Employee Ownership and Involvement Recommendation

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Table of Contents

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Introduction

Project description

The National Center for Employee Ownership (NCEO) is working with People's Community Market (PCM), a mission-driven grocery store opening in West Oakland, to provide information about potential ownership structures and employee engagement strategies.

Ownership structure

PCM is currently structured as a C corporation with common and preferred shares. Currently, 100% of common shares are held by Brahm Ahmadi, the company's founder. Preferred stock is held by California residents who purchase it through a direct public offering (DPO). Preferred shareholders will receive a 3% compounded annual interest rate, paid as a dividend. Shareholders can choose to redeem their investment beginning at the end of the seventh full year of business.

At that time or shortly thereafter, the organization expects to change its ownership structure, and is investigating the available alternatives. Some of the principal considerations in designing the ownership structure are: (1) preserving the organization's mission indefinitely, (2) promoting the organization's financial success, and (3) providing employees and possibly other stakeholders with a meaningful ownership stake.

Employee training and involvement

PCM is committed to workforce training that will help drive the company's performance by teaching employees how to think and act like owners. The organization is looking to develop a program that offers training reinforced by incentives, including a meaningful ownership stake in the company.

About this document

The recommendations included in this document are based on assumptions about PCM's profitability, the character of its workforce, and other yet unknown attributes of the company. For example, the recommendation for ownership structure in Stage 3–transitioning to a 100% S corporation ESOP–would only be beneficial for PCM if it became a stable, profitable company with consistent cash flow. Similarly, our recommendation to create a restricted stock unit plan in Stage 2 is predicated on PCM identifying a number of committed, long-term employees who are likely to stay with the company until the liquidation event in Stage 3. The NCEO is happy to update these recommendations as the company culture and performance develops.

About the NCEO

The National Center for Employee Ownership is a private, nonprofit membership and research organization that serves as the leading source of accurate, unbiased information on employee stock ownership plans (ESOPs), equity compensation plans, and ownership culture.

We are the main publisher and research source in the field, hold dozens of Webinars and in-person meetings annually, and provide services to our thousands of members and others. Today, we have over 3,000 members, ranging from employee ownership companies to consultants to academics.

Acknowledgments

The NCEO would like to thank James Steiker for his assistance with this project. James is Chairman and CEO of SES Advisors and Founding Partner and Chairman of its sister law firm, Steiker, Fischer, Edwards & Greenapple, P.C. Jim is a corporate, pension and tax attorney and financial advisor with more than 25 years of experience in ESOPs and other employee ownership matters, focusing primarily on ESOP design, transactions and compliance in entrepreneurial companies. Jim is a Chair of the Finance Committee of the ESOP Association, a trustee of the Employee Ownership Foundation and a director of the NCEO. Learn more at www.sesadvisors.com.

Definitions

Employee Ownership

Employee ownership allows workers to benefit from the wealth they create. In the United States, wages have remained stagnant for decades. Individuals who own stock, on the other hand, have increased their wealth substantially in the same period. Employee ownership bridges the gap between stock ownership and wages, grounding wealth with the people who are driving the company's success.

Thousands of companies in the United States are owned in whole or in part by their employees. These companies, which often provide more engaging, participative workplaces, have an impressive track record: employee-owned companies provide better benefits and wages, outperform traditional companies, preserve jobs, remain rooted in their communities, and stay in business longer. Employee ownership comes in many different forms, including employee stock ownership plans (ESOPs), various forms of equity compensation such as stock options, and cooperatives. ESOPs alone include more than 13 million employees at over 10,000 companies.

ESOPs

An ESOP is a kind of employee benefit plan, similar in some ways to a profit-sharing plan. In an ESOP, a company sets up a trust fund, into which it contributes new shares of its own stock or cash to buy existing shares. Alternatively, the ESOP can borrow money to buy new or existing shares, with the company making cash contributions to the plan to enable it to repay the loan. Regardless of how the plan acquires stock, company contributions to the trust are tax-deductible, within certain limits.

