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Private Equity and Employee Ownership

NCEO

NATIONAL CENTER FOR
EMPLOYEE OWNERSHIP



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Introduction



1. INTRODUCTION

In the last several years, there has been a growing movement for private equity firms to create broad-based employee ownership programs in their transactions. This trend has gained national attention, with stories on [60 Minutes](#), [Freakonomics](#), the [New York Times](#), and many other news outlets.

While there have been instances of private equity firms investing in employee stock ownership plan (ESOP) transactions going back to the 1980s, this has always been a narrow market. A small number of companies have had a particular focus on ESOP transactions, often where the ESOP buys 100% of the company. Those firms include, most notably, Mosaic, Long Point Capital, American Working Capital, Menke, and Apis & Heritage Capital Partners. (See section 5.) Some larger private equity firms in the 1980s also provided capital for ESOP transactions where the ESOP bought either all of the company or a substantial part of it. But collectively, these investments amounted to a small fraction of 1% of total private equity investments.

The trend toward private equity firms looking to share ownership with employees started about 14 years ago when Pete Stavros, now the co-head of global private equity at private equity giant KKR, began to share ownership with the employees of companies that KKR purchased. Deals typically involve employees receiving equity that could be worth about 6 to 12 months of pay when KKR ultimately sells the companies several years later. Stavros has become an evangelist for the idea, advocating among his partners at KKR that this was a good idea and should be used commonly in their transactions. In 2021, he founded Ownership Works, a nonprofit organization designed to advance employee ownership across corporate America. The organization brings together 33 private equity firms that have committed to experimenting with employee ownership in their portfolio companies, drawing on the model that Stavros developed at KKR. In addition to private equity firms, Ownership Works has built a broad base of supporters that includes financial

institutions, public companies, labor advocates, and foundations. Its purpose is to promote employee ownership models and provide resources and educational material for companies to share equity participation with all employees. As of this writing (October 2024), according to Ownership Works, 113 companies with over 163,000 employees have used this model and have delivered \$570 million in equity to employees who have been able to cash out their shares when the private equity firm either sold the company or the company went public.

The private equity model joins several other approaches to broad-based employee ownership in the U.S. Almost half of public companies offer employee stock purchase plans (ESPPs), for instance. These plans allow employees to put aside pay over a period of 6 to 12 months to buy shares. Most plans allow employees to buy the shares at a discount of up to 15%, commonly using a “look-back” feature in which the discount is taken from the lower of the price at the beginning or the end of the offering period. Shares can generally be sold right after they are purchased to lock in the discount. Despite this no-lose proposition, only about a third of employees who are offered participation in an ESPP participate. Some companies, mostly in technology-related fields, also offer all employees stock options or restricted stock grants, including some of the U.S.’s largest technology firms, such as Alphabet, Microsoft, and Cisco (but also a few non-technology firms, such as Starbucks). There are no good data on just how many people participate in ESPPs or broad-based stock grant programs, but probably several million people participate in ESPPs, and perhaps two million receive broad-based stock grants.

The most common form of employee ownership in the U.S., however, is the employee stock ownership plan (ESOP). Some 10.7 million current employees participate in these plans, plus another 4 million former employees whose accounts have not yet fully been paid out but will be. A total of 5,866

privately held companies and 456 public companies sponsor ESOPs. Most private company ESOPs own or eventually will own 100% of the stock. Public company ESOPs tend to own well under 10% of the stock. Employee account balances in both public and private company ESOPs average about \$140,000. These averages are deceptive because they include both employees who have been in the plan for just a short time and very senior employees. Employees with longer tenure tend to have substantially higher average account balances.

ESOPs are governed by the same laws as 401(k), profit sharing, and pension plans (the Employee Retirement Income Security Act [ERISA] and the Internal Revenue Code). They are almost always entirely funded by the company, either through contributions of shares or, more commonly, cash contributions to purchase shares from existing owners. ESOPs can borrow money to buy blocks of shares or even the entire company, with the company repaying the loan. Congress has provided ESOPs with significant tax benefits, including that contributions to the plan are tax-deductible, that employees do not pay tax until after they receive a distribution, that sellers can defer capital gains taxes on the sale of stock in closely held C corporations where the ESOP owns 30% or more of the shares after the sale, and that S corporations with an ESOP do not have to pay income tax on the percentage of profits attributable to the ESOP. ESOPs in closely held companies are used primarily as a highly tax-favored vehicle for business transition.

The appendix to this paper provides a more detailed look at how ESOPs and other employee ownership plans work.

Comparing the financial benefits of private equity deals to ESOPs involves a lot of variables. The Ownership Works deals have a more common pattern in terms of the expected size of benefits; ESOPs are a great deal more varied. The large majority of private equity deals provide ownership to employees through restricted stock, stock appreciation rights (SARs) or other synthetic equity, or some variation of these approaches. The private equity model typically provides grants directly to individuals or to equity participation pools, and grants usually can be

cashied in only when the company is sold or goes public. By contrast, ESOPs hold shares in a trust for employees, who can cash out the shares after they leave the company, whether the company is sold or not. Because ESOPs are qualified retirement plans, however, if employees get a distribution before retirement age, they must either roll the funds into an IRA (or other qualified plan) or pay both income tax and a 10% penalty tax.

Private equity transactions provide ownership to employees over a limited time period, typically 4 to 6 years. ESOP companies, in contrast, often operate these plans for decades. In successful private equity deals, employees may accumulate equity value equal to 6 to 12 months of pay over a 4-to-6-year time frame, or about 15% of their annual pay each year the plan is in place, although, as noted below, some of the deals are more modest than this. ESOP companies typically contribute an amount equal to 6% to 8% of annual pay to the plan, although many successful ESOP companies contribute a great deal more, often 10% to 25% of pay. These contributions continue for as long as the employee is with the company (potentially for several decades). The sustained nature of ESOP contributions, coupled with the opportunity for the ESOP company's equity to appreciate over an extended time frame (which itself is bolstered by notable tax benefits available to ESOP companies), can result in significant wealth creation for employees. Over 10 years, this may typically equate to 12 months of pay (i.e., in line with what private equity deals can deliver in 4 to 6 years), but over 20 or 30 years, this offers an opportunity to earn significantly more. These numbers will look very different from one company to another, however, because benefit levels at ESOP companies are more variable than in private equity deals.

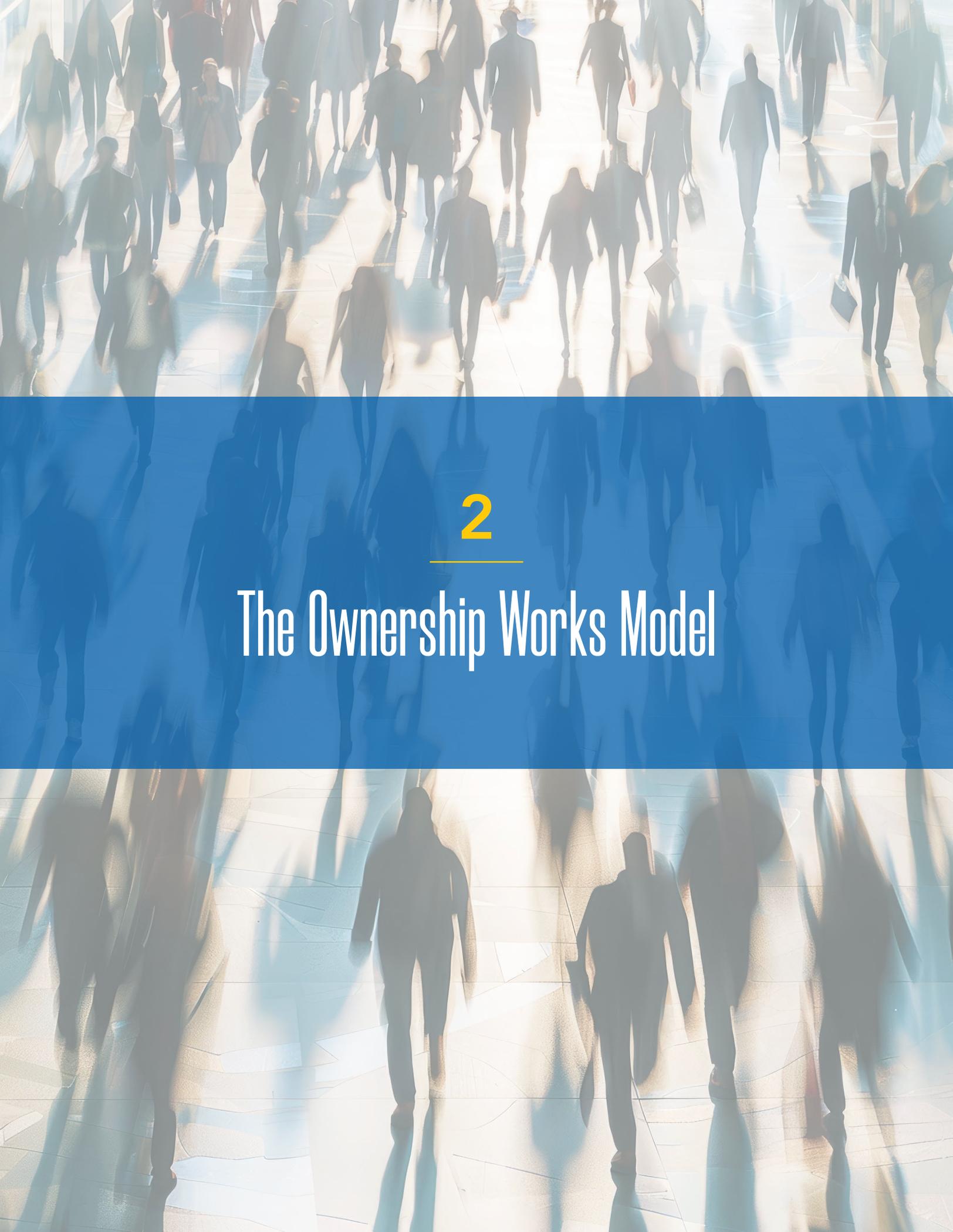
In the most optimistic scenario, if Ownership Works realizes its vision of normalizing employee ownership in private equity deals and more broadly across corporate America, employees could receive successive payouts as companies with shared ownership change hands and new owners relaunch broad-based equity programs. There are already a few examples of this happening, in which a private equity firm selling a company with an Ownership

