP trust (an inside

How a Leveraged ESOP Works

Step 1
Company ABC sets up an ESOP trust.

Step 2
Company ABC borrows $ from a lender (called an outside loan) and/or the seller.

Step 3
Company ABC reloans $ to the ESOP, usually at a similar interest rate (an inside loan).

Step 4
The ESOP then uses the proceeds from the loan to buy shares of the company. These could be existing shares or newly issued stock.

Step 5
Stock purchased by the ESOP is held in a "suspense account," to be released to employee accounts over time, as the loan is repaid.

Step 6
The company makes tax-deductible contributions to the ESOP so that it may repay the loan. It may also issue dividends (also tax deductible) on shares held by the ESOP.

Step 7
The ESOP uses those contributions plus any dividends to repay the loan from Company ABC or the commercial lender.

Source: Scott S. Rodrick et al., *Leveraged ESOPs and Employee Buyouts*, Oakland, CA: National Center for Employee Ownership (NCEO), 2000.

loan). The proceeds are then used by the ESOP to buy shares of stock in the company, which are placed into a “suspense account,” to be released gradually as the inside loan is repaid. To enable the ESOP to repay its loan to the company, the firm makes cash contributions, which are tax-deductible, directly to the trust. Eventually, the loan is repaid, the shares are fully paid for, and the employees own the shares free and clear through the ESOP. Employees receive the shares free, and cash out when they retire or leave the company.[93]

Non-leveraged ESOP: In this method, the ESOP uses company contributions to purchase stock each year, rather than to repay a loan. Employee ownership is created by simply contributing stock directly to the ESOP plan (a transaction that is tax deductible). Or companies can make pre-tax contributions of cash to the plan, which the ESOP plan then uses to buy stock from the company (either common or preferred).

Worker Cooperative Financing

To provide more detail on worker cooperative financing, the following is excerpted from Investing in Worker Ownership: How finance institutions can create deep impact at scale with worker cooperatives *(The Democracy at Work Institute 2015).*

Like any business, a worker cooperative needs capital to start up and grow. While some startup capital can be raised through worker-owners pooling their initial capital contributions to the company, and growth capital may be sourced from member internal capital accounts over time, many worker cooperatives need outside financing to meet their business needs. However, the unique structure of worker cooperatives has historically brought with it unique challenges when raising outside capital.

The lion’s share of existing financing for worker cooperatives is traditional debt lending. Cooperative-specific lenders such as the Cooperative Fund of New England or the Shared Capital Cooperative understand the cooperative structure and, as a result, generally provide more efficient financing for worker cooperatives than traditional lenders. Community Development Finance Institutions (CDFIs) are another valuable resource, as they have a mission to serve the community. However, many are not well-versed in the worker ownership model and may have requirements that are burdensome for cooperatively owned enterprises. Government programs serving small businesses can also be a valuable resource. For example, the Minneapolis business and real estate loan program has a history of lending to cooperatives. So far, $3.5 million have gone to cooperative businesses, and another $850,000 in lending to co-ops is currently pending. Some of these loans have personal guarantees or real estate as collateral, but others require underwriting that most finance institutions, including community lenders, are unwilling to do.

In addition to traditional debt, worker cooperatives are increasingly seeking equity capital that is structured to be consistent with cooperative principles [such as preferred stock or capital raised through direct public offerings]. Although there are only a handful of current examples of their use, these equity instruments are garnering interest throughout the worker cooperative community and could become much more common in the years to come.

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