Shares in the trust are allocated to individual employee accounts. Although there are some exceptions, generally all full-time employees over 21 participate in the plan. Allocations are made either on the basis of relative pay or some more equal formula. As employees accumulate seniority with the company, they acquire an increasing right to the shares in their account, a process known as vesting. Employees must be 100% vested within three to six years, depending on whether vesting is all at once (cliff vesting) or gradual.

When employees leave the company, they receive their stock, which the company must buy back from them at its fair market value (unless there is a public market for the shares). Private companies must have an annual outside valuation to determine the price of their shares. In private companies, employees must be able to vote their allocated shares on major issues, such as closing or relocating, but the company can choose whether to pass through voting rights (such as for the board of directors) on other issues. In public companies, employees must be able to vote all issues.

Restricted stock and restricted stock units

Restricted stock awards (RSAs) and restricted stock units (RSUs) either grant shares to employees at no cost or provide them with the right to purchase shares at fair market value or at a discount. Both kinds of awards are typically subject to vesting requirements, but the company can impose any restrictions. In some private companies, the restriction is both time-based and transaction-based, meaning the restrictions don't lapse until the company goes public or is sold.

The shares underlying RSAs are generally issued at grant but held in an escrow account until they vest. As a result, the holders of RSAs usually receive dividends and have voting and other shareholder rights before vesting, even though the shares remain subject to vesting restrictions.

With RSUs, the company does not actually issue shares until the restrictions lapse. The same kinds of vesting rules apply, but the tax treatment is slightly different. RSUs do not carry voting or dividend rights until the employee actually takes possession of the shares, although a kind of tracking dividend can be paid in the form of a bonus.

Worker cooperatives

Worker cooperatives are organizations that are owned and governed by workers. According to the Federation of Worker Cooperatives, the two central characteristics of worker cooperatives are: (1) worker-members invest in and own the business together, and it distributes surplus to them and (2) decision-making is democratic, adhering to the general principle of one member-one vote. There are currently approximately 300 worker cooperatives employing around 3,500 people in the United States.

In some cases, the company is incorporated as a cooperative (depending on whether the state has a cooperative statute); in other cases, the company operates as a C corporation, S corporation, or an LLC with a cooperative governance structure. In California, any organization that wants to use the word "cooperative" in its name must be incorporated under the California Consumer Cooperative Law.

New corporate forms

The traditional for-profit and nonprofit corporate forms have significant limitations for organizations seeking to blend a social purpose with business methods. As a result, advocates in the field developed new corporate forms, including the Benefit Corporation and the Flexible Purpose Corporation.

Benefit Corporations are a new class of corporation that 1) creates a material positive impact on society and the environment; 2) expands fiduciary duty to require consideration of non-financial interests when making decisions; and 3) reports on its overall social and environmental performance using recognized third party standards.

Flexible Purpose Corporations are similar to Benefit Corporations, but have relaxed qualifying and reporting standards.

The Great Game of Business model for employee engagement

Jack Stack is Founder, President and CEO of SRC Holdings Corporation. He pioneered the leadership model known as open-book management and is the author of two books on the subject, *The Great Game of Business* and *A Stake in the Outcome*. The Great Game of Business approach, which is outlined below, is widely used by businesses that want to harness the full creative power of their workforce.