Works program negotiates with the new buyer to relaunch the equity program after the acquisition. For now, however, most deals do not result in a new equity program.

In addition to the Ownership Works model, Teamshares, another investor-backed firm, has created a different model for employee ownership in which it purchases smaller companies and provides a share of ownership to employees. Over time, the company buys back most of Teamshares' stock and retires the shares, thus increasing the percentage of the company held by employees. There is also a small but growing movement of impact investment funds that seek to invest in ESOP transactions and worker cooperatives. Lastly, there is also a growing field of private equity firms specializing in ESOP transactions, including some with promising new ideas that could help this part of the field grow.

This paper looks at the trends and history of private equity and employee ownership. It begins by exploring the Ownership Works model, moves on to the different private equity model used by Teamshares, looks briefly at the impact investment community and employee ownership, and concludes with a more detailed look at both the history and the potential for private equity in ESOP transactions.

This paper is meant to describe what is going on rather than make judgments about which model is best. Much of that assessment is philosophical, but it is also too early in the development of private equity and employee ownership to be able to make any confident empirical assessments of its impact. This paper does, however, look at the potential pros and cons of each model as well as the critique of private equity and employee ownership by some people with concerns about these developments.



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The Ownership Works Model

2. THE OWNERSHIP WORKS MODEL

In a 2024 [TED Talk](#), Pete Stavros told the audience that his first job as an investment banker was overseeing wire transfers at a company that had been sold to ensure all the investors got their stock. “So I wondered,” he said, “what if everyone in a company had stock ownership, not just to the assistant treasurer level, but to the factory floor, distribution centers? How might employees’ lives be impacted, and how might the company and, in fact, the whole community be impacted? Only a tiny percentage of workers are granted stock ownership in their companies, and most workers have no wealth, and it is in fact stock ownership or the lack of it that is by a mile the biggest driver of wealth inequality.”

The idea was fresh in Stavros’s mind because he’d written his thesis for his MBA at Harvard Business School on the topic of private equity and employee ownership. He had become convinced that employee ownership was the single most important business intervention that could help companies, employees, investors, and communities all be better off. “Most employees feel their opinions don’t count,” he said at TED. “If you look at Gallup surveys, 77% of employees globally are disengaged on the job. Eighteen percent literally hate the company that they work for. They’re throwing the wrenches in the machines.” Employee ownership, he said, “could give us a form of capitalism that is actually inclusive and sustainable. And I believe it could literally change the economy.”

Stavros is now the co-head of global equity for the private equity firm KKR, the largest private equity investor in the world. Over 10 years ago, he conceived of and spearheaded KKR’s practice of providing an equity stake to all employees in the companies KKR’s industrial division was buying. In 2013, for instance, KKR acquired Gardner Denver, a Milwaukee-based manufacturer of pumps and flow-control equipment. Four years later, when KKR

took the company public, all 6,000 employees were awarded stock worth \$100 million at the time. In 2020, Gardner Denver merged with old-line manufacturer Ingersoll Rand, taking the latter’s name; all 16,000 employees received another \$150 million worth of shares. With the stock market rising—and with the company’s stock outpacing the market—the two batches of stock together were worth about \$500 million.

While KKR was experiencing notable success with its ownership programs, Stavros told us at the NCEO that it was not always an easy sell to convince others, with many public companies and other private equity firms reacting skeptically. After all, the prevailing wisdom was and, to a large extent, still is that ownership should be reserved for those with the most direct line of sight between what they do and the stock price. Ordinary workers, this view argues, won’t care much about stock and, in any event, won’t be able to do much about the stock price. Stavros’s graduate school research on this showed that, in fact, employee ownership could make a dramatic difference in company performance, especially when paired with a high-involvement employee management system.

Over time, Stavros was able to prove this performance improvement potential within KKR’s industrial division, such that KKR ultimately expanded the practice across all new control-oriented private equity transactions in the U.S. (and also in some international markets) and has implemented nearly 60 programs as of this writing in October 2024. In 2021, Stavros spearheaded the creation of the nonprofit Ownership Works, which is enlisting other private equity firms to share ownership within their portfolio companies. The goal is to grow the number of firms using the model (currently standing at 33) exponentially. Some of the companies, such as C.H.I. Overhead Doors, have already been sold, with hourly workers cashing in shares worth an average

Anna-Lisa Miller of Ownership Works and Kevin Murphy of KKR provided very useful feedback on this section.

of \$175,000 per person. The model contrasts with traditional private equity deals in which employees get nothing.

The program works by targeting an equity pool that, on average, equals 6 to 12 months of pay for the workforce envisioned to be in place when the private equity firms exit from the investment. In other words, a company might start with 500 employees and end up with 600 employees, and the target goal would be based on an equity pool to be divided among those 600 people that would equal at least six months' pay on average (and typically targeting a higher amount). Some companies have a formula under which everyone shares the same amount regardless of tenure at exit, while others have formulas that give credit for greater tenure. Some companies use more equal distributions of equity among employees, and some create more tiers between different levels of employees, although the goal is always to distribute equity broadly. It is important to note that there is variation from one firm to another in the formula used for allocating equity aside from the total pool available.

One of the challenges is that in some industries, such as retail and food, for instance, that target of at least six months' pay per employee ends up being as much as 20% of the total value of the firm at exit. In other industries, in contrast, that number could be a low-to-mid single-digit percentage, a number that the private equity firms that they've discussed this model with find more comfortable. Ownership Works also supports companies in preparing for and creating ownership cultures to go along with this model and has developed a survey tool to help companies assess their progress toward employees feeling, thinking, and acting like owners. Some private equity firms do not get very involved in the companies they purchase, so it would be up to management to decide whether to create these programs. In contrast, firms such as KKR tend to be much more involved in company operations and decisions about things like workforce culture.

Anna-Lisa Miller, executive director of Ownership Works, provided the following more detailed outline of the typical Ownership Works models:

Pool Plan

- A pool of synthetic equity is set aside and distributed to employees at a liquidity event (i.e., the sale of the company).
- The size of the pool is determined by modeling the future composition of the workforce (e.g., headcount, salary, and tenure) and target payout amounts for each employee (e.g., "an average of six months of salary per employee").
- Target payout amounts for individual employees are typically determined by an employee's annual pay, tenure, and sometimes employee type (e.g., salaried vs. hourly).
- Employees must be employed at the company at the time of distribution to receive a payout.
- Payouts are taxed as ordinary income for employees.

Individual Grant Plan

- Employees receive individual grants of restricted units (most often RSUs; sometimes SARs).
- Ownership Works generally recommends cliff vesting at exit to avoid adverse tax consequences for employees and minimize complexity for companies, thereby increasing the likelihood of adoption. Whether grants should be one-time only or recurring depends on the company's context (e.g., recurring might be more appropriate in a high-turnover workforce to incentivize retention or if the company is public or close to IPO).
- Individual grant allocations are typically determined by an employee's annual pay, tenure, and sometimes employee type (e.g., salaried vs. hourly).
- Grants are taxed as ordinary income for employees.

In addition to KKR, 32 other private equity firms are experimenting with Ownership Works' models of broad equity participation. Building Industry Partners, for instance, has adopted the model for

all of its deals going forward. Its model is discussed in more detail below. Blackstone, which, along with KKR, is one of the largest private equity firms in the world, also recently agreed to share equity with all employees in its purchases. Joseph Baratta, the firm's global head of private equity, [told](#) The Wall Street Journal it will adopt broad-based employee ownership as part of its U.S. buyout strategy. "In what we're trying to do across our portfolio, broad-based equity ownership is just a part of a much more important path." Copeland, the former global climate tech unit of St. Louis-based manufacturer Emerson with 18,000 employees, is the first such deal, but Blackstone has not made available the details of the equity formula it will be using.

