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Should Employee Ownership Be Your Next Strategic Move?

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EEA Consulting Engineers is an employee-owned firm in Austin, Texas. Like all engineering companies— and many other businesses—its success depends entirely on its people. So you'd expect the company to be worried about employee turnover.

EEA does have some voluntary turnover, acknowledges CEO Todd Schmitt—two people out of 120 in the last two years. That probably comes as no surprise to Mike Hart, who founded EEA and later sold it to an employee stock ownership plan, or ESOP. Mike wanted to create a great place to work, and making its employees the eventual owners just made sense to him.

Hell's Kitchen in Minneapolis is in an even tougher industry. The popular restaurant had to shut down early in the pandemic, then navigate its way back to profitability. But it had one big advantage over its competitors, as general manager Billy Schoenburg told a Minnesota Public Radio audience in August of 2022: "From the get-go there has been a lot of buy-in from the staff. We have relied on our employees to take more ownership of the shift," allowing Hell's Kitchen to run with fewer managers.

The secret? Like EEA, Hell's Kitchen is employee owned. "Everyone in the restaurant is an advocate for the company," says Schoenburg. "You give hourly employees a stake in the business and they care as much as the founders did. They are always coming up with new ideas. It is so hard to find good employees, but what we are finding is, not only is it easy to hold on to our amazing tenured employees, but it's also really easy to attract new employees."

Nearly every small business these days worries about its ability to attract and keep enough good people. The so-called "great resignation" is one factor. Another is the historically high number of business owners who have reached an age where they are ready to sell. When an entrepreneurial company is up for sale, employees often feel uncertain about the future. More are apt to look for work elsewhere. But plenty of companies find the solution in employee ownership. Sharing ownership broadly with employees is a great way to set your company apart from the pack.

Inspired by the possibilities of shared ownership, I founded the nonprofit National Center for Employee Ownership (NCEO) back in 1980. Today, some 30 years later, employee ownership is a significant part of the US economy. About 25 million employees own shares in the company they work for. More than 6,000 companies have ESOPs; about half of these companies are 100% owned by their employees. Employee ownership is an idea that is supported by the Left, Right, and Middle, largely because it works. Companies perform better; employees build more wealth. It's one of the few ideas for addressing the crisis of capitalism that is both economically effective and politically practical.

It's also an idea that can work for nearly every company, start-ups and established businesses alike. The most appropriate form depends in large part on the age and size of the company. For example, a particular form of employee ownership, the ESOP, lets owners gain liquidity (and capitalize on some tax advantages) while preserving the legacy of the company. I'll examine the options in a moment, but first let's look at what we know about what happens when a company is employee owned.

The Impact of Employee Ownership

There has been a lot of research on the effects of employee ownership, and it tells two consistent tales: employees accumulate a lot more wealth, and companies perform significantly better.

For example, look at the effects on workers. Since the 1970s, real wages for most people have been stagnant. More and more people struggle to buy a house, send their kids to college, and pay for a secure retirement. Meanwhile, the owners of capital have seen their wealth soar. Returns on ownership of productive assets have grown at a rate of 8% per year adjusted for inflation.

When you make employees into owners, that disparity shrinks. In a comprehensive study in 2021, the NCEO found that workers in ESOP companies had an average of $132,000 in their ESOP accounts and about half that in their 401(k) plans. That's about three times the total retirement assets of employees in non-ESOP companies that have retirement plans—and 50% of the private sector workforce has no plan at all. Research by scholars at Rutgers and the National Bureau of Economic Research at Harvard found that ESOP companies can afford all this because they grow about 2.5% per year faster after adopting their ESOP than would have been expected if they did not adopt a plan.

The Hell's Kitchen experience is not unusual. Drawing on a robust survey sample of ESOP and comparable non-ESOP food companies, the NCEO in 2022 showed that those with ESOPs had lower median involuntary separation rates (2% vs. 5%) and were more likely to have seen revenue increases from 2019 to 2020 (53% vs. 35%).

While most of the employee-ownership research has focused on ESOP companies, studies of companies that provide equity grants to most or all employees also show they perform better, both in growth and in employee attraction and retention.

Setting Up An ESOP

The most common structure for broad-based employee ownership in the US is the ESOP. Legally, it's a type of retirement plan, similar to a 401(k), except that it is funded by the company out of its future profits, not out of employee contributions. In an ESOP, the company sets up a trust to hold shares for employees. The company can then borrow money to buy shares through the trust, make cash contributions to the trust to buy shares, or even just contribute new shares. It gets a tax deduction for any of these approaches. Shares are allocated to individual employees over time. At least all full-time employees have accounts, which vest over time, and are paid out after the employee terminates. Allocations to employees are based on relative pay or a more level formula.