- **Know & Teach The Rules**
  - Business Transparency & Education: Opening the Books only works when people are taught to understand them, which is best done both formally and informally.
  - High Involvement Planning: When The Game is created with broad participation – specifically the people who are closest to the action and who understand the realities – it creates a level of commitment and alignment that just can't be matched.
  - The Critical Number: This is the financial or operational number that defines winning. When correctly identified through High Involvement Planning, targeted and tied to a reward, the Critical Number becomes the focus of the Game for everyone in the organization.
- **Follow the Action & Keep Score**
  - Keep Score: There's an old saying, "If you're not keeping score, it's only practice." The objective of keeping score is to simply and consistently inform the players if they are winning or losing, and who is accountable.
  - Follow the Action: Huddles provide a rhythm of communication where everyone is kept informed, involved and engaged in moving the company forward.
  - Forward Forecasting: You can't change history. Forecasting is the fundamental way GGOB companies communicate the numbers and create forward-looking, educational and results-oriented huddles.
- **Provide a Stake in the Outcome**
  - Rewards, Recognition: All who directly participate in strengthening the company likely do so because they have some form of a stake in the outcome. They come to work to win, because they know their work will result in significant reward, recognition and ownership in the outcome.
  - MiniGames: Short term, intensely focused, rapid improvement campaigns that affect a change, correct a weakness or pursue an opportunity. Like the big Game, there is a goal, a scoreboard and a reward for winning.
  - Ownership: Not all companies who play the Game can or will share equity, nor is it a guarantee of success. But getting employees to think and act like owners is one of the most powerful things any leader can do to create measurable and sustainable success in any organization.

Recommendations

The NCEO has developed a three-stage proposal to reflect the evolving needs of the organization as it grows and matures. For each stage, we have included recommendations for ownership structure as well as employee training and involvement. There is no set timeline for the stages. Instead, the timing depends on the development of the organization's workforce and its performance.

Stage 1: Start-up

Ownership structure

At this stage, PCM will maintain its current ownership structure as a C corporation with common and preferred shares. The stock will be held as follows:

- Common stock is wholly owned by Brahm
- Preferred shares are held by California residents and structured as a loan (3% limit on return, plus 1% in store credit)

Employees will not own stock directly or indirectly at this stage. Instead, there will be a profit sharing bonus plan for all employees who meet minimum tenure requirements, called "PCM Team Member Bonus." An additional "Superstar Bonus" will be available for committed employees who complete a training program, described in the employee training and involvement section below.

The NCEO also recommends becoming an Benefit Corporation or Flexible Purpose Corporation at this stage. By adopting a new corporate form, the mission of the organization will be incorporated in the organization's bylaws, and PCM will probably have greater protection against unwanted takeovers when the stock is more widely distributed. Additionally, Benefit Corporation status is a way to demonstrate PCM's commitment to its social mission to potential partners and consumers.

Employee training and involvement

As mentioned above, PCM is committed to workforce training that will help drive the company's performance by teaching employees how to think and act like owners. The NCEO recommends setting up a training and involvement program that is in place from the beginning, but is flexible enough to adjust as the organization's culture and policies develop. In particular, the NCEO recommends a "Core Training" program with the following elements that apply to all employees:

- Introductory business literacy training (understanding the financials and the organization's business model)
- Introductory entrepreneurship training (understanding how the employee's work affects the bottom line)
- Structured opportunities for participation in decision making

The program will also include a "PCM Team Member Bonus," which will be based on the organization's overall performance, and distributed based on relative compensation.

For committed employees, the company will offer a "Certified Superstar" training program. This program will include more extensive business literacy and entrepreneurship training with a curriculum and time frame for completion, as well as continuing education requirements. Employees who complete the program and stay up-to-date with the continuing education requirements are eligible to participate in an additional profit sharing bonus, called the "Superstar Bonus."

Both the Core Training program and this additional bonus is based on a Great Game of Business model.

To participate in either the PCM Team Member Bonus or the Superstar program, there will be a minimum employment requirement to be set by Brahm, in the range of three to nine months.

Stage 2: Transition

Ownership structure

At this stage, the NCEO recommends that PCM remain a C corporation with common and preferred shares, but that the organization changes how the shares are held. The structure outlined below will give committed employees the opportunity to become owners, while providing nonprofits super-voting shares, which will ensure mission preservation. The stock will be held as follows:

- Brahm retains the common stock held in Stage 1
- PCM creates a restricted stock unit plan for

employees who complete the Certified Employee Owners program (which will replace the Superstar program.) The restricted stock units are granted upon completion of the program and vest when the company becomes 100% employee-owned. These shares will dilute Brahm's ownership at the liquidity event.

