Promoting Employee Ownership: A Look at the States

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By encouraging employee ownership, states can retain jobs and capital, address wealth inequality, and increase retirement security.

Close to half of all privately-held companies in the U.S. are owned by baby boomers, meaning 2.7 million American businesses are owned by someone age 55 or older.[i] In the coming decades, all of these business will either change owners or disappear. The median state has 34,000 businesses approaching an ownership transition. The effects of this generational shift will be felt in cities, small towns, and rural areas.

At the same time, state governments are struggling with the challenge of preserving jobs and stimulating local economies buffeted by larger economic trends. States currently spend an estimated $45 billion and $70 billion a year on efforts to attract and retain jobs.[ii]

If even a fraction of these exiting owners pursued an Employee Stock Ownership Plan (ESOP) as their business exit strategy, the potential positive impact on workers, communities, and state economies would be substantial.[iii] Yet, many business owners are not even aware of ESOPs as an option. In light of this knowledge gap, many of these businesses will instead shut down or sell to outside investors who may not be interested in preserving and growing local jobs.

Addressing this ESOP knowledge gap can be a relatively cost-efficient way for states to preserve jobs, address wealth inequality, and increase retirement security. Specifically, states or local non-profits at a state or regional level could set up outreach programs to inform and educate business owners about ESOPs as a transition strategy. Locally based outreach programs can draw upon existing networks of experts and infrastructures, such as colleges, universities, and successful ESOP companies.

As is often the case, states are increasingly acting as laboratories for different approaches. There is much to be learned from how states and localities are shaping their efforts within their particular economic, political, and cultural environments.

How do ESOPs work?

In short, ESOPs are a kind of employee benefit plan that can be used to buy out an owner and transfer ownership to employees in part or in whole, all while creating a qualified retirement plan at no cost to the employees. This is accomplished through the unique transaction structure that is available to ESOPs under law: the ESOP trust can borrow money to buy the shares of the departing owner(s), with the company making cash contributions to the plan to enable it to repay the loan over time. Alternatively, the company may contribute new shares of its own stock and/or use cash to buy existing shares without a 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. Generally, all full-time employees are included after a year of service. 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.[iv]

From the perspective of the selling owner, it makes sense to fund an ESOP at a higher rate than other benefit plans such as 401(k)s because the ESOP accomplishes multiple goals – in addition to being an employee benefit, it also provides a succession plan that fairly compensates the selling owner and introduces unique tax advantages for both the owner and the company. ESOPs have proven to be a sustainable form of company ownership. Not only do these employee-owned companies generally continue to thrive, this unique ownership structure often improves company performance.

Supporters across party lines in Congress have determined that ESOPs are good public policy, and as a result there are significant tax benefits to establishing and maintaining an ESOP. In order to qualify for those benefits, ESOPs *by law* must be *broad-based*. They must extend to all employees meeting minimal employment requirements (with some exceptions that apply to all benefit plans), and they cannot excessively benefit highly compensated employees.

Currently, there are around 6,660 ESOPs in the United States holding total assets of nearly $1.4 trillion.[v] These plans cover 14.2 million participants. The Midwest is home to the greatest number of ESOPs, followed by the South. There is a least one ESOP headquartered in 4,131 distinct zip codes. As Table 1. demonstrates there is potential across states for more ESOP transitions.

Table 1. Current coverage of ESOPs and Potential by Region and State

	Current		Potential
State	Number of ESOPs[vi]	Total Participants	Number of business owners age 55 or older[vii]
Northeast	1,088	3,298,762	489,593
New England	320	1,030,072	136,153
Connecticut	64	422,631	32,987
Maine	42	7,320	15,667
Massachusetts	135	363,792	56,638
New Hampshire	29	6,817	13,725
Rhode Island	17	223,272	9,091
Vermont	33	6,240	8,045

