Exiting to Employees Through Employee Ownership Trusts

common trust

PURPOSE

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Opening Note

Independently-owned businesses across the US have long been a force for positive impact in their communities, enabling workers to earn an income, buy homes, support their families, and build a foundation for the next generation. However, over the past fifty years the trend of "the good paying job" has started to reverse course, as workers wages have either stagnated or fallen, even as the stock market and economy have grown. In 2020, the bottom 50% of Americans owned just 5% of American wealth.[1] While concerning, this trend is a symptom of a much deeper condition affecting our economy: the increasing concentration of economic power.

In the last several decades, the consolidation of industry has not only accelerated, but also become the dominant trend of our era. This accumulation of financial control is a trend that should concern us all, because a concentrated economy can create challenges across all levels of society. The increasing concentration of economic power is correlated with:[2]

- Lower rates of innovation and investment in business
- Decline in worker's wages as large corporations take higher percentage of profits
- Diversion of wealth away from communities and local economies as national chains replace local businesses
- Increased threats to the supply of critical goods as supply chains become more concentrated and corporates prioritizing short term profits over long-term resilience introduce supply chain vulnerabilities and risks

Taken together, these consequences have the potential to challenge the very survival of a prosperous, democratic society. As Supreme Court Justice Louis Brandeis said, "We can have democracy in this country, or we can have great wealth concentrated in the hands of a few, but we can't have both."

While small business owners may not hold these macroeconomic challenges of increased economic concentration top of mind, they do care about succession. Over the next decade, a projected three in five small business owners will seek a sale as the owners reach retirement age.[3] The US economy is at the precipice of a "silver tsunami" of small businesses with owners 55 and over who will be hitting retirement age and seeking a succession strategy. After having attentively grown their businesses over decades, how and to whom they exit is of utmost consequence.

In the process of building their businesses, small business owners have experienced firsthand the positive role that their businesses can play in communities and in society at large: acting as forces for good, being pillars of their communities, and enabling employees to build wealth, buy homes, and send their kids to college. Business owners have also

1 Distribution of Household Wealth in the US Since 1989. The Federal Reserve. Retrieved 5 November 2021 from https://www.federalreserve.gov/releases/z1/dataviz/dfa/distribute/chart/

2 American Economic Liberties Project. Retrieved 26 October 2021 from https://www.economicliberties.us/problem/

3 Project Equity. Retrieved 26 October 2021 from https://project-equity.org/

likely witnessed a variety of risks as their peers have retired and sold their businesses. These risks range from new management that fails to uphold the mission, values, and culture of a company that has been so core to its success, to a leveraged buyout that immediately lays off large swaths of the employee base in an effort to streamline and cut costs for a subsequent sale, or simply the fallout of investor pressure shifting a company's time horizons and strategy from the long term to the short term.

All too often, business owners have watched the succession strategies of their peers fail to meet everyone's expectations. Given this context, a succession strategy is not simply a question of getting liquidity out in order to fund retirement. For the 60% of small business owners who will seek a sale in the next decade, a succession strategy also must protect the company legacy and secure the future of the business they've spent their lives building.

Given this context, the rise in interest in employee ownership trusts (EOTs) over the last several years represents an exciting development for small businesses in the US. Firstly, EOTs draw upon the concept of steward ownership, a longstanding, global tradition of mission-driven approaches for operating and governing businesses with proven long-term business performance. Second, EOTs offer an antidote to the rising trend of businesses being forced to operate on ever-shortening time horizons as a consequence of short-term investor pressure. Thirdly, the rise in interest in EOTs represents a tremendous opportunity for the small business economy—representing the core of the US economic engine and nearly fifty percent of the US GDP—to solidify its role as an engine for quality jobs, economic growth, and community benefit.[4]

While employee ownership as an exit strategy has existed for decades, certain barriers still exist that prevent employee ownership from becoming more ubiquitous. These primary barriers fall into the following categories:

1. **Awareness about employee ownership as an exit strategy.** This exists at two levels: firstly among business owners themselves, who when they are ready to retire and looking for a values- and legacy-aligned succession strategy, believe that the best (or only) option is to simply be diligent about finding new management they feel they can trust, whether that be a private buyer, a strategic or a PE firm. Second, and possibly more importantly, is awareness among the business owner's advisors, including lawyers, trust and estate planners and wealth managers, as well as peers, mentors and family members. These advisors have a significant influence over an owner's succession strategy and are often the ones that guide them down a particular path. Whereas both owners and their advisors have likely experienced firsthand the rise in the number of PE firms, search funds and traditional investment bankers proactively reaching out to them, far fewer have meaningful numbers of inbound employee ownership investors or advisors reaching out. Consequently, employee ownership is far less frequently presented by these advisors as part of the menu of options. This has significant downstream consequences for employee

[4] Kobe, Kathryn and Schwinn, Robert. "Small Business GDP 1998-2014." US Small Business Administration.

ownership exits, because a major consideration when an owner sells is execution certainty, which is often directly impacted by the level of familiarity that an owner or their primary advisors have with a particular succession strategy.

2. **Financial implications:** There are several misperceptions in the market about employee ownership exits, ranging from concerns that if employees do not have the capital to buy the business, they cannot be a viable buyer to a belief that employee ownership cannot offer a competitive valuation. Without a thorough understanding of the mechanics of an employee ownership transaction, owners often prematurely write it off as simply infeasible or uncompetitive.
3. **Perceived complexity:** As owners educate themselves about the different forms of employee ownership, subsequent regulatory implications, deal mechanics and ongoing management requirements, the perceived complexity rises. This can be mediated by a robust ecosystem of support around designing and executing these transactions, which is an ecosystem that is growing annually. Nonetheless, founders or family-owners often will have been used to a simplicity of operations. Furthermore, as the sole owner, they have also been able to easily play an invisible protective role safeguarding the company's mission and values through growth. With a transition, as this invisible protective layer disappears, it must be replaced with guardrails to protect those values for the long haul. While many owners are often ultimately looking for these very mechanisms to protect their legacy and values through a transition, employee ownership will nonetheless be more complex than owners are used to in their previous operations or in comparison with more traditional buy-out options.

EOTs offer an attractive solution to the many owners who are seeking a succession strategy that will protect the core values of their business, whether that be owners who believe that finding an aligned buyer is their best and only option, or those who have already considered employee ownership, but are wary of some of the structural challenges that have accompanied other vehicles for employee ownership.

With the rise of EOTs, business owners can confidently execute a succession strategy that equips their company for long-term performance and preserves the original values, mission and vision, all while providing the next generation of leadership with the tools to carry the business owner's legacy successfully into the future.

This guide was created by Common Trust and Purpose Foundation for legacy-minded business owners in search of succession solutions that protect their company's performance, purpose and people, while also enabling them to get a fair value out.

About Common Trust

Common Trust is how small business owners exit to employees. We offer a streamlined process to exit via employee ownership trust, provide aligned debt and growth capital to finance the transaction, and equip the future generation of leadership to steward the company's growth for the long haul. Together, we are working to secure the future of great American businesses in every region and sector.

About Purpose Foundation

Purpose Foundation helps businesses and communities build equitable ownership, governance, and financing models. We are accelerating the transition to a shared-ownership economy by making new models replicable, accessible and visible. We support leaders across the US, educate capital providers, and push the field forward with legal innovations and research.

Introduction to Employee Ownership

Employee ownership trusts have emerged from a long lineage of both steward ownership and employee ownership. Steward ownership and employee ownership share many principles in common, such as approaches to structuring, governing, and operating companies. However, depending upon legal form, an employee-owned firm may or may not also be considered steward-owned. Employee ownership trusts sit at the nexus of these two approaches. This section will provide context on steward ownership and employee ownership, as well as a brief overview of the different legal forms for steward-owned and employee-owned firms in the US, and conclude with an exploration of the longstanding data on the performance of steward- and employee-owned companies.

Setting the Context: Steward Ownership and Employee Ownership in the United States

Steward Ownership

While perhaps newer in the US, steward ownership has a long-established history at a global level. According to *US Organic Steward-Ownership*:[5]

> Steward-ownership is an alternative to conventional ownership that permanently secures a company's mission and independence in its legal DNA. Solutions for steward-ownership have been found by generations of entrepreneurs all over the world. These pioneers have found innovative ways of committing their businesses to two key principles: profits serve purpose and self-governance.

Steward-owned companies, which are frequently structured as trust-owned companies or foundations, also have a long history of being very successful. They have higher long-term profit margins than traditional for-profit companies, more stable returns, and typically weather crises better as well. Steward-owned companies also typically have better employee retention due to higher wages and superior benefits.[6] Additionally, their long-term stability means steward-owned companies are less likely to make sudden staff reductions during a difficult season and then waste time re-training new staff when that season has passed.

One of the key differences between a steward-owned company and a for-profit company can be summed up as purpose driven rather than profit driven. For-profit companies focus on increasing shareholder value through a maximization of share value or profits above all else. With a steward-owned company, the purpose, as defined by key business stakeholders, is prioritized as a means of leading the company to more aligned long-term success. Purpose can have numerous meanings depending on the organization.

For instance, one of the earliest modern examples of steward-ownership is the German optics manufacturing company Zeiss, founded in 1846 by Carl Zeiss. After Zeiss died in 1888, Ernst Abbe created the Carl Zeiss Foundation, which has owned the company ever since. The Carl Zeiss Foundation ensures that the company cannot be sold and that profits are either reinvested in the company or donated to purposes for the common good. The Carl Zeiss Foundation ensures the protection of workers' rights, for instance guaranteeing them healthcare and retirement insurance, alongside paid vacation and an eight hour workday. Furthermore, the Carl Zeiss Foundation mandates the highest salary of any Zeiss employee not exceed more than twelve times the salary of the lowest paid worker at the company after having been there for at least two years. Today, Zeiss is a successful, continuously innovative company with over €7B in

[5] *Steward-Ownership: Ownership and Finance Solutions for Mission-Driven Businesses*. 2019. Purpose Foundation US, RSF Social Finance, Organic Valley, Organically Grown Company.