Case Studies

Gardner Denver¹

The best-documented case study of the Ownership Works model is Gardner Denver (now part of Ingersoll Rand), a maker of industrial products such as pumps and compressors used by the oil and gas industry, healthcare, and other industries. KKR bought the company in 2013 and granted equity to a large number of management employees. The company was struggling at the time KKR bought it, and Stavros was reluctant to initiate a broad-based equity program when the company was facing market turbulence and management turnover. The company became steadily profitable after a few years and went public in 2017. Some \$100 million in equity rights was granted to employees (an average of about 40% of one year's pay per person). Board members were split on the idea of granting so much equity, raising concerns about dilution, whether employees would just sell the shares at the IPO, and the complexities of granting equity to employees in countries outside the U.S., some of which had rules that made these grants difficult. In the end, the equity was granted, and

the company's post-IPO performance eased these concerns. In 2020, the company merged with the industrial segment of Ingersoll-Rand plc to form the company Ingersoll Rand, and another \$150 million in equity was granted to the combined worldwide workforce of 16,000.

At the time of Gardner Denver's IPO in 2017, a Gallup engagement survey of employees found low levels of engagement. To address this, KKR and management at the company created a communication program to help employees understand how the grants worked. They also embarked on a program to teach the company's 6,000 employees how the business works, discussing such issues as cash flow and net working capital. An innovation training program was implemented throughout the company, company town hall meetings were started, and employees were given forums to raise questions and ideas.

Vicente Reynal, who became CEO in 2016, told the Sloan Management Review,² "We wanted to bring a single culture and ownership mindset to the new company, so we gave equity to the entire employee base." When the company merged with Ingersoll-Rand and all employees were granted equity, there were new challenges in melding the cultures and dealing with the economic problems of the pandemic. Reynal told the MIT Sloan Management Review, "We wanted every employee to understand how cash conversion cycles work, in very simple terms. When we buy excess inventory, we have to financially account for it, which impacts our cash flow. So we gave them a tool to ensure they buy inventory at the right time and the right size and trained them on kanban systems and how to do proper procurement of the material. For the engineering team, we coached them on VAVE—value analysis and value engineering—which is a way to deconstruct a product and rebuild it in a more efficient way."

A key performance indicator (KPI) system was created to link company objectives to daily, weekly, monthly, quarterly, and annual targets at each facil-

1. This section draws heavily on a case study for the Yale School of Management: James Quinn, Adam Blumenthal, and Jaan Elias, "Gardner Denver: Implementing an Employee Equity Plan," *Yale Case 20-039*, September 15, 2020.

2. Vincent Raynal, "Why You Should Give Employees Skin in the Game," *MIT Sloan Management Review* 65, no. 3 (spring 2024).

ity. The program provides employees with metrics on critical performance numbers and provides opportunities for employee input into how to improve them. As a result of all these changes, engagement went from the bottom 20th percentile to the top 90th percentile. Enterprise value at the combined company since 2016 has grown by 800%.

C.H.I. Overhead Doors

C.H.I., based in Arthur, Illinois, is a garage door manufacturing company that serves residential and commercial end markets. It has about 800 employees. KKR bought the company in 2015 and sold it in 2022. Ownership Works has frequently used C.H.I. as the poster-child example of its model, generating considerable press coverage, including a 2024 [60 Minutes story](#). It has produced the most impressive results so far for the model, with an average per-employee payout of about \$175,000 and truck drivers who were with the company for three years or more getting \$1 million. The equity was granted in the form of SARs. Brad Edwards, an employee at C.H.I., told 60 Minutes that the payout from the sale of C.H.I. was “life-changing . . . and not just for us, for our kids, too. Our kids don’t have to worry about us being stressed out about money.”

Part of the success, Stavros believes, was that KKR and the C.H.I. leadership set up a new employee involvement program, including monthly owner meetings to go over current issues, quarterly meetings to update all employees on how the company was doing, and empowering the employees with decision-making responsibilities (e.g., giving them a say in where to allocate the capital expenditure budget). These steps (even if modest compared to best-in-class ESOP programs in place for several decades) led many C.H.I. employees to feel that their voices could be heard when they made suggestions about improving operations, and engagement, as measured by surveys, improved by 20%.

Charter Next Generation

Charter Next Generation is one of the largest manufacturers of film for wrapping food products. It has

2,100 employees worldwide. KKR and the private equity firm Leonard Green bought the company in 2021. The equity model here is different from the other KKR deals that were based on SARs. At CNG, all employees receive restricted stock grants.

As with the other Ownership Works deals, a system of employee engagement was initiated with the grants. This includes regular CEO roundtables with workers across all sites, small focus groups, an employee engagement steering committee, monthly engagement councils, KPI scorecards, and employee-directed charitable and workplace improvement programs. Although it is early in the program, engagement scores are up 23%, voluntary turnover is down 23%, and the gross margin is up 12%.

Building Industry Partners³

Building Industry Partners (BIP) presents a very different scenario from most private equity firms operating with the Ownership Works model. While these firms tend to concentrate on high-value and/or larger companies, particularly in manufacturing, BIP is focused on smaller companies in the broader building industry materials sector. When BIP buys a company, it grants SARs to all full-time employees and makes other investments to improve employee benefits. Given the nature of the companies BIP buys, significant effort is also required to evolve (and sometimes establish) the HR function to enable the administration of these investments in employees.

BIP invests in employees because it believes that robust human capital management can better attract, retain, and develop exceptional leadership talent and produce functional excellence throughout its portfolio companies. BIP intends to create a strategic advantage in an industry that is labor-intensive and has longstanding labor shortages by aligning interests with the workforce to generate returns for all stakeholder groups.

BIP has three different companies with active, broad-based employee equity. Each of these three

3. Much of the material in this section draws on and interview with Mai-Tal Kennedy, a BIP director, conducted on August 19, 2024.

companies now employ a few to several hundred people, dispersed across multiple locations and states. Acquired companies vary in size, from as small as 20 employees or so for an add-on acquisition to as many as 200 employees for an inaugural acquisition. Mai-Tal Kennedy, a BIP director, told the NCEO that the highly dispersed employee population raises challenges in setting up the kinds of communications and employee involvement programs that have typified many Ownership Works transactions. The relevant BIP portfolio includes:

- **North American Specialty Laminations** provides differentiated lamination, fabrication, and finishing solutions to the building products industry. It has four locations across three states, having grown through acquisitions and opening new facilities since 2021.
- **Endeavor Fire Protection** provides inspection, maintenance, repair, and installation of portable fire extinguishers, fire sprinklers, fire alarms, emergency lighting, and plumbing systems. It has completed four acquisitions since 2022.
- **Southeast Building Supply Interests (SBSI)** is a lumber and building materials distributor with 11 locations across five states in the Southeast. One of the companies acquired by SBSI, Haywood Builders Supply, had been 100% ESOP-owned.

Kennedy said when they bought SBSI, they had to decide whether the equity stake would be in the individual operations of the platform or in the larger platform itself. “Did it make sense for a forklift operator loading lumber onto the back of delivery trucks at one location to have a meaningfully bigger payout than someone doing the exact same job at another location? We spent almost a full year discussing it with the leadership team and came to the conclusion that we want all the locations to collaborate and partner and be bought into the company that’s being built.”

At North American Specialty Laminations, equity is also all at the platform level. The company planned to operate with strong centralized services right

from the start. In contrast, Endeavor Fire Protection is “decentralized, with little shared infrastructure across Endeavor’s operating companies. As a result, each Endeavor operating company has its own pool of equity value creation,” Kennedy stated. The typical equity arrangement is that all full-time employees receive a SAR grant after 90 days of employment. New employees who come on in subsequent years get lesser amounts. Grants are fully vested but can be exercised only upon a change in control. If someone leaves before a liquidity event, their grants are forfeited.

While specifics vary by company, generally, there are two or three bands in a company. Employees in the top band would get more than the middle, and employees in the middle would get more than those in the bottom band. For instance, it might be that the top band gets two times as much as the bottom band, but this varies by company. The target is for frontline employees to end up with about three to four months’ pay after redeeming the value of their SARs at the time of the liquidity event. The acquisitions have all been very recent, so it is too early to say exactly how employees will fare.

One of the most important interventions BIP has done in these acquisitions is to improve the companies’ human resource management and systems, including building research into its work program to test the impact of different interventions. In 2023, BIP partnered with Nandini Thogarapalli, a graduate of the Harvard Kennedy School of Government, to study the effect of BIP’s investments on the employees of Buettner Brothers Lumber Company, one of the SBSI companies. The study estimated that BIP’s investments would increase average annual employee compensation by approximately \$7,000, of which SARs would be responsible for 40%. The company also significantly increased its 401(k) match and more than doubled participation in its health insurance. One impact of these investments was that in the second year after the acquisition, net promoter scores at this location grew 34%. Additionally, this study estimated that frontline employees of the former 100% ESOP-owned company would be no worse off in total compensation than before, and in fact fare slightly better.

BIP has also made an effort to train managers and leaders on how to communicate about the equity plan and the company itself. Kennedy said it's fair to say that there was a great deal of optimism about the program but that the effort required to implement robust alignment of interests was underestimated. BIP has learned a lot about when a business does and doesn't have the foundations in place to maximize the benefits of broad-based employee equity and also about the necessary enablers for building a reinforcing culture around it.