- One or more nonprofits hold super-voting shares that only become exercisable on a proposed change in control. In the case of a conversion to a 100% ESOP (which would occur in stage 3), the shares convert to warrants
- Preferred shares are held by California residents and structured as a loan (3% limit on return, plus 1% in store credit). In this stage, the company will likely begin to redeem preferred shares

Employee training and involvement

At this stage, the NCEO recommends that PCM continue to provide the Core Training and PCM Team Member Bonus.

In this stage the Certified Superstar program becomes the Certified Employee Owner program, and employees who complete it are eligible for the restricted stock unit grants and the "Owner's Bonus," which replaces the Superstar Bonus.

Employees who received the Certified Superstar designation and stayed up-to-date with the continuing education requirements will automatically become Certified Employee Owners and be granted restricted stock units through the plan. They also remain eligible to receive the "Superstar Bonus," which, in this stage, is called the "Owner's Bonus."

As in the previous stage, this bonuses will be based on a Great Game of Business model. The organization may also want to create non-monetary rights and responsibilities associated with being a Certified Employee Owner, including greater opportunities to participate in decision making.

Stage 3: 100% Employee-owned

Ownership structure

At this stage, the NCEO recommends transitioning to a 100% S corporation ESOP. For profitable companies, this structure has significant tax benefits, including exemption from any federal corporate taxes. Additionally, it provides employees with a financially meaningful ownership stake. The ESOP contributions, which typically range from 5%-15% of payroll, are allocated to employees based on relative pay or a more level formula.

The ESOP will also provide a lasting ownership structure that makes an unwanted takeover unlikely and precludes the need for a future ownership transition

The transition will result in the following changes:

- Brahm and employees with restricted stock units sell 100% of shares to the ESOP at current fair market value as assessed by an independent valuation firm
- Nonprofit super-voting shares convert to warrants (that may or may not have economic value), which only vest on a proposed change in control
- Any remaining preferred shares are redeemed in accordance with the original agreement

Employee training and involvement

At this stage, the NCEO recommends that PCM continue to provide the training opportunities and bonuses offered in the earlier stages.

The training programs and accompanying incentives will have built the foundation for an organizational culture where all employees are expected to think and act like owners.

All employees meeting certain minimum requirements will participate in the ESOP, not just those who completed the Certified Employee Owner training. However, those who do complete the training will still have additional rights and responsibilities. The rights include participation in the Owner's Bonus and greater opportunities for decision making.

Summary of Employee Involvement Recommendations

Program element	Stages	Eligibility requirements	Description and purpose
Core Training	All stages	No requirement	Introductory business literacy training: Training to help all employees understanding the financials and the organization's business model Introductory entrepreneurship training: Training to help all employees understanding how their work affects the bottom line
PCM Team Member Bonus	All stages	Minimum service requirement (3-9 months of tenure)	Bonus based on the organization's overall performance, distributed based on relative compensation to provide short term, tangible rewards for organizational performance, and build a culture of teamwork and entrepreneurial behavior
Certified Superstar Program	Stage 1	Minimum service requirement (3-9 months of tenure)	Advanced training in ownership thinking to give dedicated employees a way to earn (1) an additional bonus, (2) the right to be a stockholder, and (3) an increased role in decision making
Superstar Bonus	Stage 1	Completion of the Superstar program	A bonus on top of the PCM Team Member Bonus based on a Great Game of Business model.
Certified Employee Owner (CEO) Program	Stage 2	Minimum service requirement (3-9 months of tenure)	The same as the Superstar Program, except that in this stage, employees who complete the program are eligible to participate in the restricted stock unit plan, and the "Superstar Bonus" is renamed to the "Owner's Bonus"
Owner's Bonus	Stage 2	Completion of the CEO Program	Renaming of the "Superstar Bonus" to reflect the fact that employees in who complete the CEO program are eligible to become owners
Restricted Stock Unit Plan	Stage 2	Completion of the CEO Program	Restricted stock units granted to employees who complete the CEO program, and annually for staying up-to-date with continuing education requirements
Employee stock ownership plan	Stage 3	Minimum service requirement (1 year maximum)	Broad-based employee ownership by all employees who meet service requirements to create a culture of ownership and provide a lasting organizational structure