[6] Steward-Ownership. 2019.

annual revenue while also donating to global initiatives spanning healthcare as well as science education and research.[7]

A few examples of common purposes that a steward-owned company may seek to protect include:

- Maintaining and improving the quality of a company's offerings
- Enshrining certain practices that relate to the companies commitment to the environment, community, or other stakeholders
- Promoting a way of doing business, such as creating high quality jobs or values-driven hiring and sourcing processes
- Protection of business practices which share the economic success of the company with employees, such as profit sharing or share ownership programs
- Ensuring the company leadership never misuses its economic power to contribute to causes that directly oppose the values set forth by founders

Another key aspect of a steward-owned business is the direct connection between ownership and participation in the company's activities, values, and purpose. The Purpose Foundation US describes this relationship thus:

> In order to safeguard its purpose, the "steering wheel" of a steward-owned company, i.e., control over its management, strategy, and key operational decisions, is held by people inside or closely connected to the organization. This is unusual for many businesses, where majority control is often held by external owners. Shareholders, private equity firms, or parent companies normally dictate strategy and decisions, with the primary goal of maximizing profit and increasing their bottom line. These "absentee owners" are rarely directly involved in the business' operation. They cannot feel responsible or accountable to the business, because they don't directly experience the needs of their customers or employees. They don't feel the impact of choices that maximize their financial gains at the expense of employees, suppliers or customers. This system removes responsibility and accountability from organizations, and relies on governments to regulate corporate norms and behavior.[8]

Steward ownership has taken many shapes throughout its long history and still has different structures today depending on where a company is located. In the US, steward-owned companies primarily take the form of perpetual purpose trusts (PPTs). Perpetual purpose trusts benefit from high flexibility and customization, so they can be configured to support a wide range of purposes that are upheld by the trust. An employee ownership trust is a specific type of perpetual purpose trust with a purpose set around protecting and upholding employee benefit and welfare.

Employee Ownership

Employee ownership has its own longstanding history both in the US and globally and sits alongside steward ownership as a

[7] Ibid.

[8] *Steward-Ownership: Ownership and Finance Solutions for Mission-Driven Businesses*. 2019. Purpose Foundation US, RSF Social Finance, Organic Valley, Organically Grown Company.

mission-driven methodology for structuring, operating, and governing a company.

According to the National Center for Employee Ownership (NCEO):

> Employee ownership is a term for any arrangement in which a company's employees own shares in their company or the right to the value of shares in their company. Employee ownership is a broad concept that can take many forms, ranging from simple grants of shares to highly structured plans. The most common form of employee ownership in the U.S. is the employee stock ownership plan (ESOP), a highly tax-advantaged plan in which employees own shares through a trust funded by the company. Other forms of employee ownership include stock options, stock grants, synthetic equity (granting the right to the value of shares but not the shares themselves), worker cooperatives, and employee ownership trusts.[9]

There are many ways the idea of employee ownership can be applied to a business, but typically, an employee-owned company is one that meets the following criteria:[10]

- Workers own a significant percentage of the company, typically upwards of 30%
- Share ownership is broad-based, meaning it is available to workers at any level of the company (as opposed to just management)
- There is some form of governance and decision-making rights allocated to employees

[9] *What is Employee Ownership?* National Center for Employee Ownership (NCEO). Retrieved 26 October, 2021 from https://www.nceo.org/what-is-employee-ownership.

[10] Armeni, Andrea and Kerr, Camille. October 2019. *Investing in Employee Ownership: Financing Conversions through a Private Equity Model*. Transform Finance.

Forms of Employee Ownership in the United States

In the US, there are several mechanisms through which employees can participate in ownership of a company:

- Employee stock ownership plans (ESOPs)
- Worker-owned cooperatives
- Employee ownership trusts
- Equity compensation plans, including stock options, employee stock purchase plans, restricted stock, phantom stock and stock appreciation rights

Typically, an employee-owned firm that meets the three criteria described earlier will fall into one of the first three forms—ESOPs, worker-owned cooperatives, or employee ownership trusts. Equity compensation plans are primarily found at startups and larger corporations as a mechanism to compensate and incentivize early team members and senior management.

In the US, many people already participate in these forms of employee ownership. According to the NCEO, "over 14 million U.S. employees participate in ESOPs, about 9 million hold shares or share rights (e.g., stock options) they have been granted, and perhaps 11 million participate in stock purchase plans. Worker cooperatives and employee ownership trusts cover, collectively, about 20,000 employees."[11] These numbers represent both the diversity of employee ownership structures already in use and the consistent use of these diverse employee ownership types.

ESOPs

ESOPs are by far the most common structure for broad-based employee ownership in the US. While the use of ESOPs in the US dates back to the 1950s led by Louis Kelso, a lawyer and economist, ESOPs were formalized in 1974 by Congress as a qualified retirement plan regulated by the Employee Retirement Income and Security Act (ERISA). ESOPs were designed to provide employees with a way to use their savings or payroll deductions to gain company stock. As an added benefit, instead of employees paying ownership interest, the company uses future cash flow to pay the interest over time.[12] In order to incentivize adoption of ESOPs, Congress created significant tax benefits. Of primary importance to an owner is the 1042 rollover, a benefit that allows owners to sell any portion of their stock to the ESOP and then defer the tax on the gain from the sale, if certain requirements are met.[13]

Worker-Owned Cooperatives

Worker-owned cooperatives are businesses that are majority-owned and democratically-controlled by their employees, typically through a one-member, one-vote model. As the second most common form of broad-based employee ownership in the US, this form has emerged from a variety of movements.

[11] NCEO.

[12] Armeni & Kerr (2019).

[13] NCEO.

Worker-owned cooperatives can be traced back through a number of global traditions including systems of mutuality and solidarity that arose from historically marginalized communities all over the globe, as well as specific African American cooperative economies, and even European examples such as the Rochdale Society of Equitable Pioneers in the United Kingdom. Due to organizing efforts of the Knights of Labor and Cooperative Workers of America, the number of worker cooperatives grew dramatically during the 1800s. The 1970s saw another dramatic increase when Mondragon, a large global group of worker cooperatives, began to gain international attention.[14] The concept of worker-owned cooperatives touches every part of the globe and is part of the past, present, and future of the US economy. Like with ESOPs, the 1042 rollover, the capital gains incentive for owners, is also available to worker-owned cooperatives.

Employee Ownership Trusts

While Employee Ownership Trusts (EOTs) are a relatively new structure for employee ownership in the US, they have a longstanding history around the world. EOTs are typically structured as perpetual purpose trusts in the US, with a primary purpose defined around protecting and upholding employee benefit and welfare, making them unique among employee ownership vehicles in that they also incorporate aspects of steward ownership.

The largest opportunity for increasing employee ownership lies among business owners who are simply unaware of employee ownership as a viable exit strategy and would otherwise sell their company to private equity, a strategic or a private buyer. Yet, the surge of interest in EOTs in the US represents an exciting trend, because EOTs combine the benefits of both steward ownership and employee ownership. Additionally, they also offer a solution to some of the structural challenges that may have prevented small businesses wanting to pursue employee ownership from following through with the transition. Compared to other forms of employee ownership that US business owners may be more familiar with, EOTs are:

- Less expensive to convert to and to administer, making them a viable structure for businesses with 10 employees and 10,000 employees alike
- Flexible, enabling companies to customize the design of economic benefit and governance across employees as well as other key stakeholders
- Oriented toward the long term and free from fiduciary issues that sometimes arise with ESOPs when presented with an opportunity for a sale

Employee Ownership as a Private Equity Alternative

Employee ownership and private equity set companies on fundamentally different paths. By definition, broad-based employee ownership transfers a significant portion of the company's economic ownership to employees, while also allocating some form of governance and decision-making rights to employees. As a result, transitioning to employee ownership will set companies down a path of being owned, operated and directed with the input of employees, people who are intricately involved

[14] Armeni & Kerr (2019).

in the company's operations, while also enabling them to share in its success.

Private equity, which typically requires both equity and control, shifts owner-operated companies onto a fundamentally different track. Once a company becomes investor-owned and directed, company strategy and decision-making are made subject to that individual investor's economic goals, timeframes and external pressures. Furthermore, the end game of private equity ownership is eventually to sell the company. Rarely do private equity time horizons line up with those of a generational company. As a result, for any company thinking on a long-term, generational time horizon, subordinating the long term to a single investor's goals comes with significant risk.

The Employee Ownership Advantage

Over the last several decades, dozens of studies have showcased the positive benefits of steward and employee ownership. In addition to creating positive benefits for employees, steward- and employee-owned firms also benefit from significant performance advantages.

While employee ownership is not the sole solution for the myriad of societal challenges facing the world today, the data demonstrates that it significantly improves the economic security of employee-owners and ensures that the wealth created by businesses benefits those who contributed to creating it.

Employee Benefits

According to a study conducted by the NCEO comparing non-employee owners with employee-owners, employee-owners experienced:[15]

- Increased variety and amount of benefits including flexible work schedules, retirement plans, parental leave, and tuition reimbursement
- 92% higher median net wealth per household
- 33% higher median wages
- 4x higher rate of access to childcare benefits

Performance Benefits

In addition to the employee benefits of employee ownership, there are numerous benefits to the business itself. Transitioning a firm to employee ownership can put the "owner mindset" into action at all levels of the company, thus yielding positive business benefits across all departments and areas.

According to dozens of studies conducted over the last few decades, steward- and employee-owned firms outperform conventionally-owned firms on the following dimensions:

[15] Armeni & Kerr (2019).

- **Greater employee retention** with employees at employee-owned firms 40% less likely to say they will look for a new job in the next year[16]
- **Improved longevity and resilience** with steward-owned companies 6x more likely to survive over 40 years than conventional companies[17]
- **More innovation** as businesses are able to reinvest more of their earnings into R&D without the short-term pressure from financial markets or investors[18]

As a result, for any company wanting to explore paths the bolster resilience while enabling growth, employee ownership represents a compelling strategy that can benefit the company's long-term performance while also producing significant employee impact.

[16] NCEO.

[17] Børsting, C., Kuhn, J., Poulsen T., Thomsen, S. Industrial Foundations as Long Term Owners. Corporate Governance: An international Review, Vol. 26, Issue 3, 2018.