The research on employee ownership makes it very clear that the process is more complicated than structuring a plan and awarding equity. Employees need to feel that the change in ownership structure is accompanied by a change in the way day-to-day management occurs. This includes a variety of the kinds of programs described in the Ownership Works model, as well as leading practices in ESOP companies, where companies share a substantial amount of business information with employees and provide them with more structured opportuni-

ties for day-to-day input and decisions about how their work is done.

One of BIP's tasks at these companies is to help local leaders learn effective ways to implement these practices, given the disparate workforces and business models of each company. They know that what works for one company might not work for another. The best of these companies spend a lot of time on training. The leaders hold all-hands meetings plus management meetings at the local level, sharing financial performance and business goals, and they take steps to get employees more involved in day-to-day decisions. For instance, at one company, the CEO met with drivers as part of a routine discussion about the SAR program, and as the conversation turned to possible challenges ahead of the company, the CEO was surprised and pleased to hear how many solvable problems the drivers identified. However, the uptake of this approach has not been uniform, and not every BIP company is at that stage yet.



3

Teamshares

3. TEAMSHARES

Teamshares was established in 2019 and is backed by venture capital investors. Their goal is to create 10,000 employee-owned businesses and create \$10 billion of employee-owned company stock. As of July 2024, they had purchased 84 companies with about 2,100 employees. Most of their businesses have between 20 and 80 employees, but a few are larger or smaller. Teamshares is buying companies across industries, including in retail and service. Teamshares initially grants 10% of the ownership to all employees; over time, the percentage of employee ownership increases gradually, with a goal of 80% employee ownership within 20 years. Teamshares hires the presidents for its companies, and some may serve as the president of multiple Teamshares companies. As of 2023, Teamshares had received \$245 million in capital investment.

Over time, the company buys back shares from Teamshares. The shares held by the employees represent a growing percentage of total equity, eventually growing to 80%. People employed at the time of purchase get restricted shares that can be purchased by the company after they leave employment. Shares are subject to a four-year vesting requirement. New employees are provided shares upon joining the company, subject to the same vesting period and shareholder agreement as incumbent employees.

The Teamshares model rests on both getting a return on investment from the company's repurchase of shares from Teamshares and receiving dividends proportionate to its ownership stake in the company.

In addition, Teamshares provides its companies with proprietary shared services and products that help with company operations and growth at a reduced cost. One example is health insurance provided through a common pool. Many employees in the companies Teamshares buys do not have health insurance through their employer, says Michael Brown, a Teamshares cofounder. The company of-

fers banking and credit cards as well. Other shared services could include HR, payroll, software, and other services. The companies pay Teamshares for these services but save money by doing so. These services and products also include ongoing financial and education software and training for employee-owners, as well as training the presidents to run employee-owned companies successfully.

Some examples of Teamshares network companies include:

- Brad's Service Center is an auto service business in Chicopee, Massachusetts, purchased by Teamshares in 2021. Peyton Leveillee, the son of the founder of Brad's Service Center, said in an article on Teamshares' website that "to this day, over 90% of the customers from the business are residents of the same town where the company is located. The business was a labor of love for my father, who grew it from a single automobile bay with one employee to a 20-bay operation with 15 employees. Unfortunately, my father passed away during the pandemic. Like many business owners, he was focused on building the business and taking care of his employees; he didn't have the time to think about small business succession. . . . The president who stepped into my business [from Teamshares] had a generalist background like me. I'm excited to say that during my last visit the employees told me 'it has not wrecked the vibe at all' and that 'everyone has realized that efficiency is what's going to make us more profitable.'"
- Don & Millie's is a fast-food restaurant chain in Nebraska. "Don & Millie's is a substantial employer," Kevin Ames, president of Don & Millie's told KMTV in 2024. "We have well over 200 employees here. Had Don & Millie's not been successful in finding a buyer. . . . that would be 200 plus team members that potentially could

Madhuri Komareddi of Teamshares provided helpful feedback on this section.

have been out of a job.” Vincenzo’s, another Nebraska restaurant, was also bought by Teamshares in 2024. General Manager Rhonda Sahner, who has been with the chain for 10 years, [told KMTV](#), “This is, even for me, an exciting adventure because I now have shares. Yes, I will have to retire one day myself. That will just give me an extra retirement.”

- Horn Photo is a specialty photography retailer in Fresno, California, that became employee-owned through Teamshares in 2022. An [article in GV Wire](#) noted that “apart from the current Horn employees who have received these benefits, new employees can expect the same benefits once they join.”
- [Maggie’s Organics](#) is a sock and apparel company in Ann Arbor, Michigan. In an article on Teamshares’ website, Bená Burda, former owner of Maggie’s Organics, wrote, “I founded Maggie’s Organics 30 years ago, with a commitment to treat people and the planet with care, and to try to always do the right thing. Transferring ownership of my life’s work to my employees seemed the natural next step to solidify my legacy and impact for future generations.”

Some other examples include:

- [Runkle’s](#), a notary, tag, and title retail chain in Central Pennsylvania
- [PlanForce](#), an architecture and design firm in Minneapolis, Minnesota
- [Select Sand & Gravel](#), an aggregates distributor in Texas and Oklahoma
- [Old Town Market](#), a butcher shop in Double Oak, Texas
- [Pumphouse Brewery](#) in Longmont, Colorado
- [Rolling Hills Industries](#), a cleaning services company in Latrobe, Pennsylvania

Teamshares provides an alternative to the traditional private equity models for employee ownership, worker cooperatives, and ESOPs. The kinds of companies that Teamshares purchases typically are not

good ESOP candidates because they may not have both the profitability and the ability to absorb the cost and complexity of setting up an ESOP. They may also not be good candidates for worker cooperatives because of the difficulty workers have in obtaining financing to set up a cooperative and the owner not being interested in pursuing that democratic model of ownership. By selling to Teamshares, owners can get a market price for their company and provide their employees with an ownership stake in the company’s future. Unlike selling to an ESOP, employee ownership trust, or worker coop, the owners also get the money up front rather than (as is usually the case in these other models) over time.

Observers of the Teamshares model have noted that there are significant challenges for this approach to work, most significantly whether the kinds of companies that Teamshares is buying can generate significant enough profits to justify the investment of outside investors in Teamshares who, while often having a mission-oriented element to their investment, also are looking for a substantial return on their equity, given the risks of the investment. To date, no one has tried to purchase a disparate group of companies in sectors that traditionally have low profitability and high turnover in a way that can provide the kind of return that these outside investors expect. Part of the success of Teamshares will also hinge on whether the shared services model proves to be one that can generate long-term profitability for Teamshares and reduce costs for the companies that it is purchasing. It is also too soon to assess whether the shares employees will receive will accrue significant value and if the companies will be able to have the liquidity for repurchase.



4

Can Private Equity Be Good for Employee Ownership?

4. CAN PRIVATE EQUITY BE GOOD FOR EMPLOYEE OWNERSHIP?

Pete Stavros of Ownership Works has been clear that ESOPs are the most effective model for spreading ownership widely due to the significant tax incentives and industry-wide structures in place to support ESOPs, but he argues that they are unlikely to be adopted by a significant sector of the economy as they are currently structured. He has initiated an effort to find a legislative solution that might make at least partial ESOPs more appealing to the companies that currently will not adopt them.

Stavros told [Freakonomics](#) in 2024 that “ESOPs tend to work in smaller businesses, [with] fewer shareholders, and most ESOPs are in two sectors of the economy. Seventy-five percent roughly are in service companies or industrial companies. So we’re missing a lot of software and media and financial institutions and medical technology and pharmaceuticals.” He also noted, as have many other observers of ESOPs, that they are almost never used in major corporate divestitures, and their use in public companies has largely been limited to being a match to 401(k) contributions.

The number of newly formed ESOPs has not exceeded 300 annually in recent years. There has been significant growth in the number of ESOP participants, however, at least in part because established ESOP companies are increasingly acquiring other companies. Over time, this may provide a significant competitor to private equity for business owners who would prefer to retain the legacy of their company and make their employees owners on a longer-term basis. But it is nonetheless incontrovertible that ESOPs have had difficulty penetrating certain kinds of businesses and sectors of the economy, and absent any major legislative changes, this seems unlikely to change. Given that, finding alternative ways to spread employee ownership is arguably an important step forward.

Stavros agrees, however, that a significant issue for the private equity deals is that when private equity firms exit, employee ownership most often

does not continue. “We exit our businesses in three ways,” he told [Freakonomics](#). “A company can go public, we can sell to another investor, or we sell to a big corporate. When we sell to a big corporate, it is the most difficult situation in terms of sustaining this program. Because if you are 3M or any big corporate with hundreds of thousands of employees, and you’re buying one of our companies, you’re not going to upend your whole comp and benefits philosophy for our little company. So it’s very difficult to sustain everything that we’ve built when you sell to a big corporate. Now, when we take the company public, that’s easy because effectively, this model gets crystallized and it’s there in perpetuity. Now you’ve got employee-owners, hopefully forever, in this public company. And then when we sell to another investor, that’s also pretty easy, because a new investor would be crazy to tear this model down. If we’ve done all this work over all these years to build this different type of culture, imagine you’re the new owner, and you say, ‘Okay, well, we’re the new investment firm, and the bad news is, this is all over. No more ownership, no more voice. We’re not going to listen to you anymore.’”