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Appendix: Social Enterprise Structures and their Attributes

Majority Employee-Owned Company through an ESOP

	Tax and Other Financial Benefits	Complexity and Costs	Employee Benefit Options	Flexibility on Participation	Mission Preservation	Raising Capital	Issues to Consider
100% S Corp ESOP	No corporate taxes. Contributions to the ESOP are tax deductible up to 25% of payroll. If converting from a C corp to an S corp ESOP, the §1042 benefits are available (see below)	ESOPs require retaining various service providers, including a trustee, lawyer(s), appraiser(s), and a plan administration firm. The start-up costs will likely range from $75,000 to $200,000. On an ongoing basis, administration and valuation fees will likely range from $10,000 to $30,000 per year.	Employees will receive a substantial retirement benefit. The organization may also use distributions, profit sharing, a bonus plan, or synthetic equity for more immediate rewards. Distributions are not tax-deductible, but they can be used to repay the ESOP loan. No limit on amount of distributions.	All employees meeting certain minimum eligibility criteria (21 years or older, 1 year of service, 1000 hours in the plan year) participate in the plan. After at most 6 years, all participants must be fully vested, but within the legal limits, there is flexibility in how vesting is structured.	Because ESOPs require a vote by participants to approve a sale of all major assets, ESOPs are often seen as a way to keep a company private and independent. There are additional "poison pills" that can be added to the bylaws, such as requiring participant voting for a stock sale or a provision that gives 50% of sale proceeds to a nonprofit, that increase the likelihood of staying independent and mission driven. However, because of federal ESOP law, there is no way to ensure it.	ESOPs can borrow money and are therefore a valuable tool for raising capital. For example, once the initial ESOP loan is repaid, the ESOP can take out a new loan to buy treasury shares from the company, thereby providing the company with growth capital. The same tax benefits re deductibility apply.	
Majority S Corp ESOP	No corporate taxes for percentage owned by ESOP. However, dividends provided to non-ESOP owners to cover tax payment must also be given to ESOP. Contributions to the ESOP are tax deductible up to 25% of payroll.						Who would own the rest of the stock? Note that ownership in an S corporation is limited to 100 total shareholders and a single class of shares.
100% or Majority C Corp ESOP	§1042: Selling owner(s) can defer taxation on the sale if proceeds are used to purchase stock in US companies or other qualified replacement property. Contributions to the ESOP are tax deductible up to 25% of payroll. An additional 25% of payroll can be deducted for both interest and principle repayments on the ESOP loan.		Employees will receive a substantial retirement benefit. The organization may also use dividends, profit sharing, a bonus plan, or synthetic equity for more immediate rewards. Dividends are deductible and not are not subject to the 25% contribution limit, but must be "reasonable."				If less than 100%, who would own the rest of the stock? C corps can issue multiple classes of stock, so the remainder could be preferred stock for investors.