[18] Thomsen, S. Foundation Ownership at Novo Nordisk. Center for Corporate Governance Copenhagen Business School. 2017.

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Employee Ownership Trusts: A Deep Dive

Given their performance and long-term resilience advantages, EOTs represent an attractive succession pathway for business owners who would have otherwise pursued a private transaction with private equity, a strategic buyer or a private buyer, as well as those who have already had some exposure to the concept of employee ownership and are determining how best to enact a transition. For both of these types of business owners, this section will examine the structural aspects of EOTs that enable them to uniquely serve as a conduit that ensures the business' continued operations and growth stays in alignment with a higher purpose to serve as a force for quality jobs, economic growth and community benefit.

Structure: The Perpetual Purpose Trust & Employee Ownership

In the US, an EOT is usually structured as a **Perpetual Purpose Trust.** A PPT is a non-charitable trust that operates in perpetuity, and is established for the benefit of a purpose rather than a person. Trust-ownership is the gold-standard for mission driven ownership in the US.

While purpose trusts have long existed in the US, they have historically been used to hold and protect inheritances and assets for the benefit of heirs and other family members.

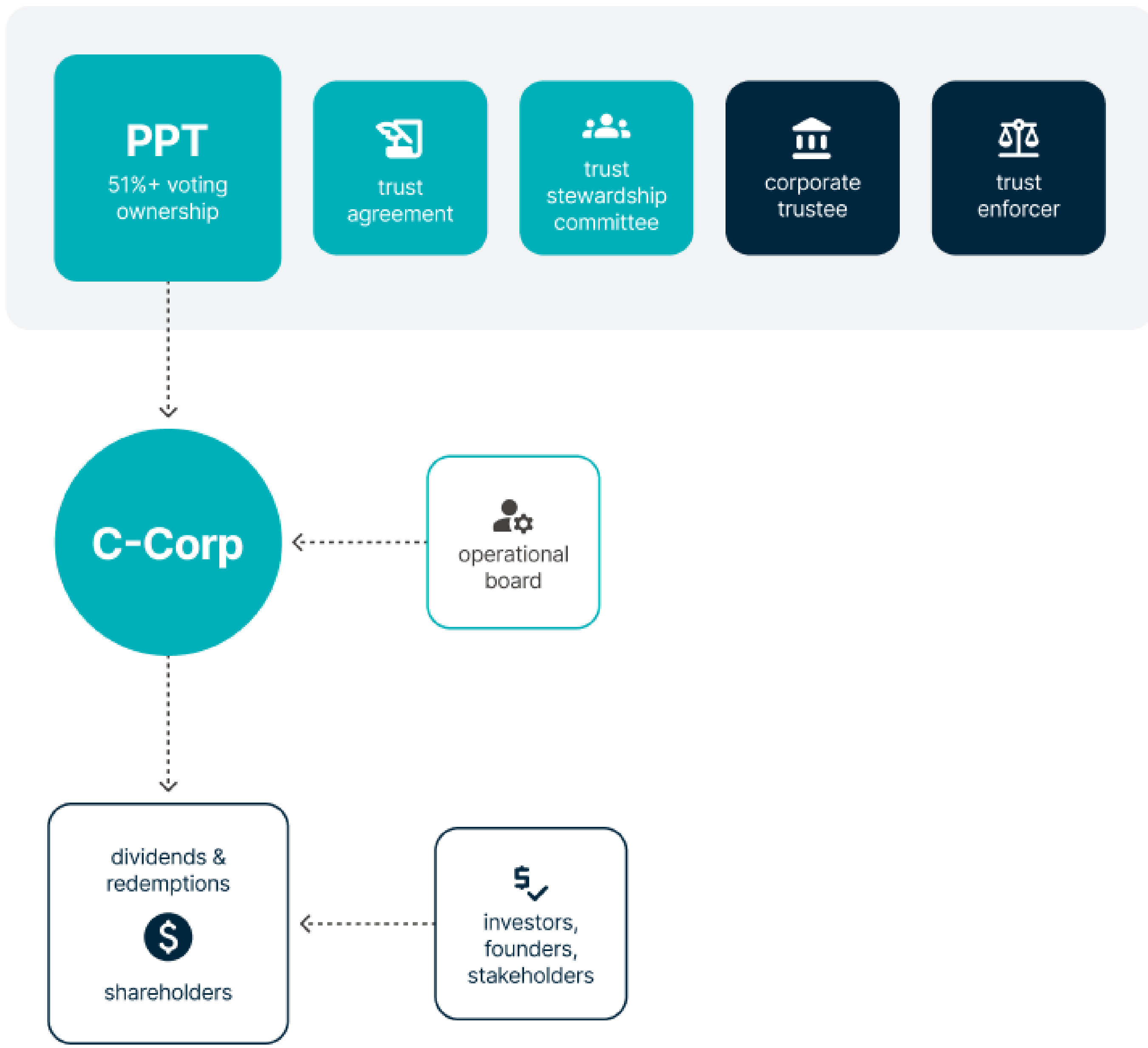
Recently, there has been an expansion of interest in using PPTs as values-aligned ownership succession tools. This is due in part to their flexibility, which lends itself to customization, and also to their long standing and well understood use as estate planning tools.

Key Components of a PPT as Pictured to the Left

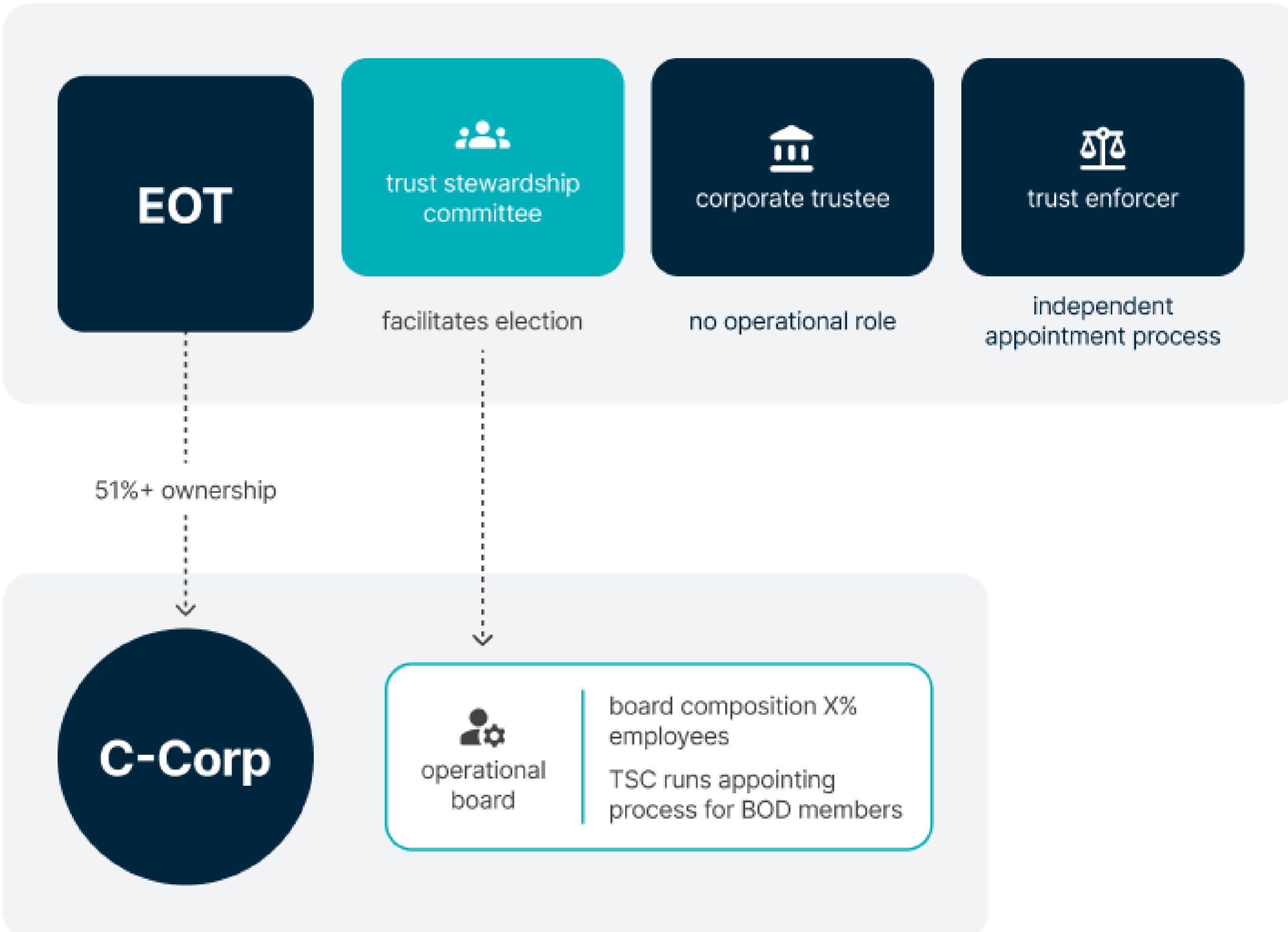
- **Trust Stewardship Committee:** The group tasked with ensuring the Trust upholds its stated purpose.
- **Trust Agreement:** The document detailing the purpose of the trust, how responsibilities are distributed across roles, and which processes the trust will undertake to make decisions and fill roles.
- **Trust Enforcer:** An independent arbitrator for grievances brought by stakeholders against the Trust Stewardship Committee.
- **Corporate Trustee:** A bank or trust company appointed to administer, collect and file documents on behalf of the trust. In most EOTs, the corporate trustee is "directed" and has no substantial role in decision making.

An EOT is a specialized way of *designing* a perpetual purpose trust, such that the company is held in trust for the long term, and employees are ensured participation in the governance and economic benefit of the company as co-owners and stewards.

The result is a reliable legal mechanism for employee ownership that has been used in asset management and estate planning for decades and at scale, that can be specifically tailored to protect the mission, values, and purpose of the company.