Skeptics about the Ownership Works model within the employee ownership community are concerned that this approach may undermine ESOPs, provide too narrow a benefit for workers, or, worse, simply be a way to improve the image of private equity.

Marjorie Kelly at the Democracy Collaborative [told \[Freakonomics\]\(#\) in May 2024](#), “The first thing is, what KKR is doing is not real employee ownership. It’s basically a one-time bonus of cash. It has no voice for workers. It has no long-term security for workers. My second criticism is that, while it is a step forward—workers can get maybe \$25,000 in an equity bonus, and that’s real money—it’s a step up on an escalator that’s moving rapidly down. So, private equity gives workers this little hit of money, but then it sells the firm and they’re highly likely to be laid off. So, the losses can vastly outweigh the

gains. And the third thing I am concerned about is that the KKR model could eclipse authentic employee ownership. It already has attracted tens of millions in philanthropic funding. I did a back-of-the-envelope calculation, and the amount of philanthropic funding they've received at Ownership Works is larger than all three major employee ownership membership organizations combined. So I'm afraid that they're going to eclipse the real thing."

Since the Freakonomics interview, Kelly told us she has somewhat softened her view. "My hope is private equity's attention to employee ownership can bring momentum to the entire field," she said. "And I hope this momentum can be used to advance truly authentic worker ownership—with worker voice, long-term worker job security as well as economic wealth, and company resilience because firms are not overloaded with debt."

Kevin McPhillips, the executive director of the Pennsylvania Center for Employee Ownership, told us, "The entry of private equity in the employee ownership space is very concerning. Private equity has a long history of ravaging businesses, piling them with debt, stripping them down, and reaping large returns for a small number of wealthy investors. Pulitzer Prize-winning business journalist Gretchen Morgenson explains in her recent book *These Are the Plunderers* how bankruptcies are 10 times greater in PE-held firms than others.

"KKR brags that its recent sale of CHI Doors resulted in employees getting an average of \$175,000 each, but the sale was for a whopping \$3 billion, netting KKR itself a staggering 10-fold return on its original investment after including dividends paid to it. More recently, KKR sold GeoStabilization, giving employees an average of \$83,000 each before taxes. The best estimates are that KKR investors saw a return of \$1.1 billion. As one employee said, 'I'm gonna buy a new car!' This is not employee ownership. This is Kool-Aid for the workers. ESOPs are designed to create a real future for working people. These deceptive practices by PE serve to exacerbate the wage and wealth gap, exactly what employee ownership was designed to remedy.

"Many in the business and employee ownership worlds argue that 'at least the employees get

something.' That is a straw horse and is equivalent to saying, 'At least those in poverty get food stamps.' This is a wolf in sheep's clothing and has the potential to do significant damage to the solid reputation of employee ownership that has been hard-earned over 50 years."

This skeptical response to the motives of the private equity firms involved in employee ownership is common among its critics. Given the controversial track record of private equity firms on employee well-being, it's understandable that there would be this skepticism. Stavros has acknowledged this issue and urged the skeptics to judge the substance of what happens. It should be noted that the model that Ownership Works is using does not in any instance require employees to spend their own money on equity. The model is intended for this to be a free and incremental benefit, which Ownership Works asks the investors and companies it supports to validate.

Joseph Blasi, the Distinguished J. Robert Beyster Professor of Human Resource Management at Rutgers, says, "The main argument for this model is that minority ESOPs in large, valuable corporations can deliver comparable wealth accumulation to millions more workers. In 2021, the 424 public company ESOPs had 8.3 million ESOP workers with \$1.5 trillion in total value, for an average of \$158,000 per ESOP worker, compared with 5,823 closely held company ESOPs having 2.3 million ESOP workers with \$539 billion in total value, for an average of \$185,000 per worker." It should be noted, though, that public company ESOPs are almost invariably part of a combined ESOP and 401(k) plan, and a majority of the assets are in things other than company stock. Private company ESOPs are usually standalone plans, and most companies have a separate 401(k) plan, so the dollar value per worker in private companies is just what is in company stock. Nonetheless, Professor Blasi is correct that a small percentage of very large companies still can deliver considerable value to employees.

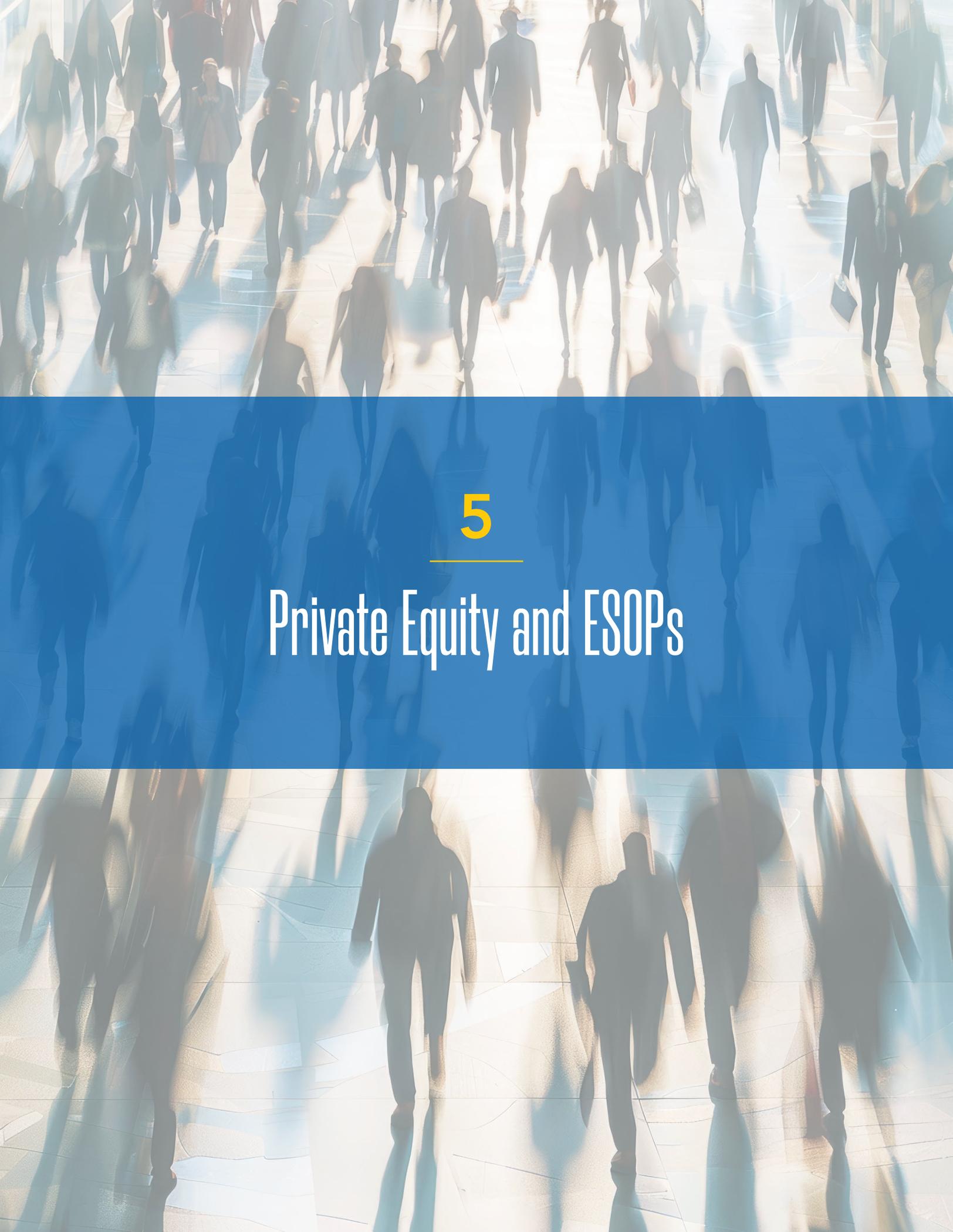
Because the involvement of private equity with broad-based employee ownership is such a new phenomenon, it is impossible to make reliable empirical assessments of what the impact of these programs will be. What we have now is primarily a

set of anecdotes, and naturally, the anecdotes that private equity firms want to publicize tend to be the ones that have worked out well. Because most private equity deals have been done in the last few years, the employees have not reached a point where their equity can be sold, and a better determination can be made about the impact of these programs. Future research will have to look at both the value of the equity and whether there are any trade-offs for the equity in terms of other compensation.

Another key issue is the establishment of ownership culture in these companies. While it appears that at least in some of the deals, significant steps have been taken in this direction, the NCEO's experience with ESOP companies is that changing from conventional cultures to high-involvement cultures typically is a multi-year process, often involving false starts to find the particular set of involvement structures that works for an individual company. It may also require changes in leadership. The difficulty with private equity deals is that these companies are bought

with the intention of being sold within a relatively short time, compressing the time frame to establish effective ownership cultures.