Middle Atlantic	768	2,268,690	353,440
New Jersey	141	1,036,682	83,850
New York	321	846,576	166,831
Pennsylvania	307	385,432	102,759
Midwest	2,119	3,615,255	615,420
East North Central	1,229	2,138,293	399,850
Indiana	186	133,882	55,928
Illinois	347	747,387	113,639
Michigan	207	288,117	82,473
Ohio	296	784,564	91,516
Wisconsin	193	184,342	56,294
West North Central	889	1,476,963	215,570
Iowa	161	455,337	33,553
Kansas	106	72,071	30,518
Minnesota	270	790,124	54,283
Missouri	204	102,518	54,204
Nebraska	70	24,073	22,485
North Dakota	54	25,855	9,111
South Dakota	24	6,985	11,416
South	1,949	5,934,370	904,232
South Atlantic	999	2,805,033	501,226
Delaware	9	52,011	7,411
District of Columbia	14	4,410	5,377
Florida	186	501,923	177,617
Georgia	157	579,349	70,002
Maryland	130	343,563	47,503
North Carolina	122	781,487	77,948
South Carolina	60	37,439	34,039
Virginia	292	499,738	69,211
West Virginia	28	5,114	12,118
East South Central	341	373,148	127,003
Alabama	76	48,337	31,808
Kentucky	111	131,911	32,653
Mississippi	46	24,997	18,095
Tennessee	109	167,902	44,447
West South Central	609	2,756,189	276,003
Arkansas	59	1,709,215	23,422
Louisiana	83	38,624	36,841
Oklahoma	85	61,033	34,040
Texas	382	947,317	181,700
West	1,501	1,430,522	672,947
Mountain	422	168,222	216,196

Arizona	104	45,644	48,313
Colorado	116	36,832	61,091
Idaho	37	28,277	18,529
New Mexico	39	7,057	17,470
Montana	34	7,002	15,828
Utah	60	31,299	25,391
Nevada	23	9,702	19,878
Wyoming	11	2,408	9,696
Pacific	1,078	1,262,300	456,751
Alaska	27	1,594	7,386
California	806	681,229	319,612
Hawaii	66	16,867	11,894
Oregon	72	54,333	46,212
Washington	107	508,277	71,647
Total	6,657	14,278,909	2,682,192

The Wider Benefits of ESOPs

At the company level, ESOPs have been associated with greater firm performance, productivity, and job stability. Employee ownership has been linked to greater employment stability in the face of an economic downturn, and firms with employee-ownership were more likely to survive the last two recessions.[viii]

Promoting ESOP transitions would be a smart investment for states even if all they did was increase business longevity and sustainability, but research conducted over the last three decades points to wider benefits. These findings are underpinned by general characteristics of ESOP companies. As a result of several factors, including the culture often created in these companies, ESOP companies tend to invest more heavily in employee education, training, and engagement for the long-term success of the company. Privately-held ESOPs generally intend their ESOPs to be permanent[ix] such that they have structural reasons to buck the trend of "short-termism" often seen in publicly traded companies and private equity firms that can have negative impacts on workers and communities.[x]

First and foremost, these companies create retirement savings at a time when the median retirement savings among Americans without traditional pensions is *zero.*[xi]

ESOP companies tend to lay off employees at lower rates compared to other companies. National surveys show that among employees at private firms both actual layoffs and the perceived likelihood of being laid off are lower for employee-owners than for nonowners.[xii]

This increased job tenure translates into quantifiable benefits for workers in ESOPs. An ongoing analysis of panel data from the National Longitudinal Survey comparing younger workers with

ESOPs to similar workers without such a benefit finds the median job tenure of employee-owners is 5.1 years, 46% greater than the 3.5 years for those without an ESOP. This translates into appreciably higher median household wealth for ESOP workers.[xiii]

Interviews conducted with lower-wage ESOP employees demonstrate very real impacts on emotional well-being and positive inter-generational effects that go beyond the quantifiable financial security.[xiv]

Promoting employee ownership

Many business owners either don't know or have misconceptions about ESOPs and how to use them for ownership transition.[xv] In this context, education and outreach can be powerful tools. There are already many experts who can be drawn upon and infrastructures such as colleges and universities that can be leveraged for information, support, and access to business owners. Successful ESOP companies often have knowledgeable and engaging spokespeople. The task is to bring together these resources in a way that works best in each state.[xvi]

In order to increase the effectiveness and penetration of local outreach and education, states can:

- Create an Office of Employee Ownership with a dedicated staff person. The office could exist within a state agency or as a nonprofit receiving state funding;
- Provide grants to one or more nonprofits to run an outreach program;
- Hold seminars statewide in conjunction with professional, business, and trade publications and organizations;
- Publish and disseminate brochures and other material; and
- Work with the media to encourage stories on local ESOP companies.