A simplified PPT structure overview



A simplified EOT structure overview

Key Principles of Steward Ownership and EOTs

As steward-owned businesses, EOTs are designed to uphold the following principles:

Profit Serves Purpose

For EOTs, profits are a means to an end, not an end in and of themselves. EOTs are intended to be successful, competitive businesses, with their success serving a higher purpose. All profits generated by the company are reinvested in the business, used to repay investors, shared with employees and key stakeholders, and/or donated to charity.

Perpetual Independence

For-profit businesses often find themselves beholden to the interest of shareholders who are not involved in the operation or management of the business and may be disconnected from the purpose or intended legacy of the business. EOTs keep the people who are actively engaged in or connected to the business in control with an express mandate to uphold and protect the purpose set by the EOT.

Orientation Toward the Long Term

When control of for-profit businesses is sold to external shareholders, a mismatch often emerges between the time horizon of those investors and that of legacy-minded leadership and the management of companies that take a long view on their work. EOTs enable businesses to invest in long-term strategy, innovation and culture, while avoiding the risks that come from investor pressure that drives short-term growth at all costs.

A Purpose-Driven Economy

The idea of a purpose-driven economy is distinct from how most investor-owned firms operate today. Unlike conventional businesses, the individuals, or stewards, at the helm of steward-owned companies are deeply committed to the organization's mission and are involved in its operations. "Ownership" in these organizations represents the responsibility and the freedom to determine what is best for the continual survival of a company as it serves its purpose. Such companies are not put up for sale, and are instead deliberately passed on to capable and values-aligned successors to be grown and stewarded for the long term.

Why Having a Purpose Matters

For decades all across America, independent small business owners have chosen to build their companies in a way that contributes a portion of the value they generate to their communities. Whether that is through local volunteering, employee profit-sharing, benefits programs, or community philanthropy, these longstanding practices have a data-backed impact on communities across the country.

Some of those positive impacts include:[19]

- Increased revenue into the local economy
- Increased use of local workers, services, and goods
- Increased job growth
- Increased median incomes

Many of these outcomes have been the result of decision-making to create profit-sharing programs, generous employee benefits programs, business-directed local philanthropy, and procurement through local supply chains. These practices have often been the result of an original founder-owner simply deciding that sharing the benefits of the business was the right thing to do. As long as those small businesses remain independent and privately owned, those kinds of decisions are easy to protect.

However, simply holding on to the business to preserve its mission is not an option for the projected three out of five small business owners who are facing an upcoming succession in the next decade.[20] It is increasingly apparent that measures must be taken to protect a company's ability to continue its legacy as a positive community institution. Not doing so has clear consequences for communities and the US at large. The decline of small purpose-driven businesses alongside rising corporate consolidation has been linked to lower wages and increased income disparity.[21]

In order to protect the purpose that is central to these businesses, a different kind of transition is essential, and while there is a spectrum of control mechanisms that can be utilized to protect purpose, ranging from golden share voting rights to aligned board members and investors to steward ownership (e.g. PPT, EOT), among others, not all of these are feasible as part of a succession event.

Protecting a company's mission with golden share voting rights or super shares is technically feasible through a sale to an individual private buyer, but in practice it is almost never possible. Very few individual private buyers coming in as an operator are likely to accept the seller retaining control. Finding aligned board members and capital providers is the option most frequently pursued by owners who care about purpose. However, this strategy is significantly more risk-exposed than "aligned" suggests, consistently subordinating mission-protection to investor rights. While term sheets will include numerous terms designed to protect an investor's ability to realize their economic rights, there are rarely such terms representing the purpose and values that a founder-owner may want to see protected through a transaction.

One of the strongest mechanisms available to an owner wanting to secure their legacy is the steward ownership model of an EOT, which essentially allows a founder to employ legal devices to protect the interests they care to see memorialized. By creating an EOT, an owner will define a purpose and, depending on its contents, that purpose will code the protection and stewardship of employee benefit directly into the company bylaws. Most significantly, unlike with private equity or an independent buyer, an EOT's purpose cannot

[19] American Economic Liberties Project.

[20] Project Equity. Retrieved 26 October 2021 from https://project-equity.org/

[21] American Economic Liberties Project.

be subordinated to decisions that would be deemed in opposition to the purpose, such as operating for short-term gain for an investor's singular benefit.

The EOT Advantage to Building a Purpose-Driven Company

Employee ownership has long been viewed as an effective strategy to create strong alignment and incentive structures between employee contribution and company performance. When the company does well, so do employees, which motivates everyone.

For those companies seeking to exit through employee ownership while ensuring the company's continued operation as an enduring purpose-driven company, EOTs offer an exciting new option. EOTs represent a significantly less risky option for owners wanting to protect mission and otherwise considering private equity, M&A or a private buyer. For these owners, EOTs represent a pathway that they can be confident will not subordinate the long-term stewardship of their company as an engine for superior products and services, quality jobs, economic growth and community benefit to any individual investor's return. Meanwhile, for business owners who may be considering other forms of employee ownership, EOTs additionally overcome some of the structural constraints that owners may be wary of with those other forms.

EOT Benefits to a Legacy-Minded Owner

Customization and Flexibility

Businesses are not one-size-fits-all and the operating principles that led one company to success might not work for other companies. EOTs allow companies to exit to their employees with a model designed for their unique situation. EOTs uniquely allow for customization on how employees benefit from the company's success, how governance is structured, and how other stakeholders can benefit when the company does well. Above all, the flexibility and customization of an EOT ensures that the higher purpose of the company is officially protected and maintained.

Simple and Affordable

EOTs are a simple and lower-cost transition option. ESOPs are more complex and expensive to set up and administer for two key reasons: firstly, share allocation across all employees is simply more complex than in an EOT; secondly, as a regulated retirement plan, ESOPs come with regulatory issues that EOTs do not face. As a result, EOTs are an effective way to keep the administrative burden of operating as an employee-owned company low.

Mission Protection

EOTs legally protect the purpose of a company for the long haul. EOTs enable employee-owned companies to take into account their higher purpose when presented with offers to buy the business, thus preventing them from having to accept an offer from parties with misaligned interests. This protection is a significant distinction from ESOPs, because when confronted with a competitive offer, ESOPs can sell the employee-owned firm back into private ownership, thereby eliminating the benefits of employee ownership for future generations.

Long-term Independence

Most for-profit companies are governed by investors. EOTs legally protect their higher purpose as a governing principle, which insulates the company's strategy from short-term investor pressure and misaligned interests. EOTs also enable companies to operate and invest with an abiding legacy in mind.

Good Governance and Management

EOTs create a strong foundation for exceptional governance and management, which are two critical factors in the long-term success of any business. The process of transitioning to an EOT requires an exploration and articulation of the values, mission, purpose, and goals of an organization. This required exploration results in governance and management systems that are more productive for employees and management, and more successful in fulfilling the purpose of the company.

An Explainer: EOTs and ESOPs

For those business owners who have already had exposure to employee ownership as an exit strategy and have explored ESOPs, this section will dive into some of the distinctions between the two forms of employee ownership.

Since an ESOP is by far the most widely used model for broad-based employee ownership in the US, it is often the model that owners are pointed to first when exploring an exit via employee ownership. Furthermore, ESOPs can be an attractive option to owners on the basis of its preferential tax treatment under the 1042 rollover, a benefit that is not yet recognized for EOTs.

However, for some types of companies, ESOPs can come with certain structural constraints that may make it difficult to transition to the model or sustain it over the time. Depending upon the underlying business characteristics of a company and its long-term goals, some of the challenges that may be associated with ESOPs include:

- **Expensive to convert:** Generally costing between $100,000 and $300,000 to set up, costs increase in larger and more complex deals.[22]
- **Complex to maintain**: Given the current available infrastructure, ongoing administration of an ESOP includes many complex, moving pieces, including managing internal capital accounts, required annual valuations and in many cases relatively complicated pay-out mechanisms.
- **Fiduciary duty:** ESOPs require that employee-owners make stock share value the highest priority. While this is a positive characteristic from the standpoint of employee wealth built through share value, it can simultaneously come at the expense

[22] NCEO.

of employee welfare and benefit, preventing companies from prioritizing employee welfare at or above stock share value.

- **Repurchase obligation:** As a mechanism by which ESOPs are required to purchase back shares from retiring employees in order for them to get liquidity, this can often result in cash to be directed toward buying back shares as opposed to other uses of that capital that would more directly impact the business, such as reinvestment.
- **Longevity of the company as employee owned:** ESOPs are required to consider any serious offers to buy the business. Because of the liability held by trustees, with an attractive enough offer, many will choose to sell the company—even when that sale would wipe out the firm's employee ownership in its entirety. Because employee owned firms can often outperform their peers, they can often find themselves the target of private equity or mergers and acquisitions.

Comparing EOTs with ESOPs

While EOTs and ESOPs are both forms of employee ownership, there are key differences across a number of areas. Although both forms vary widely in their implementation, there are common patterns that can be seen in the market. The chart below outlines some important distinctions between EOTs and ESOPs. ESOP practice has and will continue to evolve, but these distinctions are based on field research on ESOPs in practice, including hundreds of conversations with owners, technical assistance providers, and ESOP company leaders.

Category	EOTs	ESOPs
Governance	Owners can define the most appropriate purpose of their organization which will then be legally enshrined in the EOT. Trustees are elected to uphold that purpose in matters of company decision-making.	Although it varies, ESOPs are usually managed by a trustee on behalf of employees with the express requirement to uphold fiduciary duty on behalf of shareholders, i.e. current employee owners. Trustees will elect certain board directors and approve annual valuations, but often delegate significant decision-making to the board of directors.
Employee Benefits	EOTs typically enable employees to participate in the company's economic success through a profit-share plan, but this aspect of an EOT is very customizable. An EOT can also protect additional employee benefits programs such as a 401k plan, expanded health care, etc.	As a retirement product, ESOPs establish an individual savings account for employee-owners. ESOP benefits are mainly paid to participants near or at retirement age, or upon a sale or other liquidity event.