Appendix: Social Enterprise Structures and their Attributes

Worker Cooperatives

	Tax and Other Financial Benefits	Complexity and Costs	Employee Benefit Options	Flexibility on Participation	Mission Preservation	Raising Capital	Issues to Consider
Worker Co-op LLC	Dividends paid out to worker-members are deductible by the company (and possibly nontaxable to the workers) under Sub Chapter T of the Internal Revenue Code, as long as the organization "operates on a cooperative basis," meaning one-member-one-vote, limited investor returns, and limited retained earnings.	There are a few examples of worker cooperative LLCs, including the WAGES cooperatives. (Learn more at http://wagescooperatives.org/) The LLC structure is flexible and relatively informal, but LLC cooperatives do involve legal and administrative costs (less than an ESOP).	Worker members will receive patronage dividends as cash, deferrals, or a combination of the two. Additionally, the company could offer other cash incentives, but only on a limited basis.	An LLC can design membership requirements and the timeline for workers to become members.	Members own the cooperative and vote on a one-member-one-vote basis to receive tax benefits under Sub Chapter T. Decisions about the mission or a change in control are made on a democratic basis.	LLCs have the flexibility to offer investment opportunities with limited or no rights attached, but they are not as investor-friendly as, say, preferred equity. Also, to receive the tax benefits under Sub Chapter T, returns to investors must be limited. Traditional loans are likely difficult to procure. Coop LLCs are also limited in their ability to retain capital for the company.	How would the coop determine membership in a way that would preserve the long-term mission of the company? And would democratic governance stunt the growth of the company?
Worker Co-op under Consumer Co-op Law		This law has been used many times to create worker cooperatives, and there are lawyers and CPAs well versed in it. It does involve legal and administrative costs (less than an ESOP).		A coop can design membership requirements as well as the timeline for workers to become members.		As with an LLC, coop corporations can have multiple classes of membership with a non-worker class having limited or no rights attached. However, this is not likely to attract traditional investors and traditional loans will also be hard to secure. They are also limited in their ability to retain capital for the company	

Appendix: Social Enterprise Structures and their Attributes

Nonprofit/For-Profit Hybrids

	Tax and Other Financial Benefits	Complexity and Costs	Employee Benefit Options	Flexibility on Participation	Mission Preservation	Raising Capital	Issues to Consider
For-Profit Subsidiary of a Nonprofit	Dividends, interest, rent annuities, and royalties paid from for-profit to nonprofit may not be considered taxable income to the tax-exempt organization depending on how ownership is structured.	This subsidiary relationship requires caution regarding control of the entities and their separateness. Extensive legal advice is required.	The organization may use non-voting membership or stock, profit sharing, a bonus plan, or synthetic equity.	Ownership (or at least voting rights) will likely be held primarily or completely by the parent nonprofit, limiting the extent of stock or membership owned by employees or other stakeholders.	Ownership is held by a nonprofit, which decides about any potential sale/change in control.	With a nonprofit structure, the organization has access to foundation money, such as REDF. The company could issue preferred equity or nonvoting stock to investors.	Separateness of the two entities may be difficult with People's Community Market.
For-Profit where Copyright, Assets, Etc. Held by Nonprofit	Interest, rent annuities, and royalties paid from for-profit to nonprofit are not be considered taxable income to the tax-exempt organization as long as the arrangements are passive.	This arrangement is much less complex than a subsidiary relationship, but requires care regarding revenues to the nonprofit.	Depends on how the company itself is structured.	Depends on how the company itself is structured.	The name, logos, and assets of PCM are held by a nonprofit, but the company itself could be sold depending on its structure.	Depends on how the company itself is structured.	Who would own the company? This could be an ESOP.

Multi-Stakeholder Company

In addition to each of the structures listed above, there are various ways to structure multi-stakeholder companies, including:

- Multi-Stakeholder LLC. The company could be owned by any combination of stakeholders using trusts or direct membership. The structure could include different classes of membership that allow for investment while keeping decision making with a few people or a trustee.
- Multi-Stakeholder Co-op under Consumer Co-op Law. The company could be structured as a consumer and worker cooperative.
- Multi-Stakeholder ESOP. The company could be partly owned by an ESOP, and partly owned by other stakeholders either directly or through a trust held on their behalf. The company would have to be a C or S corporation to have an ESOP.
- Multi-Stakeholder Corporation without an ESOP. The company could structure its stock any number of ways to provide various stakeholders with an ownership stake while maintaining control with a mission-driven group. This could include dual share structures, trusts held on behalf of stakeholders, direct offerings reserved for particular stakeholder groups, etc.

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