In order to promote ESOPs as an attractive alternative to private equity, outside competitors, and other potential purchasers of the business, ESOP outreach should:

- Focus on business owners who are approaching retirement or a liquidity event, as opposed to start-ups or businesses who are interested in progressive management.
- Focus on the human side and emotional impact of employee ownership. Videos and other personal testimonials contrasting the storylines of a company that becomes employee-owned versus one that becomes owned by an outside investor can be powerful.
- Take advantage of the ESOP community by facilitating peer-to-peer connections, where company leaders talk with their peers who have sold to an ESOP. These connections are usually fostered based on location or industry.
- Take care to ensure that the center is seen as providing objective information as opposed to being perceived as trying to "sell" owners on the idea.

Currently, there existing and burgeoning employee ownership state organizations in California, Colorado, Indiana, Massachusetts, New Jersey, North Carolina[xvii], Ohio, Pennsylvania[xviii], and Vermont[xix], and exploratory efforts in other states, as well as a city-based program in Newark, NJ.

These centers all have roughly the same mission--to encourage the adoption of employee owned business models through education and outreach. That said, they differ in their funding, strategy, and methods. These centers range from purely volunteer driven to fully fledged organizations with an executive director and full-time staff support.

These centers are most often set up as independently operated 501(c)3s, though several are operated out of state universities. Of these, Vermont, Colorado, and Massachusetts have state-funded programs.

The California Center for Employee Ownership (CCEO)[xx] is housed at the University of San Diego's Rady School of Management, and the New Jersey/New York Center for Employee Ownership (NJ/NYCEO)[xxi] is a based out of the Rutgers University's School of Management and Labor Relations.

The most long-lived of this type of effort, the Ohio Employee Ownership Center (OEOC)[xxii], was established at Kent State University in 1987 and is funded via public and private grants; memberships and sponsorships; fee-for-service work; donations; and other sources.

The Indiana Center for Employee Ownership (INCEO)[xxiii] resulted from the initiative of a CEO of a successful ESOP company to make sure other businesses in his state knew about the benefits of ESOPs.

The Massachusetts Center for Employee Ownership (MassCEO)[xxiv] was created by an act of the Massachusetts legislature in 2017 and has been formally operating as part of the Massachusetts Office of Business Development since April 2019.

States can set up the centers as part of a state agency, as Colorado did in 2019. The state plans to work closely with the nonprofit Rocky Mountain Employee Ownership Center (RMEOC)[xxv] to implement the program, similar to the MassCEO. The RMEOC has been operating out of Denver since 2009 and was a key driver in the creation of the Colorado state agency.

And at the local level, the City of Newark, in partnership with the Newark Community Economic Development Corporation (CEDC) and private investors, is implementing the development of employee-owned businesses as a community wealth-building strategy.[xxvi]

Other policy approaches

Arguably, the lowest-hanging fruit is simply informing and educating business owners. In terms of potential there is enormous room to grow. Beyond this, there is a fluid and varied landscape of ideas and approaches to encourage and support employee ownership.

One such approach involves providing purchasing preferences for ESOP-owned companies.[xxvii] Currently, programs such as woman-owned business enterprise, minority-owned business enterprise, and service-disabled-veteran-owned business enterprise designations almost universally exclude any company where a majority of the stock is held by an ESOP. That is because the stock is legally held in an ESOP trust, and a trust is, by definition, not a qualified individual for set-asides. This leads to the anomalous situation where a company could be majority-owned by employees in the qualifying group, as well as, run by people in that group and yet not qualify, whereas a company owned by just one individual of that group does qualify.