Sale Provisions	EOTs are able to specify conditions under which a sale may happen in order to ensure the protection of its purpose and avoid a misaligned sale. An EOT cannot be forced or compelled to sell the company for short-term gain.	In an ESOP, the board is required to consider an offer, and make a recommendation to the trustee. Of note, the trustee faces greater liability in the event that they decide to go against a board's recommendation to sell. Consequential to a company wanting to transition to enduring employee ownership, ESOPs offer no explicit protection against potential risks to the company and employees that could occur after the sale.
Inclusion of Additional Stakeholders	EOTs are able to include additional stakeholders in matters of benefit and control, such as customers, supply chain partners, and the local community. Companies that have a rich history of giving back to their community when the company does well can ensure that practice is protected into the future with an EOT.	Companies without 100% ESOP ownership may design mechanisms to include additional stakeholders, although with limited flexibility. ESOP rules on share class design are highly restrictive under ERISA.
Regulation	Governed by trust law, EOTs are simple and affordable to set up and administer.	Governed by ERISA, ESOPs face significant regulation and oversight, resulting in high set-up and administration costs, as well as significant general management requirements.
Generational Employee Ownership	The EOT structure ensures that the company will remain independent and employee-owned once established and well into future generations.	ESOPs may be compelled to sell by the trustee or employees, which may eliminate employee ownership of the company.
Employee Wealth Diversification	Diversification is variable and depends upon employee benefits chosen, which are typically at the discretion of the management and/or trustees of the EOT. For instance, an EOT may choose to establish a 401(k) plan alongside profit-sharing, bringing diversification to employee wealth-building.	For the most part, the wealth created through an ESOP is initially based on the company's share value, and therefore not diversified. As employees age, ESOPs have a diversification requirement that comes into effect, requiring the company to cash out employee shares for other investments. Failing to comply with the diversification requirement can jeopardize the ESOP's tax qualified status.[23]

[23] Ray, Jason. ESOP Diversification Requirements. Butcher, Joseph & Co. Retrieved 26 October 2021 from https://butcherjoseph.com/blog/esop/a-refresher-on-the-esop-diversification-requirements

Tax Treatment

ESOPs enjoy significantly favorable tax advantages as an incentive for business owners to sell to their employees through ESOPs as a succession strategy. Passed in 1984, the Tax Reform Act included key provisions providing favorable tax treatment to ESOPs, chief among those:[24]

1. Tax-free rollover treatment: the sale of a C-Corporation to an ESOP or cooperative can be structured as a tax-free sale under Section 1042 of the Internal Revenue Code, such that the capital gains tax on the sale can be deferred indefinitely.
2. For S-Corporations, any earnings attributed to the ESOP are treated as tax-exempt, thereby immediately making the company more cash-efficient, which often results in the seller note being repaid much faster than with a typical third party sale.

Combined, these tax advantages afford significant benefits to owners choosing to sell to an ESOP over a third party.

By default, EOTs do not come with the same tax benefits that selling to an ESOP does. However, there are numerous ways to make a sale to an EOT more tax-efficient for owners and to structure transactions such that owners and the company can reap comparable benefits. Because most EOT transactions are a specialized version of conventional estate planning tools, these techniques are well known and commonly used, but vary depending on the unique factors associated with the business, its ownership and the design of the transaction.

Hybrid Models

While both ESOP and EOTs are mechanisms to establish employee ownership in a company, they are not necessarily mutually exclusive. This book is largely geared toward highlighting EOTs as a well-aligned method for business owners to exit via employee ownership; however, there are scenarios under which a hybrid model may be the optimal fit.

While this is not yet a very common practice, most hybrid models employ the ESOP as the primary vehicle for employee wealth generation and an EOT as the primary vehicle for protecting governance and purpose. This can be achieved by designing the ESOP in such a way so as to largely delegate control to the company's board, and the EOT to hold the majority of voting control and board seats. This functionally allows the EOT to drive the company and the ESOP to operate as more of a 'silent' financial partner.

[24] The Origin and History of the ESOP and Its Future Role as a Business Succession Tool. The Menke Group. Retrieved 26 October 2021 from https://www.menke.com/esop-archives/the-origin-and-history-of-the-esop-and-its-future-role-as-a-business-succession-tool/

In these scenarios, the sale to a hybrid would typically be structured in such a way that after the sale, the company would be:

- Majority-owned by the EOT, in order for the EOT to have sufficient voting shares to protect its board controlling position, and
- Partially owned by the ESOP, in order for employees to benefit from the company's share appreciation and for selling owners to benefit from the 1042 rollover that comes with the ESOP.

For owners evaluating how an EOT, ESOP or hybrid transaction may impact them differently, hybrid models may be good for owners to consider when all of the following are true:

1. Companies and ownership have the appropriate appetite and budget commensurate with the complexity of establishing and maintaining two separate employee ownership vehicles simultaneously
2. The circumstances of the business and an EOT transaction do not lend themselves to receiving substantially similar benefits to an ESOP
3. The circumstances of the business and an ESOP transaction lend themselves to being able to leverage benefits of both models in parallel

Potential Benefits of Hybrid Models

In these situations, a business may be able to leverage a hybrid model to get some or all of the benefits of the ESOP model alongside an EOT.

Benefits from the EOT

- Aligning employee benefits with long-term values
- Design flexibility and customization
- Expanded scope of purpose and mission protection
- Evergreen provisions protecting the company from takeover and sale

Benefits from the ESOP

- Tax-advantaged employee share ownership plan through the ESOP
- Tax benefits for a selling owner at the time of transaction
- Ongoing tax benefits (S-corp) that may increase company's value and cash flow
- Access to a mature capital market for ESOP transactions

Key Tradeoffs and Considerations with Hybrid Models

While this may seem like an obviously 'better' model than either structure alone, there are also important tradeoffs to consider when using a hybrid model, including:

ESOP benefits come with less flexibility and more liability: One of the appeals of the EOT is that it is much simpler and flexible to set up, administer and govern. This is especially true regarding valuations, liability and long-term governance structures.

In a hybrid model, in order to receive the substantial tax benefits of the ESOP, the company must navigate the complexity of the ESOP liability structures and valuation regulations, balanced with the EOT's governance. This may be either trivial or difficult depending on the circumstance, as these two structural imperatives may sometimes be at odds with how to best serve the interests of the employees, purpose and business as a whole.

Curbing the benefits of the EOT for future workers: Another reason EOTs appeal to many business owners is that they are able to fairly distribute economic value among employees over many generations, without being subject to valuations, value concentration among certain employee groups, and market conditions that may change the value of employee's ownership dramatically.

In a hybrid model, especially with a large block of ESOP ownership, it may be the case that the EOT's duty to pursue purposes other than financial gain will eventually come into conflict with the requirements to provide liquidity to current and past ESOP employee-owners when they reach the age for diversification or repurchasing of their ESOP shares. The ESOP liquidity requirements can therefore run the risk of overweighting sharing the economic success of the company with earlier generations of workers, while constraining future workers from growth opportunities.

Trading growth in the present for growth in the future: A business with a newly set up ESOP can often benefit from share value growth associated with its newly favorable tax treatment and cash-free employee wealth generation through share contributions. However, it is not uncommon for mature ESOPs to require substantial portions of the company's market value to be liquidated in a given year to meet liquidation requirements, which can severely limit the cash available to the company for reinvestment and growth down the line.

Competing Incentives: Fundamentally, an EOT and ESOP are at odds in their purpose for existing. While an EOT exists to ensure the benefits of employee ownership itself (and other purposes) are maintained into the future, the ESOP exists to maximize financial benefit to current employee-shareholders who may or may not still work for the company. It is a common misconception that ESOPs are at serious risk of being 'forced' to sell by a trustee; however, it is understandable that an employee for whom a meaningful amount of their retirement is bound in a company's share price value may feel a desire or pressure to vote to sell the company and 'cash out'. This is especially true in rapidly consolidating industries, where independent companies are most needed for a healthy economy, and where the sale of the company is most likely to result in a destructive effect on the local economy and community. In this case, EOTs are well positioned to seek acquisitions to grow, while ESOPs, often with considerable debt loads, are well positioned as acquisition targets.

While there is tremendous promise and opportunity for exploration with the use of hybrid models, we highlight each of these points as potential risks for owners considering a hybrid approach, because hybrid models are as of yet not very common practice. As a result, the extent to which each of these points represents significant or minimal risk is still largely unknown in practice.

Hybrid Case Study: Berrett-Koehler Publishers

Background

In May of 1991, Steve Piersanti was running a small publishing house called Jossey-Bass in California, which had recently been purchased and made a division of the publishing giant Macmillan.

Soon after the sale, Steve had been ordered by Macmillan to lay-off 10% of his staff as part of a corporate-wide Macmillan workforce reduction. This made no sense to Steve and his colleagues because Jossey-Bass was growing rapidly, had just finished a record-breaking year in which profit was up 46 percent, and had already been approved to add more staff. Steve refused to carry out the layoffs, and soon after was fired.

Berrett-Koehler (BK) was born out of Steve's desire to do business differently. From Day 1, the company held a "deep sense of responsibility to administer the company for the benefit of all of our 'stakeholder' groups—authors, customers, employees, suppliers and subcontractors, owners, and the societal and environmental communities in which we live and work." BK's core mission is "connecting people and ideas to create a world that works for all".

In its nearly three decades of operation as a social impact publisher, BK has set up numerous associated entities for sharing and creating value for stakeholders- including an ESOP and more recently a Steward-Ownership Trust as a succession vehicle for a large part of Steve's ownership.

Problem: Like many mission-driven founders, Steve was the largest single shareholder of his company and BK's independence and mission-focus were still ultimately backstopped by his ownership. In 2019, after successfully carrying out a leadership transition and appointing a new CEO and President, Steve and the BK board set their sights on completing the ownership structure work needed to preserve the company's mission and values over the long term.

Solution: With the help of the Purpose Foundation, Steve and the BK board designed a steward-ownership model, using a Purpose Trust alongside a recapitalization plan that will serve all of BK's stakeholders long-term and keep ownership of the company aligned with a non-negotiable mission focus.

Main Purpose (simplified):

To preserve the company's perpetual independence, values, and mission of connecting people and ideas to create a world that works for all.