Whatever the ultimate assessment of these issues turns out to be, what is clear is that this movement in private equity has raised the profile of employee ownership substantially. The idea is being covered in multiple major media outlets in a way that other forms of employee ownership have had difficulty achieving. While the Ownership Works model has a long way to go to approach the impact that ESOPs have had on workers, communities, and companies, the juxtaposition of private equity investors and employee ownership is striking enough to draw attention from the media. While there is a danger that this could overshadow other forms of employee ownership, there is also the possibility that by bringing more attention to the concept in general, it will bring more attention to ESOPs and other approaches to sharing ownership with employees.



5

Private Equity and ESOPs

5. PRIVATE EQUITY AND ESOPS

There is a long history of private equity investment in ESOP transactions. In the 1980s, several private equity firms, most notably Kelso & Company (the investment company founded by Louis Kelso, the creator of the ESOP concept, but not run by him at that time), used ESOPs to buy out many large companies. Meanwhile, a few private equity firms used ESOPs as an exit vehicle for companies that they purchased. WesRay, a private equity firm cofounded by former Treasury Secretary William Simon, used an ESOP to buy 100% of Avis and Simmons Mattress, companies WesRay had bought a few years earlier. The Avis ESOP transaction proved to be very successful. Purchased in 1987 for \$1.75 billion, the company was sold for three times that much in 1996. Simmons did not fare so well. The company lost money and ended up in litigation that required WesRay to return some of the funds to the ESOP.

In another large deal, in 1987, Morgan Stanley bought Burlington Industries in a \$46 million leveraged buyout. In 1989, the company created an ESOP to replace an existing employee profit-sharing plan and used the ESOP to buy back some of the shares from Morgan Stanley. The stock price dropped 74% by 1992. Employees took Morgan Stanley to court and won a \$17.6 million settlement.

A smaller private equity firm, American Capital Strategies, was set up specifically to buy smaller manufacturing companies and then resell them to an ESOP. The track record of these deals was mixed. In each of the deals, American Capital Strategies required that employees take wage concessions to help pay for the transaction. The company eventually decided not to do any more ESOP deals, partly because of concerns about litigation around similar plan structures deals set up by Kelso & Company.

Kelso & Company used ESOPs as part of the capital structure to purchase many companies in leveraged buyouts, including American Standard, Cone Mills, and Maui Land and Pineapple. Joe Schuchert, the company CEO at the time, told the author that they would only do deals in which the employees

effectively paid for the shares the ESOP acquired through the present value of any tax benefits of the ESOP plus wage and or benefit concessions. A major issue in these transactions was the allocation of equity between the ESOP and the other investors in the deal. Schuchert argued that because the investors were putting up cash while the ESOP was acquiring the shares with non-recourse debt, the ESOP shares should be valued at a lower price than the shares held by the other investors. The Department of Labor strongly disagreed with this approach and initiated litigation. In response to these legal challenges, Kelso & Company withdrew from the ESOP market.

One of the more significant Kelso & Company-led deals was Dan River, a Virginia textile company. In 1983, to prevent a hostile takeover by corporate raider Carl Icahn, the company set up an ESOP that bought 70% of the shares. Investors, including Kelso & Company, bought the other 30% of the shares. The ESOP purchased 4.9 million class A shares at \$22.50 each, and the management and investor group purchased 1.7 million class B shares at \$2.06 each. In theory, the ESOP shares were worth more because they had voting rights mandated under ERISA. These voting rights did not include the ability to vote for the board of directors or otherwise exert control over the company. The Class A shares also had superior dividend rights. Employees voted to give up their pension plan in return for the ESOP, in part due to concerns about being purchased by Icahn. Kelso & Company argued that the investors should be able to purchase the shares at a much lower price because they were making a cash investment in the deal. Over the next several years, the company did not fare well, and more than 1,000 workers were laid off. In 1989, the company was sold.

The mixed record of these transactions as well as concerns from the Department of Labor about their structure spelled the end of this phase of private equity involvement in ESOPs for some time. Interest in ESOPs among private equity firms started to grow again in the 2000s, but primarily as providers of mez-

zanine debt for ESOP buyouts. There are currently only a handful of private equity firms that are involved in ESOP transactions, most notably Mosaic, Long Point Capital, American Working Capital, Menke, and Apis & Heritage Capital Partners.

How Private Equity Can Invest in ESOP Companies

The table on the following page, based on a presentation by Greg Fresh and Matt Dennison of Chartwell at an NCEO conference in 2023, provides an overview of how private equity can invest in ESOP companies. A drop-down LLC is one where the parent sets up an LLC that the ESOP and a private equity group (PEG) own together in varying amounts. In other scenarios, the PEG helps finance the ESOP, or the PEG purchases the ESOP company. While private equity has so far played a limited role in ESOPs, Fresh and Dennison reported there is growing interest.⁴

The most common transaction is one where the ESOP buys 100% of the company, partly financed by senior debt and seller financing. Because many sellers want more money up front, a private equity firm provides mezzanine debt and/or receives warrants as part of the transaction. This means the seller note portion is smaller. This mezzanine debt is typically priced a few to several points higher than senior debt. From the seller's standpoint, this makes it easier to take advantage of the tax deferral available when selling to an ESOP. Section 1042 of the Internal Revenue Code provides that if an owner of a closely held C corporation sells to an ESOP that holds at least 30% of the stock after the sale, the seller can defer

taxation on the gain by reinvesting in stocks and bonds of U.S. operating companies. This reinvestment must occur within the period from 3 months before to 12 months after the transaction date. If the seller finances the deal in whole or in part with seller notes and does not have enough other funds to invest in the ensuing 12 months, the only option to get the deferral is to purchase a special investment product called an ESOP note.⁵ These are long-term noncallable bonds that pay a very low interest rate. To acquire these bonds, the seller takes out a loan, which will have a higher interest rate than the bonds are paying. If the seller gets more money up front through mezzanine debt, the seller can invest more in any stocks and bonds of US operating companies. That means the seller will normally get a better rate of return. Of course, in return for this, the company takes on more expensive debt.

Another option would be for the private equity firm to acquire warrants in the transaction. With a warrant, a private equity firm has the right to purchase a fixed number of shares at a price fixed at the transaction for a defined number of years into the future. In other words, a warrant is similar to purchasing stock options in the company. Because the ESOP typically buys 100% of the company, the structure of the warrant is that the private equity firm will never actually become a literal owner but instead will cash in its warrants in the future if the stock price rises. This is important because a 100% ESOP-owned S corporation does not have to pay any income taxes. If an S corporation were to become, for instance, 80% owned by the ESOP, 80% of the company's profits would not be taxable. But the private equity firm, as the 20% owner, would want a distribution of earnings to pay its share of the taxes. Under S corporation rules, the ESOP would have to get a distribution in proportion to its 80% ownership, so it would be four times as large, even though it has no tax obligation. The warrant structure avoids this problem.

Although many ESOP advocates have argued that these structures should be attractive to private equity firms, only a relatively small number of deals

4. An email to the author by Aziz El-Tahch of Stout explains the drop-down LLC model in further detail as follows:

- A 100% ESOP-owned S corporation drops its operations down to an LLC.
- The LLC then sells preferred LLC units to a private equity investor.
- The LLC uses the cash generated from this sale to fund growth opportunities and acquisitions, or it distributes the cash to the ESOP-owned entity and then further down to the ESOP participants to provide diversification and "pay down" future repurchase obligations.

5. There is one product currently on the market that allows sellers to invest in a hedged portfolio of stocks and bonds instead.

How Private Equity Can Invest in ESOP Companies

	Structured equity & ESOP leverage	S corporation and drop-down LLC	C corporation & ESOP conversion	C corporation & drop-down LLC	Buyout & partial ESOP rollover
Summary description	<ul style="list-style-type: none"> PEG provides structured equity (jr. note and warrants) and, if desired, mezzanine financing ESOP uses PEG funds to re-leverage the ESOP PEG receives "equity-like" return through warrants and note interest 	<ul style="list-style-type: none"> PEG invests equity and, if desired, mezzanine financing PEG holds direct equity in the form of LLC units Some liquidity available for warrant holders, seller note holders, SAR participants Retains company's tax-exempt status through ESOP holding 100% of S corp. ownership 	<ul style="list-style-type: none"> Revoke S election/C corp. conversion Settle ESOP loan Convert ESOP to profit-sharing plan and merge with existing 401(k) plan PEG invests preferred equity into HoldCo. and mezzanine debt into operating Co. 	<ul style="list-style-type: none"> Third-party and/or PEG recap refinances outstanding third-party and seller note debt, as well as warrants PEG, former seller note/warrant holders, and management reinvest in exchange for participating preferred stock in the LLC ESOP is diluted from 100% ownership 	<ul style="list-style-type: none"> PEG acquires 100% of ESOP-owned equity with debt (third-party and mezzanine, as desired), equity, and a portion of ESOP rollover proceeds ESOP receives proceeds in cash (~90%) with the balance rolled over (~10%) Accounting for leverage, the PEG retains ~80% ownership to the ESOP's ~20% ownership
Form of private equity group investment	Structured equity (optional: mezzanine)	LLC units (optional: mezzanine)	Preferred equity (optional: mezzanine)	Preferred equity (optional: mezzanine)	Common equity (optional: mezzanine)
Direct ownership	No	Yes	Yes	Yes	Yes
Return type	"Equity-like" through warrants & interest	Equity (interest on mezzanine, if applicable)	Equity (interest on mezzanine, if applicable)	Preferred equity (optional: mezzanine)	Equity (interest on mezzanine, if applicable)
Company tax savings	Significant	Yes	Limited	Limited	Limited
Management participation	Pari passu with PEG	Segregated from PEG, except via LLC & profits interests	Pari passu with PEG via ESOP and separated via SARs	Pari passu with PEG via preferred	Pari passu with PEG via ESOP and separated via SARs

use this structure. ESOP advocates have also argued that private equity firms should consider ESOPs as an exit vehicle, but this also has not been common. Private equity firms have typically viewed the sale to an ESOP as too constrained by regulations, too time-consuming, and possibly not offering as good a sale price if the private equity firm can find a synergistic buyer. ESOPs cannot pay a synergistic price because they are standalone entities.

