THE SECOND GENERATION OF GOOD

AN OVERVIEW OF OWNERSHIP TRANSITION STRATEGIES FOR SOCIAL ENTERPRISES

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WHY IS TRANSITION PLANNING IMPORTANT?

Mature, established social enterprises are critical to the growth and development of the field. With a proven business model and a history of impact, these organizations have the potential to scale and serve as an example for future value-driven companies.

However, a lack of transition planning can threaten their continued success. What happens when the leadership is ready to move on or early investors want liquidity? Without proper transition planning, many will not survive or will make hasty decisions that are not in the best interest of the company, its shareholders or other stakeholders.

In the social enterprise sector, a successful ownership transition respects the organization's values and the interests of all its stakeholders. Below is an overview of transition strategies that can achieve these goals, including various forms of employee ownership, foundation or family control through dual-class share structures, community-owned organizations, and selling to impact investors. This article also discusses how becoming a benefit corporation can help position companies to continue to serve their social mission through a transition. The best approach for a given company depends on the goals of the selling owners and the organizational mission and values.

OWNERSHIP TRANSITION STRATEGIES

EMPLOYEE STOCK OWNERSHIP PLANS

An employee stock ownership plan, or ESOP, is a tax-advantaged way for selling owners to transfer their shares to a trust held on behalf of employees. In general, ESOPs are funded by the company through a loan; employees pay nothing for their ownership stake.

Congress incentivizes the use of ESOPs in order to encourage broad-based employee ownership in the U.S. The federal incentives include significant federal tax benefits for the company, selling owners, and employees. For example, S corporation ESOPs that are 100% employee-owned through an ESOP pay no corporate taxes.

While ESOP companies are owned by employees, they are not required to have a democratic governance structure. Most ESOP companies have a traditional board of directors and do not provide full voting rights to participants. Instead, a trustee is responsible for voting the shares on most issues, while employee participants vote on issues such as the sale of all major assets or liquidation. Some ESOPs provide full pass-through voting rights, however. Additionally, many ESOP companies build a culture where employees are encouraged to participate in decision making and to "think and act like owners."

The federal tax incentives and flexibility to operate as a more traditional business make this ownership transition model popular for a wide range of businesses. There are currently over 10,000 ESOP companies covering approximately 13 million employees nationwide, including many socially-conscious companies, such as New Belgium Brewing Company, a certified B Corporation. The National Center for Employee Ownership recently released infographics on how ESOPs work, the history of ESOPs, and their benefits, available at http://www.esopinfo.org.

OTHER TYPES OF EMPLOYEE TRUSTS

There is a variety of trust-based employee ownership models used in countries throughout the world. The most recognizable example is the John Lewis Partnership, a leading UK retail store that has over 80,000 co-owners (or Partners, as the company refers to them). The trust is held for the benefit of all Partners; individual employees are not allocated shares. Instead, each employee receives dividends based on the company's overall performance, relative to salary. With regard to its governance structure, the Partnership has a constitution that designed it to be "both commercial - allowing the company to move quickly and maintain a leading position in a competitive industry, and democratic - giving every Partner a voice in the business they co-own." For more information about the John Lewis Partnership, visit their website: www.johnlewispartnership.co.uk.

In addition to the UK, many nations have legislation supporting broad-based employee ownership, including South Africa, Ireland, New Zealand and others. There is an article on laws supporting employee ownership throughout the world, available at www.nceo.org/articles/employee-ownership-laws-outside-us/

OWNERSHIP TRANSITION STRATEGIES (CONTINUED)

SELLING DIRECTLY TO EMPLOYEES

There are ways to transfer ownership to employees without using a trust, as well. Companies can sell directly to management or all employees. These sales have obstacles: they are not tax-advantaged and can be difficult to fund. Often, the seller will finance the sale or donate the company because traditional bank loans are not available and the employees do not have the capital to purchase the shares. However, selling directly to employees has benefits as well. One advantage is that direct ownership by employees gives the company more flexibility to choose its governance structure.

DUAL-CLASS SHARE STRUCTURES

Both publicly traded and private companies have used dual-class share structures to maintain the values of an organization while raising capital from outside investors for, among other things, providing liquidity for retiring owners. These organizations generally create "super shares" that have increased voting rights compared to stock available to investors. The "super shares" can be held by the founder(s), employees, the family, or another group charged with maintaining the company's mission. This structure also allows a foundation to hold a controlling interest in a company without violating IRS regulations that prevent foundations from holding more than 20% of the voting shares at a private company.

A number of newspapers, including the New York Times, have used a dual-class share structure to receive investment while maintaining independence. Novo Nordisk, a world leader in diabetes care headquartered in Denmark, is foundation controlled using a dual-class structure to preserve the company's values, which they have dubbed "the Novo Nordisk Way." Private company cooperatives, such as Equal Exchange, have also used this structure, providing non-voting shares to outside investors in order to receive funding while maintaining a democratic governance model.

SELLING TO IMPACT INVESTORS

Impact investment is a growing field that places capital with the intent of creating measurable social impact as well as financial returns. The community of investors that fall in this category is diverse, including angel investors, private foundations, banks, pension funds, development finance institutions, as well as impact investment intermediary funds.

Investors in this field vary in their goals. Some seek investments that address specific social or environmental issues, such as global health. Others are broader in their scope. Some seek market returns on their investments, others allow for below market returns based on the impact. Some require standardized impact measurement and reporting. Others do not.

For social enterprise owners seeking liquidity, impact investors provide an impact-oriented private equity market. Often, impact investors provide greater flexibility in governance and management structure than traditional private equity firms.

COMMUNITY-OWNED ORGANIZATIONS

There are a number of examples where community members, consisting of individuals and/or local businesses, band together to keep a company in business when it was struggling or the owner was leaving without any prospect of selling. The governance structures for these community-owned organizations vary, ranging from more traditional models to cooperatives. One example of this is Clare City Bakery in Clare, Michigan. After being in existence for over 100 years, the bakery was at risk of immediate closure. The town's police force, consisting of nine officers, each contributed personal funds to jointly purchase the shop, which they renamed "Cops & Donuts." The bakery is now a thriving business. For more on Cops & Donuts, visit their website at www.copsdoughnuts.com/.

CONVERTING TO A NONPROFIT

Unlike traditional businesses, social enterprises pursue a social purpose. In some cases, the organization's mission will meet the criteria for operating as a 501(c)(3) nonprofit. This option will allow the organization to continue to serve its social purpose without concern about future ownership transitions. However, if one or more owners want to sell their shares, this is not a viable option.

HOW DO BENEFIT CORPORATIONS FIT IN?

The benefit corporation is a new corporate form that has been adopted in a number of states. This new class of corporation 1) creates a material positive impact on society and the environment; 2) expands fiduciary duty to require consideration of non-financial interests when making decisions; and 3) reports on its overall social and environmental performance using recognized third party standards.

Unlike the options above, it is not a way to structure a sale. Instead, it allows business leaders and investors freedom to make decisions that are in the best interests of society as well as their bottom line.

For companies that want to remain private and independent, benefit corporation status can provide fiduciaries protection from being acquired by a buyer that would comprimise the organization's values. For companies interested in being acquired or going public, this corporate form can position the company to continue to serve its social purpose through the sale, and inform potential investors or buyers about the company's committment to its social mission. To learn more, visit: http://www.benefitcorp.net/.

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