Additional Purposes (simplified):

- Ensure the Company embodies and practices its values as defined in the Berrett-Koehler Constitution.
- Serve and balance the interests of all the Company's stakeholder groups...rather than operating the Company principally for the benefit of any one or two groups.
- Keep the Company owned by its stakeholder groups so that there is a balance of

power among the groups and all share in Company decision making and benefits.

- Continually increase the positive impact of the Company and its publications, while also supporting financially healthy growth of the Company
- Ensure the Company's leaders seek to achieve all of the above.

While the ESOP allows the company's employees to participate cash-free in share ownership of the company, the Purpose Trust's governing documents direct it to:

- Protect the diversified ownership and governance of the company by preventing investors, ESOP owners or other shareholders from owning too large a majority stake
- Vote against a sale of the company, except under extreme circumstances like insolvency
- Prevent changes in the multi-stakeholder board composition that favor any one group inappropriately

In this way, the company values of shared prosperity, independence and stewardship will be protected at the deepest level of company DNA—the ownership of the company itself.

"Many of the first generation of mission-based companies are now in the hands of multinationals uncommitted to the core values, because they did not have a sustainable capital structure beyond the founders' tenures to prevent acquisition or public exchanges beholden to shareholder primacy. We hope our multifaceted steward-ownership approach anchored by our new PPT will serve as a beacon to other B Corp, Benefit Corporation, or triple-bottom-line organizations on how to grow and flourish for generations to come as independent enterprises."

David Marshall,
CEO & CFO of Berrett-Koehler

The Process: Designing an EOT Ownership Transition

A successful transition to an EOT that fully enables a company to tap into the benefits of employee ownership for the long term includes three key phases:

1. **Design** of the EOT
2. **Financing** the transaction to ensure fit-for-purpose investment terms while ensuring a tax-efficient exit for the owners
3. **Stewardship** of the company by the next generation of leadership, including the trustees, management team, and employees

These steps address the three critical pillars necessary for the successful operation of an EOT in the post-transition period and into the future: governance, economics, and culture.

Step 1: Governance Design

The design of an EOT is a key step that allows companies to truly tap into the benefits of employee ownership. This step is centered around a deep exploration of a company's values, mission, purpose and goals as an organization which are then formalized in standards of governance and purpose in the EOT.

The design process includes several important decisions about governance including:

- Defining the purpose of the organization
- Determining the optimal governance structure to protect and steward that purpose while taking into account factors like industry, business model, and company size
- Setting any specific sale provisions to ensure enduring protection of the purpose

Taken together, these decisions will be configured to create a fit-for-purpose governance model that is unique to each company's needs. In order to protect and uphold the established purpose, the design process will also clarify and establish the roles within the EOT across the Trust Stewardship Committee (TSC), the operational board of the company, management and employees, detailed further below. This design is highly customizable, so may be directly mapped to reflect the unique characteristics, operating principles, values and mission of a company that have been critical to its success to date. Fortunately, there are several examples of EOTs currently in operation that businesses may use to guide this process.

This governance design process leads current owners and stakeholders to identify their company's "true north" and the core operating principles they deem critical for long-term success. The results of this process are that the governance and management systems are more aligned with the company's goals, more resonant for workers, and consequently, more effective at protecting the legacy of the original owners.

Step 2: Financing the Transaction

Once the EOT has been designed, the next step is to create a capital stack that is tailored to the cash flow patterns of the company, its growth plans, and the liquidity needs of owners, all while ensuring a tax-efficient sale.

A sale to an EOT is a private transaction, so valuations are determined privately between the transacting parties (typically the senior lender, mezzanine lender and sellers). This is a significant reason why owners like the EOT over the ESOP, which is required by ERISA to obtain an independent, third party valuation of the stock for the transaction and every year thereafter.

For owners, the cash provided on closing will depend upon the valuation determined by the transacting parties as well as the amount of seller financing required for the transaction. Typically, an EOT transaction requires some amount of seller financing in order to bring in a senior and mezzanine lender. This enables owners to get a fair value out for the value they have created, while also attracting external capital providers, who will view the presence of some amount of seller financing as a de-risking factor to their investment.

In order to uphold and protect the key principles of steward ownership discussed earlier, financing for a business transitioning into an EOT requires options that allow the EOT to:

- Grow steadily, profitably, and stay oriented toward the long term
- Continue to uphold the founding mission, values, principles, and practices that have enabled their success to date
- Steward the purpose that has been established in the EOT

In order to ensure these principles are upheld, founder-owners and their teams need to ensure that the purpose set in the EOT is designed directly into the financing terms. Designing financing with purpose in mind ensures that employees will benefit alongside investors, while also appropriately acknowledging and rewarding risk taken on by investors and other relevant stakeholders.

In practice, this means:

- Models for investor returns that are aligned with steady, profitable, and long-term growth
- Time horizons that prioritize long-term strategy and endurance and eliminate undue pressure to pursue short-term growth
- Healthy debt loads and terms that protect companies from being overburdened with bad debt or too much debt
- Adequately and equitably balancing risk and reward across the range of stakeholders that drive the business value

Many owner-operators who have been growing their company privately and profitably for decades may have reservations about taking on debt, and that reluctance is not necessarily an unwarranted concern. Debt can take many forms, and the debt used for an EOT transaction is meant to be a transitory way of facilitating an exit. However, depending upon the terms, it can either accelerate the benefits of employee ownership on the one hand, or hamstring them on the other. As a result, it is critical that businesses transitioning into an EOT can access capital partners who are able to offer terms that support, rather than work against, a sustainable employee ownership structure. This means ensuring that the debt is serviceable without sacrificing long-term performance of the company, enabling owners to get a fair value out for the value they've created, and proactively building in mechanisms to ensure that the employees don't bear unreasonable risk.

Step 3: Stewardship

While the design of the governance and financing are critical to giving an EOT the foundation it needs to succeed, its future success will ultimately be determined by how its business—as an expression of its purpose—is stewarded over the long term. With traditional capital, governance and financing are often designed on a separate, non-intersecting track from purpose, mission, and values. Case in point, a company's governing documents or term sheets rarely have clauses about purpose, mission, or values. With an EOT transition, these tracks are integrated into a single process, so that each of these pieces mutually reinforces the other pieces.

For EOTs, this integration is the starting point for what is to come, not the finish line. The long-term advantages of employee ownership through an EOT comes from bringing these terms to life through company culture, operations, and day-to-day decision-making. A critical goal of the transition period is to ensure the team is adequately equipped with a communication, participation, and decision-making architecture that enables new employee-owners to take up their role as true stewards of the company and its purpose. For example, in shifting from a privately-owned firm to an EOT, a successful roll-out and integration strategy will equip all employees to understand:

- Their role as an employee-owner
- Individual financial implications for employee-owners if and when the company does well
- Methods for contributing to company decision-making
- The day-to-day impact of the transition from employee to employee-owner

As with all questions related to culture, communicating this new architecture should not be viewed as a one-off, deliver-once-and-be-done event, but rather as a continuous practice that reinforces the what, how, and why of employee ownership through small but everyday actions, conversations, and decisions.

Purpose Clauses

EOTs are often set up with additional purposes beyond just creating value for employees. These purposes act as legally binding guidelines for the company at every level, and compel its employees, management, and financiers—regardless of who they are—to act in a way that aligns with the EOT's stated purposes.

An EOT's purpose creates the foundation for a high-performance, deeply values-driven organization to endure for the long haul. The flexibility of the EOT model and its purpose clauses make it an excellent fit for values-driven founders and owners, because it allows them to create a legal structure that benefits and empowers employees, while ensuring the company remains values-driven and independent after the owner has moved on.

An EOT purpose has two sections:

1. A "main purpose" that is a high level description of why the company exists and is often based on or connected to the company's stated mission. This section legally replaces the default mandate to create financial value as the primary purpose of a corporation.
2. "Additional purposes" that describe different aspects of the purpose to be balanced in decision making. These "additional purposes" can act as clarifications of the main purpose and are integrated and balanced by the trust, management, and the company's board.

While the purpose clauses of an EOT can be varied and are highly customizable for each organization, they do share some basic similarities. All EOT purposes include some form of:

- Financial benefit sharing among employees
- Employee control structures and processes
- Self-protection against demutualization (i.e. undoing the EOT itself)
- Process around extreme conditions allowing for major changes to the EOT

A well-designed set of EOT purposes acts as a strong framework for the company's decision-making long into the future without being overly prescriptive or limiting. Many owners choose to craft these purposes to ensure the company's board and management protect certain values, take care of employees, maintain prudence regarding the health of the business, uphold commitments to quality and community, and, of course, preserve employee ownership itself. The amount of time put into customization can vary depending upon the objectives of the seller. Fortunately, there are many examples and models already in operation for owners to draw from.

These purposes should be designed with an awareness of the company's history, a responsiveness to its forward-looking strategy, and a dedication to the transitioning owner's legacy and commitments. Attention to these aspects allows the transformation to empower employees, while giving a transitioning owner confidence that the company will be managed with a high standard of values, execution, and accountability.

Case Study: Firebrand Artisan Breads

Background

Founded in 2008, Firebrand initially faced many challenges common to food service: emotionally and physically demanding work with long hours in an industry marked by high turnover, limited career opportunities, and little to no safety net for workers.

When presented with an opportunity to employ formerly incarcerated and unhoused community members in 2013, founder Matt Kreutz seized the chance to do things differently. Firebrand would become an inclusive, encouraging employer and community player that invited employees to bring their whole selves to work and create quality job opportunities.

Today, Firebrand offers extensive training programs for employees that create avenues to leadership positions and build capacity in the community. 60% of Firebrand's managerial staff are women and 80% are people of color. Firebrand is an active community-member that offers community baking classes and supports local minority-run businesses by integrating their products into Firebrand's value chain.

Problem: Firebrand needed to raise growth capital as a profitable and ambitious business while ensuring employees and community stay at the core of the company's values-driven operations.

Solution: Firebrand created an EOT where the trust owns a 33% stake in the company that will increase to 66% as the owner sells their remaining shares into the trust over time.