Apis & Heritage Capital Partners

One firm that has adopted this model is Apis & Heritage Capital Partners (A&H). The company has the mission of using employee ownership for “attacking the racial wealth gap and helping restore dignity, status and the American Dream for low-income workers across the country.”

A&H does not purchase the company but, along with bank loans, instead provides partial financing for an ESOP to buy 100% of the company. The company started a few years ago and has received initial funding from various investors. A&H’s website describes three of the four companies where it has used its model so far:

- [Accent Landscape Contractors, Inc.](#), is a commercial landscaping, irrigation construction, and maintenance services company in Texas with approximately 120 full-time workers, most of whom are lower-income hourly-wage minority workers.
- [Apex Plumbing Co.](#) is one of the largest providers of residential, commercial, and municipal sewer and water line repair and replacement in the Denver metro area. Apex also performs emergency repair and underground infrastructure rehabilitation for cities and districts and provides excavation services and turnkey surface restoration solutions for concrete, asphalt, and landscaping. Apex has a workforce of approximately 50 people, about 50% of whom are minority workers.
- [Blooming Nurseries](#) in Cornelius, Oregon, employs more than 110 employees in high season. Almost 25% of employees come from Mexico through the USDA H2A visa program; most of

these workers will qualify for ESOP shares, provided they come back each year to vest their shares.

- [Sky Blue Builders](#) is a construction company in Denver employing more than 40 employees. The company does a variety of infrastructure projects for private and public customers. Mowa Haille is the CEO of both Sky Blue and Apex.

A&H plays an active advisory role in both management and ownership culture issues. A&H helps companies set up communication systems around the ESOP as well as high-involvement employee work systems; it also has workers participate at the board level. While these companies have been employee-owned only for a short time, employees and management say there have been meaningful improvements in employee engagement and workplace performance. A&H also makes sure that employees have access to a separate 401(k) plan and health insurance, and it aims to increase base compensation.

Apex CEO Mowa Haile told the Aspen Institute in April 2024 that the ESOP was already making a significant difference. “Apex had previously pursued the Denver Water contract twice and lost both times,” he said. “The third time, we won it. It was the same contract, so what had changed? I believe one change was the ownership mentality. The team worked together to put in a great proposal with the right pricing. It meant more to them because it was their company. It was great to win, but this is a huge contract that required an additional 25 people—a very tough hurdle with the shortage in labor. Our HR manager did an amazing job in hiring new employees, and the team trained all of them one month in advance of starting the project. I believe the differentiator in our hiring process—besides having an amazing HR Manager—is being able to tell potential candidates that they will have ownership in the company.”

A&H is partly funded by impact investors. A 2024 report by Curt Lyon and Julie Menter of Transform Finance, [Employee Ownership: Overview for Mission-Oriented Investors](#), identifies 53 funds in the U.S. and Canada that invest partly or entirely in

employee-owned companies. Twenty-two of these funds focus only on employee ownership and target raising \$1.6 billion to invest. The other funds, which target raising \$3.8 billion, invest only some of their assets in employee ownership companies. Five funds focus just on ESOPs, while the others focus on non-ESOP equity sharing, mostly small worker cooperatives.

While these funds invest a significant amount of capital in these transactions, they represent only a tiny fraction of private equity and similar corporate investments.

Todd Leverette, a managing partner at A&H, told the NCEO that ESOPs are one of the best and most underused tools for providing an onramp to wealth for workers and an offramp to retirement for founders. Investment firms like theirs, he said, bring much-needed liquidity for sellers who want to take that path. But beyond that, he thinks there is a lot of room for innovation and that other opportunities exist to create greater liquidity for sellers in ways that support the growth of ESOPs as a corporate structure, including expanding the market for ESOP seller notes.

Other Private Equity Firms

Aside from A&H, several other private equity firms have specialized in investing in ESOPs. The most notable of these are Mosaic Capital and Long Point Capital. Mosaic provides mezzanine debt for 100% ESOP transactions. On its website, Mosaic notes that it “has created or supported over 3,000 employee owners through 13 platform investments, spanning a range of industries including manufacturing, business services, retail, food & beverage, industrials, and healthcare.” It focuses on the lower middle market, with most companies being in the \$10 to \$100 million revenue range.

Long Point provides a more complex financial structure and has financed six ESOP deals. It helps arrange bank debt but also makes an equity investment in the form of warrants (the right to buy shares at the transaction price for some years into the future, with Long Point cashing in the warrants rather than actually buying shares).

A small number of other investment firms have been involved on a less regular basis in providing capital for ESOP transactions. ESOP advocates argue there is a significant opportunity for such firms to get involved in these transactions, but so far, interest has been limited.



Appendix

ESOPs, Phantom Stock, Restricted Stock, Stock Appreciation Rights, and Stock Options



APPENDIX: ESOPS, PHANTOM STOCK, RESTRICTED STOCK, STOCK APPRECIATION RIGHTS, AND STOCK OPTIONS

Employee Stock Ownership Plans (ESOPs)

The most common structure for broad-based employee ownership in the U.S. is the employee stock ownership plan (ESOP). Approximately 6,300 U.S. companies have an ESOP, and approximately 14.7 million U.S. workers (or ex-workers who have not received all their benefits yet) are ESOP participants (see [Employee Ownership by the Numbers](#)).

An ESOP is a type of retirement plan, similar to a 401(k) plan, that invests primarily in company stock and holds its assets in a trust for employees. An ESOP may own 100% of a company's stock, or it may own only a small percentage. ESOP participants (employees) accrue shares in the plan over time and are paid out by having their shares bought back, typically after they leave the company.

ESOPs are often created in the process of selling a business, as an ESOP can buy a departing owner's shares in pretax dollars on terms that are highly favorable to the owner, the employees, and the business itself. Selling owners can sell any portion of their stock to the ESOP, and they can defer tax on the gain from the sale if certain requirements are met. Congress created incentives for ESOPs to borrow money ("leveraged ESOPs"), allowing them to purchase more shares than they otherwise would be able to. Nonleveraged ESOP transactions tend to be smaller and have lower transaction costs. Companies can also use ESOPs simply as a way to reward and engage employees even if there is not a selling owner.

Many sellers take advantage of the tax-deferred "rollover" under Section 1042 of the Internal Revenue Code: If the company is a C corporation, the owner has held the shares for at least three years, and the ESOP owns 30% of the company's shares after

the sale, the owner can reinvest ("roll over") the sale proceeds in securities of other U.S. companies (other than real estate trusts, mutual funds, and other passive investments) during the period from 3 months before to 12 months after the sale, and no taxes are due on the amounts that have been reinvested until the replacement securities are sold. If the owner buys income-yielding securities and lives on the proceeds, giving them to an estate at death, no capital gains tax is due. If some of the securities are sold, tax is due only on a prorated basis. (This tax incentive is not currently available for S corporation owners, although they can defer 10% starting in 2028.)

Financing an ESOP

The simplest way to finance an ESOP to transfer ownership is to have the company make tax-deductible cash contributions to the ESOP trust, which the trust then uses to gradually purchase the owner's shares. Alternatively, the owner can have the ESOP borrow the funds needed to buy the shares. In this way, larger amounts of stock can be purchased all at once, up to 100% of the equity. The loan is made to the company (the external loan), which then reloans the money to ESOP (the internal loan). The external loan is usually paid off in five to seven years; the internal loan is paid off more slowly because the payment of that loan releases shares to the employee accounts, and by extending the internal loan, the shares can be released to current and future employees more gradually.

Normally, the bank will loan a company only enough to buy a portion of the total shares, often around 30% to 50%. The bank may also want a personal guarantee if company collateral is insufficient. This is often in the form of the investments the seller purchases with the gains from the sale.