ESOPs are often created in the process of selling all or part of a business. An ESOP can buy an owner's shares with pre-tax dollars on terms that are fair to the owner, the employees, and the business itself. 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. The money goes into the ESOP, which uses it to buy shares. As the loan is repaid, the shares are allocated to employee accounts. If the company is or becomes an S corporation, profits attributable to the ESOP's owners are not taxable, meaning "100% ESOP" companies pay no income tax.

Although you might hear that ESOPs are most suited to one industry or another, there is no reason to think that, and in fact ESOPs are found in every industry. Still, ESOPs are not for every company. If a company is not profitable enough to buy back its own shares and still run its business, then an ESOP will not work. Successor management is a must. They also have significant set-up costs, which can be $100,000 or more. That is a lot, although for profitable companies with more than 15 or 20 employees, these costs compare favorably to the transaction costs of selling the business to another firm, and they don't carry the financial contingencies usually attached to other sales.

ESOPs are also not usually a good fit for startups. Not only are they costly, but private equity investors, with some exceptions, have preferred companies that use equity grants that can be given out with more discretion. Many startups have a liquidity model based on being sold in several years, and an ESOP is far too complex to get in and out of in a short time to make the costs worthwhile.

Because of these things, many privately held companies rely on another form of employee ownership: equity compensation plans that provide workers with stock or stock equivalents as part of their pay. There are several types of such plans, each with different structures, incentives, and tax treatment. The most common are stock options, restricted stock, phantom stock, and stock appreciation rights (SARs). Here's a quick primer on each one.

Other Options For Employee Ownership

Stock options give the employee the right to buy a certain number of shares over a period of years once the right vests. You can choose the terms for each employee. If an employee gets the right to buy 100 shares at $10 for seven years, and vests after three, for instance, the employee can buy those shares and then resell them at whatever price they reach between years four and seven. A **restricted stock** plan gives employees shares directly, but only once some vesting

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requirement has been met.

These plans do have some drawbacks. For example, employees must use after-tax dollars to buy the options. They often have to pay taxes on any gain. And there's no market for their shares unless the company is sold or taken public.

So unless a founder plans to sell or go public in the next several years, a better approach is what is called synthetic equity, meaning either **stock appreciation rights** or **phantom stock**. Employees are awarded the economic value of stock options (SARs) or restricted stock (phantom stock), but not the stock itself. Companies usually pay out that value at set increments over time or do not vest them until the company is sold (because as soon as they vest they are taxable).

Companies with ESOPs have to follow the regulations that govern the plans, which is one reason they can be expensive. Other types of equity awards have no rules about who gets how much and when, and they are much cheaper to set up.

Equity plans have disadvantages as well. These plans have only limited tax benefits for the employee and none for the company. They also are not a way for an owner to sell ownership—in fact, they dilute the owners' interest by creating more shares. Some employees will have a hard time equating some forms of equity grants with really being an owner, because many of these approaches do not grant shares *per se* but rather the right to the value or increase in the value of shares. The tax issues can be complicated and surprising to employees, too, so companies will likely need to spend more time communicating how they work.

Employee ownership plans are largely governed by federal law, mostly tax law. State laws can come into play with equity grants, but are not usually an issue. Federal law trumps state law on ESOP issues. But state and federal laws can both come into play with equity grants if any part of the grant is structured as a purchase offer. This can trigger expensive, but avoidable, compliance issues. Securities laws do not apply to ESOPs.

Ownership Includes More than Equity

The best employee ownership companies go beyond just sharing ownership. Like EEA and Hell's Kitchen, they also share a lot of information about how the company is doing. They set up structured systems by which employees brainstorm ideas, identify problems, and find solutions. They become "idea factories," and the employees come to feel like full participants in the business.

Managers tell us that these companies are a lot more fun to run than a conventional business. That sense of satisfaction is an important intangible. Imagine you are a leader of a company where you can wander around and see people talking about how to improve business on a regular basis. Or the "eureka moment" when an employee generates an idea you never thought about that can really improve operations. Or when you see ordinary employees accumulate account balances that change their lives. Or when you look at turnover for the year and see how much less of it you have than your competitors. This sense of common purpose is missing in a lot of workplaces, but it can be the norm in employee-owned companies.

Conclusion

If you want to learn more about all this, a good place to start is the website of the National Center for Employee Ownership, www.nceo.org(http://www.nceo.org/) . Also, you might like to check out a book that I've co-written with John Case called,—*Ownership: Reinventing Capitalism, Companies, and Who Owns What* (https://www.nceo.org/publication/ownership-reinventing-companies-capitalism-and-who-owns-what) (Berrett Koehler, 2022). It provides a broad overview of why we think capitalism is broken and reinventing ownership is a practical, effective solution. In today's economy, pursuing employee ownership is also a smart strategic move for companies.

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