In the creation of the EOT, Firebrand determined a main purpose as well as many additional purposes to keep the company aligned with the founder's mission, values, and vision while ensuring its operation would continue into the future. Summarized versions of these purposes are below.

Main Purpose (simplified):

To preserve the company's perpetual independence, values, and mission of creating great jobs, shared value, and thriving communities.

Additional Purposes (simplified):

- Promote engagement of employees and community in the decision-making of the company
- Prioritize hiring people who are formerly incarcerated, unhoused, or otherwise have high barriers to entering the workforce
- Ensure that the company management and board maintain a profit-sharing program
- Ensure that financial decisions serve the mission and long-term sustainability of the company
- Continually increase the positive impact of the company
- Practice transparency and radical candor with all stakeholders of the company through open-book management principles
- Promote equitable and diverse supply chains from farm to marketplace, including fair labor practices

Ultimately, Firebrand chose to use an EOT to allow the company to operate for the benefit of the stakeholders rather than profit maximization and shareholder return. It was able to balance this purpose with a continued focus on financial and competitive security for the long-term viability of the enterprise. They were able to use the EOT structure and flexibility to integrate their values and practices into their company's legal documents and responsibilities.

> "Steward-ownership tied all the things together for us. We could lock-up the mission, align the ownership structure, and then tie that to the fundraising in a very clear path."
>
> Matt Kreutz,Firebrand Founder

Good Governance and Management as a Competitive Advantage

Hiring and retaining highly-motivated and skilled people at every level is key to an organization's success. Most founders are able to protect and sustain the long-term continuation of high-quality management due to their role as majority business owners. As a company's ownership changes hands, this invisible protective role that the founder or family-owner plays disappears. As ownership of the business moves further and further away from the people, operations, mission, and values that the business was founded upon, the ability to guarantee quality leadership fades.

In the case of a conventional private equity buyout, carefully vetted management successors are replaced with short-term operators who are mandated to take on expensive and risky capital, grow financial metrics at all costs, and prepare the company for a sale in three to five years. All too often, the most skilled values-aligned leaders do not stay on long in these types of situations, despite generous financial incentives.

Since founders cannot stay and vet future management forever, and conventional transitions often lead to loss of quality leadership and abandonment of the company's founding legacy, a different kind of transition must be used in order to sustain excellence and values-alignment at every level over the long term.

Spectrums of Employee Ownership

Employee ownership offers a compelling solution to the "governance problem" described above, because it allows the people invested in the everyday operations to lead the company forward. Scalable and effective employee ownership governance design showcases the versatility of employee ownership trusts and is made up of choices across a number of cultural and structural spectrums.

There are no right and wrong ways to answer these design questions. Organizations may find overlaps between the spectrums as well as gray areas in their answers. Even with this plethora of governance design options, for many transitioning owners, the practicality of employee ownership as a transition solution seemed daunting before the current explosion of interest and research in EOTs.

As it relates to governance, employee ownership structures have historically been limited to:

- **Worker Cooperatives:** one worker, one vote structures, which lock in the governance purely as broad-based democratic elections with the majority of the board seats held (or delegated) by employees
- **ESOPs:** indirect share ownership through a tax-advantaged trust, in which important aspects of economic benefit and governance are strongly influenced by a decision-making framework regulated by ERISA that emphasizes compliance and reduction of liability

The complexity and rigidity of these structures have often been a cause for hesitation towards employee ownership among transitioning owners. Fortunately, with the rise of EOTs and similar structures, employee ownership can be done much more easily and can be customized to suit a given business strategy, context, history, community, and culture. While there are many employee ownership models, a well-designed EOT can uniquely integrate different values to address the complexities of real-world organizations and allow for an evolution of these themes over time.

transfer of control

How do governing representatives (e.g. a board member) change?

broad-based election	mixed structure	unilateral appointment

voting

How are vote and election decisions made?

one worker, one vote	integrated decision framework	representative committees

benefit allocation

How are rewards and rights to participate distributed?

based on tenure	tiered or mixed rewards	based on results

organizational focus

How does the culture prioritize purposes, values, and direct worker benefit?

primarily focused on worker benefit	balanced focus	primarily focused on mission

risk tolerance

How are risk and stability valued within the company culture?

risk taking	risk neutral	preservation

Hierarchy

How is power shared?

concentrated at the top	multilateral or cyclic control structures	distributed (e.g. by division, expertise, etc.)

Clarifying Roles of the Trust, Board, Management, and Employees

When it comes to employee ownership there are many misconceptions about the different roles that exist in a company and how they are fulfilled. Conventional worker cooperatives often utilize non-traditional management and governance structures like a one-member one-vote model, although that is not always the case. An ESOP's role in company governance on the other hand often varies widely, ranging from completely delegating control to the board, to empowering a single trustee to vote for all employees, to deeply incorporating employee voice in decisions.

In all cases, these input structures vary greatly by industry, size, and culture. To add to potential confusion, EOTs, as perhaps the most flexible model in the market, include a large variety of methods for including employees in decision making and the economic success of the company.

That said, the roles played by different decision making and worker groups in an EOT are generally very similar to a mature owner-operated company. For example, management may be hired, evaluated, and incentivized in exactly the same manner as in an owner-operated company with incentives and evaluations tied to company performance. Similarly, employees may be recruited, hired, fired, and evaluated based on experience, performance, role fit, and other factors, even after becoming employee-owners of a trust.

Additionally, the company's board still acts as an operational governing body, overseeing major decisions, reviewing budgets, evaluating management performance, and supporting strategic initiatives. Many independent owner-operated companies don't utilize a developed board process, and these functions are fulfilled by the owner, family members, and/or trusted managers in much the same way.

However, there are a few key differences in certain roles when using an EOT that are important to note.

Addition of Employee Control and Benefit Structures

By definition, all employee ownership structures include employees at the highest level of decision-making and in the financial success of the company. There are many ways to include employees in these roles. The Employee role in decision-making can range from electing trust stewards and/or board members as representatives, to employees directly approving budgets and everything in between. Employees sharing in financial benefits can include profit-sharing programs, direct share ownership, bonuses, creative benefits programs, and more. Decisions about these programs are at the heart of designing a fit-for-purpose EOT structure.

Trust Stewardship Committee and Voting Control

The owner-operator role, which normally spans from management, to board control, to mission-protection, becomes a "Trust Stewardship Committee" (TSC) in an EOT. The TSC then operates as the ultimate "mission-driven" owner. In more direct-democratic structures, the TSC may simply be responsible for running employee elections for the board, while in more mixed structures that seek to incorporate additional stakeholders beyond workers, the TSC may include outside experts, representatives of the community, etc. A TSC also directs voting control without the need to sell shares.

The chart below outlines the roles of the TSC, board, management, and employees as they pertain to an EOT.

	Trust Stewardship Committee	**Operational Board of Directors**	**Management**	**Employees**
Authority	Highest level of oversight and control. Analogous to a group of owner-operators.	Main site of operational and performance oversight and control. Operates as a normal board does, within the scope of the trust agreement.	Reports to board on objectives, make suggestions on high-level matters. Operates as a normal management team does.	Participate in various structures for employee control as designated by the EOT.
Responsibilities	Oversees the board as representatives or delegates of the ownership group.	Hires and fires management, high-level approvals, fiduciary responsibility of the business, etc.	Runs the company day-to-day. Strategy development, planning, people management, resource deployment, etc.	Execute work in a given area of function.
Decision-making Scope	Decision-making, procedures and reporting structures as set by the trust agreement.	The company charter sets decision-making power and procedures. Can be removed by the TSC.	Decision-making is largely autonomous within the guidelines set by the board.	Variable, depends on employee control structure.

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Financing an EOT for Transition and Growth

Although all parts of the EOT process are vital for a company's successful transition and future, designing aligned financing structures and terms associated with the transition to employee ownership is especially crucial. Unlike other aspects of the transition that rely primarily on the owner's knowledge of their legacy and company's purpose, financing requires collaboration with entities beyond those who already have direct experience with the company.

Due to a long history of employee ownership in the US, financing for employee-owned businesses is not new, so finding financing to support an employee ownership transition is not impossible. However, most of today's financing structures either fall short of—or are simply incompatible with—the unique needs and nuances of employee ownership structures. A different kind of financing is often needed to take a company from employee-owned in legal form to actually realizing the multitude of benefits that come with employee ownership.

Together with Purpose Foundation, Common Trust set out to build the first fit-for-purpose financial product for EOT transitions and growth. This section is based on that work and shares learnings about how to create financial structures that go beyond the constraints of traditional debt and equity models, which often don't align with the practical, ethical, and strategic aspects of employee ownership.

Where Traditional Financing Falls Short for Employee Ownership

Many companies seeking a sale will do so through a combination of debt and equity. However, any business owner evaluating a sale through employee ownership can quickly spot that the investor liquidation models and risk management strategies utilized by traditional debt and equity providers are not well suited to finance a successful employee ownership transaction.

Private Equity

With ever-increasing pressure on equity providers for higher returns on shorter timelines, the traditional strategy of private equity investors rarely aligns with broad-based employee ownership. A typical private equity transaction would purchase a business through a combination of debt and equity, enact an aggressive, multi-year strategy to rapidly grow the business and increase share price, then sell the company to another party for a higher price for investors to make their return. As an appropriate financing strategy for employee ownership, this typical private equity model fails for two primary reasons: private equity typically requires both equity and control, and each of these come at the direct expense of the amount of shares or control that would be owned by employees.

While some PE firms are beginning to offer small amounts of economic ownership to employees as part of their transaction in large part to tap into the business flywheel effects that come with employee ownership, that will often fall well below the thirty percent that typically defines broad-based employee ownership. Furthermore, the form of ownership offered is typically shares, and particularly for low- and middle-wage workers, granting small amounts of share ownership that cannot be easily liquidated can at times be a mismatched tool of economic benefit and incentivization given the economic and cash flow realities of those workers. While profit-sharing may be the more effective method of economic benefit for these workers, it sits at odds with the management strategies employed by a PE firm, who would struggle to justify distributing cash to employees while also trying to grow share value within their time frames for a future sale.