Legislation being considered in Texas would allow these set-asides if the trustee was a qualifying individual. It also would designate majority-owned ESOPs as historically underutilized businesses, another set-aside preference. Similarly a bill in California would provide a 3% purchasing preference for majority employee-owned companies regardless of the status of individuals involved. This change could both make it more practical for businesses qualifying for set-asides to move to majority employee ownership as well as encourage some companies who might otherwise not qualify to become eligible.

States are considering and attempting other ways of encouraging ESOP formation, including:

- Providing loan funds, loan guarantees, and incentives for ESOP loan providers.
- Providing funding for ESOP feasibility studies.
- Extending and expanding tax breaks to owners of companies selling to an ESOP.
- Creating tax abatement programs for companies with ESOPs or other broad-based employee ownership structures. Iowa and Missouri, for instance, have extended the deferral of state taxes on the sale of stock to an ESOP to S as well as C corporations.

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[i] NCEO analysis of the Annual Survey of Entrepreneurs, 2016.

[ii] See the work of Professor Timothy Bartik and Professor Kenneth Thomas, and the research conducted and compiled by https://www.goodjobsfirst.org/

[iii] Of course, this course of action is not suitable for every company. Generally, companies should have at least 20 employees to be able to absorb the transactional costs of an ESOP, have enough profits to purchase shares and still run the company, and have a culture open to sharing ownership.

[iv] See this booklet for an overview of how ESOPs work in practice. https://www.nceo.org/assets/pdf/misc/Employee-Ownership-NCEO.pdf

[v] https://www.nceo.org/articles/esops-by-the-numbers
[vi] NCEO analysis of Form 5500 data as of filing year 2016
[vii] NCEO analysis of the Annual Survey of Entrepreneurs, 2016. Number of business owners of respondent firms with paid employees, 2016, age 55 or older[vii]
[viii] See https://www.nceo.org/Guide-Research-Employee-Ownership/id/125/ for an detailed summary of academic research findings.
[ix] For example, in the 2017 NCEO Repurchase Obligation Survey, 72% of the ESOP respondents *strongly agreed* that they intend "our ESOP to be permanent". https://www.nceo.org/ESOP-Repurchase-Obligation-Survey-2017-Full-Report/m/926/
[x] See for example, https://www.fcltglobal.org/research/reports/article/measuring-the-economic-impact-of-short-termism
[xi] Author's calculations using the Survey of Consumer Finances (2016). For additional data on the state of Americans' retirement savings see, https://www.nceo.org/assets/pdf/articles/NCEO-S-ESOPs-Retirement-Dec-2018.pdf
[xii] The General Social Survey (GSS) is a nationally representative, face-to-face survey covering a broad range of behavior and attitudes conducted by the National Opinion Research Center (NORC) at the University of Chicago. The General Social Survey does not break out ESOPs. Employee-owners are identified based on the GSS variable *ownstock*, which asks respondents if they own any shares of stock in the company where they now work, either directly or through some type of retirement or stock plan.
[xiii] See the full results at https://www.ownershipeconomy.org/
[xiv] https://smlr.rutgers.edu/news/study-employee-ownership-narrows-gender-and-racial-wealth-gaps
[xv] For example, in a 2016 Business Enterprise Institute, Inc. (BEI) survey of business owners, just 6% of that sample noted selling to an ESOP as a [business] exit path they are considering. https://www.exitplanning.com/2016-business-owner-survey-report
[xvi] For more information on state and local employee ownership initiatives, contact NCEO outreach coordinator Tim Garbinsky at tgarbinsky@nceo.org
[xvii] https://www.broughton-consulting.com/nceoc/
[xviii] https://ownershippennsylvania.org/
[xix] http://www.veoc.org/
[xx] https://www.ownershipcalifornia.org/
[xxi] https://ownership.rutgers.edu/
[xxii] http://www.oeockent.org/
[xxiii] https://inceo.org/
[xxiv] https://www.massceo.com/
[xxv] http://www.rmeoc.org/
[xxvi] http://www.newarkcedc.org/employee_ownership
[xxvii] For more details on this issue see https://www.nceo.org/assets/pdf/EO_Preferred-Status.pdf