Many, and probably most ESOPs, are funded at least in part by a seller note. The seller note can be used to fund the purchase of shares the bank loan does not cover, or it can be used for the entire sale. The ESOP acquires the shares and then pays back the seller at a reasonable rate of interest (not more than what a commercial lender would charge for loans of similar risk). Sellers often like this idea because they not only sell their shares but get a reasonably good rate of return on the note. In this scenario, however, the seller could use the Section 1042 tax-deferred rollover described above only for what is reinvested in the first year because the deadline for reinvestment is 12 months after the sale. The entire sale amount could only be reinvested on a tax-deferred Section 1042 basis if the seller has other funds available or, as normally happens, the seller borrows money from a bank to buy special ESOP investments that qualify for this kind of sale (an increasingly common approach). The seller then repays the banks with the proceeds of the note. However the money is obtained, the price is set by an independent appraiser, as discussed below.

Many sellers are very comfortable with the idea of being paid off in a seller note at a reasonable rate of interest over time. Others, however, either need the money up front or are concerned that the seller note is not guaranteed to be repaid. While the default rate on ESOP loan transactions is extraordinarily low (.2% per year), some sellers prefer a buyer who can pay more of the money up front, sometimes including private equity firms. Established ESOP companies are increasingly buying other companies. This can offer sellers the best of both worlds, providing a fair price, preserving the legacy of the firm, and rewarding the employees who helped build the company.

How the Price the Selling Owner Receives Is Determined

The price the ESOP will pay for the shares, as well as any other purchases by the plan, must be determined at least annually by an outside, independent appraiser. The appraiser's valuation is based on several factors. Most appraisers try first to find comparable public companies and use their price/earnings ratio,

price/assets ratio, and other guides for setting a price. Discounted cash flow, book value, the company's reputation, future market considerations, and other factors are considered as well. The appraiser tries, as much as possible, to determine how much the business would be worth if there were a market for it. The appraiser is assessing what a financial buyer would pay, one who would operate the business as a standalone entity. A strategic buyer, such as a competitor, by contrast, might pay an additional premium because when the target company is acquired, there are perceived operational synergies that make the target more profitable to the buyer than it would be as a standalone entity. The ESOP cannot match this price because it cannot generate these synergies. Sales to synergistic buyers do trigger capital gains taxes, however, and often come with numerous contingencies.

How Employees Get Stock

ESOPs are much like other tax-qualified retirement plans. At least a minimum percentage (70%, defined in a few alternate ways) of employees who have worked at least 1,000 hours in a plan year must be included. They receive allocations of shares in the ESOP based on relative pay or a more level formula. If there is an ESOP loan, the shares are allocated each year based on the percentage of the loan that is repaid that year. The allocations are subject to vesting for as long as six years. Employees do not receive a distribution of shares until they terminate, and then the distribution can be delayed for five years if the termination was not due to death, retirement, or disability. The plan is governed by a trustee appointed by the board; employees only have very limited required voting rights (they do not have to elect the board, for instance), although companies may provide additional rights.

It is important to understand that ESOPs do not allow employers to pick and choose who can get stock or to make allocations based on discretionary decisions. It is also critical to remember that ESOPs, as a rule, do not entail employees using their own money to buy shares. The company funds the plan. The ESOP trust holds the shares, and the ESOP

trustee is the shareholder of record for the company stock in the plan; the participants are beneficial owners who have accounts in the ESOP.

S Corporation ESOPs

If a company is an S corporation, the profits attributable to the ESOP are not taxable. So if the ESOP is a 30% owner, income taxes are not due on 30% of the profits; if it is a 100% owner, no taxes are due, a rule that has led to the rapid growth of 100% S corporation ESOPs, often conversions from C corporations with ESOPs after they make the final purchase of shares. Most ESOP companies are 100% ESOP-owned S corporations.

Equity Compensation Plans

The other major form of employee ownership in the U.S. is equity compensation: grants of stock or stock equivalents from the employer. There are several types of equity compensation, each with different structures, incentives, and tax treatment. The most common types are:

- Stock options
- Employee stock purchase plans (ESPPs)
- Restricted stock
- Phantom stock
- Stock appreciation rights (SARs)

Stock options give employees the right to buy a number of shares for a defined number of years into the future at a price fixed at the grant date. Restricted stock and its close relative restricted stock units (RSUs) give employees the right to acquire or receive shares by gift or purchase once certain restrictions, such as working a certain number of years or meeting a performance target, are met. Phantom stock pays a future cash bonus equal to the value of a certain number of shares. Stock appreciation rights (SARs) provide the right to the increase in the value of a designated number of shares, paid in cash or shares. Employee stock purchase plans (ESPPs) provide employees the right to purchase company shares, usually at a discount.

Stock Options

A few key concepts help define how stock options work:

- *Exercise*: The purchase of stock pursuant to an option.
- *Exercise price*: The price at which the stock can be purchased. This is also called the strike price or grant price. In most plans, the exercise price is the fair market value of the stock at the time the grant is made.
- *Spread*: The difference between the exercise price and the market value of the stock at the time of exercise.
- *Option term*: The length of time the employee can hold the option before it expires.
- *Vesting*: The requirement that must be met to have the right to exercise the option, usually continuing service for a specific period or meeting a performance goal.

A company grants an employee options to buy a stated number of shares at a defined grant price. The options vest over a period of time or once certain individual, group, or corporate goals are met. Some companies set time-based vesting schedules but allow options to vest sooner if performance goals are met. Once vested, the employee can exercise the option at the grant price at any time over the option term up to the expiration date. For instance, an employee might be granted the right to buy 1,000 shares at \$10 per share. The options vest 25% per year over four years and have a term of 10 years. If the stock goes up, the employee will pay \$10 per share to buy the stock. The difference between the \$10 grant price and the exercise price is the spread. If the stock goes to \$25 after seven years, and the employee exercises all options, the spread will be \$15 per share.

Restricted Stock

Restricted stock plans provide employees with the right to purchase shares at fair market value or a discount, or employees may receive shares at no

cost. However, the shares employees acquire are not really theirs yet: they cannot take possession of them until specified restrictions lapse. Most commonly, the vesting restriction lapses if the employee continues to work for the company for a certain number of years, often three to five. Time-based restrictions may lapse all at once or gradually. Any restrictions could be imposed, however. The company could, for instance, restrict the shares until certain corporate, departmental, or individual performance goals are achieved. With restricted stock units (RSUs), employees do not actually receive shares until the restrictions lapse. In effect, RSUs are like phantom stock settled in shares instead of cash.

Phantom Stock and Stock Appreciation Rights

Stock appreciation rights (SARs) and phantom stock are very similar concepts. Both essentially are bonus plans that grant not stock but rather the right to receive an award based on the value of the company's stock, hence the terms "appreciation rights" and

"phantom." SARs typically provide the employee with a cash or stock payment based on the increase in the value of a stated number of shares over a specific period. Phantom stock provides a cash or stock bonus based on the value of a stated number of shares, to be paid out at the end of a specified period. SARs may not have a specific settlement date; like options, the employees may have flexibility in choosing when to exercise the SAR. Phantom stock may offer dividend equivalent payments; SARs would not. When the payout is made, the value of the award is taxed as ordinary income to the employee and is deductible to the employer. Some phantom plans condition the receipt of the award on meeting certain objectives, such as sales, profits, or other targets. These plans often refer to their phantom stock as "performance units." Phantom stock and SARs can be given to anyone, but if they are given out broadly to employees and designed to pay out upon termination, there is a possibility that they will be considered retirement plans and will be subject to retirement plan rules under ERISA. Careful plan structuring can avoid this problem.

About the NCEO and the Author

We are the National Center for Employee Ownership (NCEO), a nonprofit organization that has been supporting the employee ownership community since 1981. Our mission is to help employee ownership thrive. We have thousands of members because we help people make smart decisions about employee ownership, with everything from reliable information on technical issues to inspiration to help companies reach the full potential of employee ownership.

We generate original [research](#), facilitate the exchange of best practices at our [live and online events](#), feature the best and most current writing by experts in our [publications](#), and help employee ownership companies build [ownership cultures](#) where employees think and act like owners.

Whether you are considering employee ownership, managing an existing plan, or advising clients, we can help. Our [members](#) have access to all of our online resources, and we are committed to providing extensive materials for anyone interested in learning more about employee ownership, from [business owners](#) to [ESOP participants](#) to journalists to stock plan administrators and other service providers. We welcome everyone to sign up for our twice-monthly [email bulletin](#) and to visit our [blog](#).

Our [staff](#) covers the nation from multiple locations in the U.S., and our [board](#) includes representatives from employee-owned companies and the professional advisors who serve them.

We are supported almost entirely through membership fees and our activities, but we do accept donations, which are tax-deductible (we are qualified as a 501(c)(3) nonprofit charitable organization).

Corey Rosen

Corey Rosen is the NCEO's founder and former executive director and now is its senior staff member. Corey has spoken on various subjects related to employee ownership all over the world with government, business, and union leaders, and he is regularly quoted in leading magazines and newspapers. He has appeared on national television and radio programs and also has authored four books on employee ownership, plus more than 100 articles for various business, academic, and professional publications. He has authored or coauthored several of the NCEO's practical and research publications. He holds a PhD in political science from Cornell University.

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