Further to this, in addition to being constrained around being able to offer meaningful profit-sharing, in order to achieve the rapid share appreciation necessary for a future sale at a meaningfully higher multiple, a PE firm will often direct a company to pursue aggressive growth strategies. Frequently, these strategies focus on streamlining and cost-cutting, which are achieved by laying off significant numbers of employees, reducing R&D budgets, and cutting back on benefits programs and other strategies that are not in the long-term interest of the company.

Traditional Lending

Traditional debt from commercial banks has been and will remain an important component of most EOT transactions. However, structural aspects of traditional lending can often leave a capital gap that must be filled by more flexible, fit-for-purpose capital in order to achieve the goals sought through employee ownership. For instance:

- Traditional debt typically requires repayment quickly, often on a three to five year amortization schedule. As a result, when traditional debt comprises a large percentage of the capital stack, this rapid repayment schedule can have the unintended consequence of subordinating any meaningful employee distributions until several years into the future.
- Traditional lenders may require a personal guarantee, which over-allocates risk onto founder-owners as they are transitioning away from the business. While personal guarantees are generally not typical mid-market and above, for smaller businesses where this is required, this can often become an inhibiting factor to the transaction.

With that in mind, traditional lending from commercial banks can come with important benefits, such as low interest rates, so will continue to remain an important source of capital for a portion of the capital stack for EOT transactions. However, as discussed previously, strong incentive alignment is a core aspect of how and why employee owned companies outperform traditionally owned companies. Thus, it stands to reason that the capital financing a transition must be structured in such a way that employees themselves experience the benefits of employee ownership early on. If that incentive alignment is punted down the road, then the business benefits that come with employee ownership, namely greater employee retention and better long-term performance, are also delayed or put at risk.

For owners thinking through the types and sources of capital to use for their EOT transaction, traditional debt will likely play a role, but will often need to be balanced with other capital sources that can afford greater flexibility and that ensures that key aspects of employee ownership, such as employee profit-sharing, is not punted several years down the road.

Growth Capital

Some companies that can maintain significant debt on their books are able to transition to employee ownership by using debt to buy out the owners. However, because that debt is being used to buy out the shares of previous owners, it is often insufficient to meet any capital needs for the company to invest in growth. In these scenarios, the traditional equity model that might be stacked on top of a debt buy-out is incompatible with employee ownership for the same reasons that the traditional approach of private equity is: in order for equity investors to realize their return, they would need to both hold and sell those shares, thereby selling a portion of the business out of employee ownership.

EOTs need growth capital that is compatible with long-term operation and won't require a future sale that ends the employee ownership structure. This financing need is one that has not yet been adequately met by the financing landscape, but a meaningful opportunity to overcome the financing barriers that may prevent small businesses transitioning to EOTs.

Designing Aligned Financing for EOT Transitions

Recognizing the inherent barriers within the traditional capital landscape, at Common Trust we use financing structures and terms that not only meet the reality of EOT transactions, but also help set the flywheel effects of employee ownership into motion sooner.

To do this, our financing terms integrates the following key design principles that:

- Ensure healthy, serviceable levels of debt
- Enable employees to participate in the economic benefits associated with converting to employee ownership from the beginning
- Ensure existing employee benefits aren't reduced or wiped out
- Allow companies to take on growth capital that isn't dependent selling to another buyer in order for investors to get liquidity

These investment terms act as "impact guardrails" for the transaction, which help EOTs realize their full purpose and ensure that employee benefit and economic gain are not deferred until debts are fully paid off, while simultaneously acting as a risk management technique for the transaction's financiers.

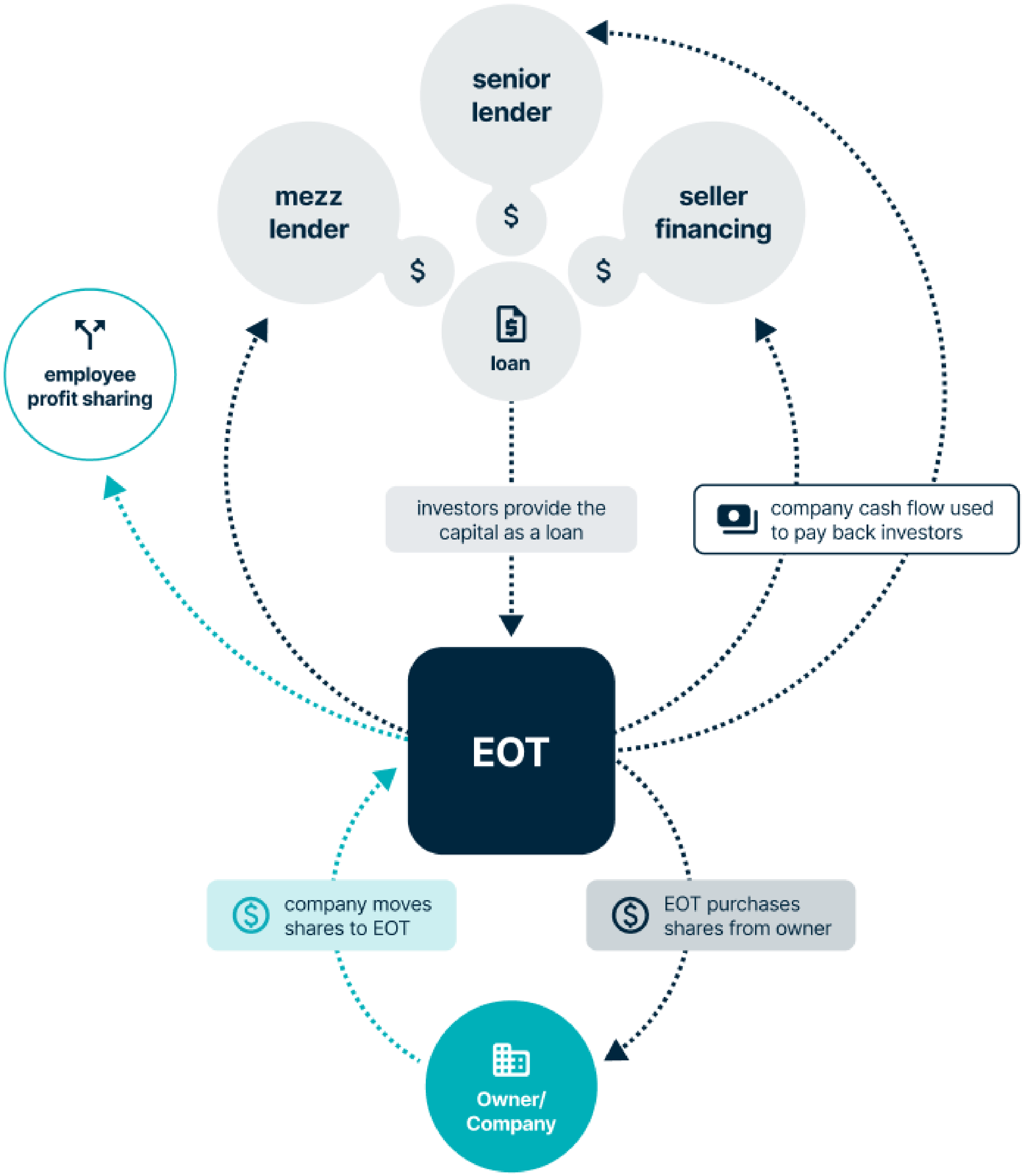
Growth financing will depend upon the unique financial profile of the company and long-term strategy, and therefore may take a variety of forms, including a structured exit, revenue-based financing, and redemption-based financing.

Sample EOT Capital Stack and Transaction

This approach ensures that:

- Investors are appropriately rewarded according to the risk they take on
- A baseline of employee benefits are realized immediately
- The path to investors making a return is not dependent upon a future sale of the business

As with any financing, the details of the investment terms are critical. In partnership with Purpose Foundation US, Common Trust has developed a unique profit waterfall structure that designs a company's mission directly into the economics of the deal, ensuring that all stakeholders benefit from the company's success, and that the capital stack supports employees and purpose alongside investors.



1. **Senior Lender, Mezzanine Lender and Seller Financing provide loan to EOT**
2. **EOT uses loan to purchase shares of the company from the owner, providing liquidity to the owner**
3. **Company shares move into the EOT**
4. **Company uses cash flow to pay back investors**
5. **EOT provides profit-sharing and other benefits to employees from company cash flow**

Concluding Thoughts

As discussed throughout this primer, EOTs build upon a longstanding history of employee ownership here in the US and beyond. However, they also represent a new and unique way for owners to transition to employee ownership, by bridging employee ownership with a form that is able to incorporate and protect the longstanding principles of steward ownership.

As interest in employee ownership rises, three key components are needed to galvanize these types of transitions:

- Access to information about available pathways to an exit through employee ownership for retiring owners seeking a sale
- Capital and financing instruments that are uniquely designed to support employee ownership trust transitions
- An ecosystem of support and shared learning for the growing number of employee ownership trusts

The rise in interest and the possibility for aligned financing for EOTs comes at a particularly critical juncture in the life of the US economy. On one hand, economic concentration has been rising in the US for the last several decades, the downsides of which are plainly evident in the lives of individual workers, in whole communities and in society at large. On the other hand, the US is about to undergo the most significant transition of economic ownership of small businesses in its history, with 60% of small business owners expected to seek a sale over the next decade. For many of these owners, employee ownership represents not just a viable option, but the most aligned option. For owners who want to pursue a succession strategy that protects their business, purpose, and people, EOTs provide a compelling new legal mechanism to do just that.

Written in partnership between Common Trust and Purpose Foundation.

About Common Trust

Common Trust is how small business owners exit to employees. We offer a streamlined process to exit via employee ownership trust, provide aligned debt and growth capital to finance the transaction, and equip the future generation of leadership to steward the company's growth for the long haul. Together, we are working to secure the future of great American businesses in every region and sector.

About Purpose Foundation

Purpose Foundation helps businesses and communities build equitable ownership, governance, and financing models. We are accelerating the transition to a shared-ownership economy by making new models replicable, accessible and visible. We support leaders across the US, educate capital providers, and push the field forward with legal innovations and research.

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