In Pursuit of Good & Gold: Data Observations of Employee Ownership & Impact Investment

Christopher Geczy  
*University of Pennsylvania Wharton School, geczy@wharton.upenn.edu*

Jessica S. Jeffers  
*University of Pennsylvania Wharton School, jeffersj@wharton.upenn.edu*

David K. Musto  
*University of Pennsylvania Wharton School, musto@wharton.upenn.edu*

Anne M. Tucker  
*Georgia State University College of Law, amtucker@gsu.edu*

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In Pursuit of Good & Gold: Data Observations of Employee Ownership & Impact Investment

Christopher Geczy, Jessica S. Jeffers, David K. Musto & Anne M. Tucker*

ABSTRACT

A startup’s path to self-sustaining profitability is risky and hard, and most do not make it. Venture capital (VC) investors try to improve these odds with contractual terms that focus and sharpen employees’ incentives to pursue gold. If the employees and investors expect the startup to balance the goal of profitability with another goal—the goal of good—the risks are likely to both grow and multiply. They grow to the extent that profits are threatened, and they multiply to the extent that balancing competing goals adds a dimension to the incentive problem. In this Article, we explore contracting terms specific to impact investing funds and their portfolio companies. We observe one possible private ordering mechanism to balance and align interests to serve both goals: employee ownership.

Traditional VC investments confront contracting challenges as the portfolio companies and investors balance their interests, which may not align. Additionally, portfolio companies are contracting with their own employees. The VC contracting literature identifies several agency costs that contractual terms can address. Contracts can help attract the right employees, then encourage them to work, stay, and share their best ideas. But, the existing literature addresses traditional agency costs with respect to the pursuit of a single monetary goal. Impact investment funds that balance monetary goals, short-term or long, with other goals may strike a different balance in negotiating with companies. We examine how the introduction of new motivations and interests into a precarious negotiation process shapes contracting outcomes.

We address this question empirically by analyzing the role of employee stock ownership in impact investment fund contracts when investing in targeted portfolio companies. That a startup’s employees might receive shares and options is uncontroversial. Indeed, this appears in many ways to be fundamental to today’s startup culture. Might impact
investors mandate that employees own shares as a means to balance dual goals? That is the key question for our analysis.

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INTRODUCTION

Employee ownership is a source of corporate governance optimism. It can help recruit and retain better employees, and it can neutralize agency costs by aligning employees’ and other shareholders’ interests. High-profile tech companies like Facebook and Twitter, and fictional ones like those depicted in the show Silicon Valley, associate tech employment with ownership.1 Outside of the tech world, established, large-scale

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1 Christopher Geczy, Academic Director, Wharton Wealth Management Initiative, Director of Jacobs Levy Equity Management Center for Quantitative Research; Jessica S. Jeffers, Ph.D. candidate, Wharton School, University of Pennsylvania; Anne M. Tucker, Associate Professor of Law, Georgia State University College of Law; David K. Musto, Ronald O. Perelman Professor in Finance & Department Chair, Wharton School, University of Pennsylvania. David Musto is also an economist at the Securities Exchange Commission. The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the authors colleagues upon the staff of the Commission.

companies like Whole Foods, Starbucks, and Chobani boast strong employee ownership programs.

Impact investing is a source of optimism about society’s potential benefit from profit-seeking firms and investment funds. In the impact sector, venture capital (VC) partnerships aim to produce societal benefits alongside monetary returns by seeking out portfolio companies dedicated to both goals. The importance of the nonmonetary goal in impact investing raises the question of whether employee ownership plays the same role as it does when only profits are sought. We address this question in our Article. In reviewing 100 contracts and preliminary contracts, we observe a relatively high incidence of employee ownership plans as a deal term, a condition, of the joint agreement for the impact fund to invest and for the portfolio company to accept the financing. That is, the investors appear to not only allow but also require portfolio companies to encourage employee share ownership. This finding raises further questions. Are employee ownership programs compatible with small-scale companies in emerging or developing economies? Can employee ownership programs further additional ends in the unique context of impact investment, such as fostering social and employee quality of life benefits? Who benefits from the creation of employee ownership plans: portfolio companies or impact funds?

In this Article, we examine the intersection of shared employee ownership, private equity/venture capitalism, and impact investments. Drawing upon a unique data set of impact investment fund survey responses and voluntarily supplied documents, we examine shared

2. About Our Benefits, Whole Foods, http://www.wholefoodsmarket.com/careers/about-our-benefits [https://perma.cc/2JXL-U2GW]. “All of our full-time and part-time team members are eligible to receive stock options through annual leadership grants or through service-hour grants once they have accumulated 6,000 service hours (approximately three years of full-time employment). Approximately 95% of the equity awards granted under the Company’s stock plan since its inception in 1992 have been granted to team members who are not executive officers. In fiscal year 2013, more than 14,000 team members exercised over 4 million stock options worth approximately $120 million in gains before taxes, or an average of about $8,400 per team member.” Form 10-K, Whole Foods, https://www.wholefoodsmarket.com/sites/default/files/media/Global/Company%20Info/PDFs/WFM-2013-10-K.pdf [https://perma.cc/S5TL-LH9Z] (describing the stock ownership plan).


ownership from the point of view of the funds through a contract theory lens.

Within our study, we found that contractual terms, particularly regarding employee share ownership, cluster by fund. This clustering suggests that, to some extent, funds drive the observed commitment to employee ownership. When surveyed, fund managers’ responses suggest that employee ownership is compatible with impact investment objectives. We offer several hypotheses for the motive at the portfolio company and fund level to include employee ownership schemes. Through extensive cross-sectional analysis, we investigate the various employee ownership theories, offer preliminary observations gleaned from our sample, and suggest future areas of research in this new field.

The existing shared ownership literature focuses on employee ownership in startups, best practices in implementing employee ownership programs, and the benefits of employee ownership plans such as recruitment, retention, and performance. The private equity and VC literature focuses on mechanisms of contract to structure investment and financial incentives at the fund level and the portfolio company level. The private equity and VC literature, however, is mostly silent on funds contracting for shared ownership in portfolio companies. The impact investment literature, the most nascent of the fields both in terms of practice and study, is largely dominated by industry and grant-funded research-backed in part by financial intermediaries with impact investment products available. Our Article adds to the existing employee ownership literature by building out the fund’s perspective and interest in shared ownership. It also adds to the existing private equity and VC literature by examining shared ownership and to the emerging impact investment literature by providing an extensive academic review of a large set of contracts in this space.

Our Article proceeds as follows: In Part I, we introduce impact investment for those unfamiliar with the topic. In Part II, we provide a brief overview of employee ownership structures. In Part III, we state the various hypotheses for company and fund preferences for employee ownership and introduce predictions for data observations. In Part IV, we state our methodology and review our sample. In Part V, we introduce survey and document review results. In Part VI, we discuss the limitations

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6. Survey responses on file with authors.
7. See, e.g., ADOLF A. BERLE, STUDIES IN THE LAW OF CORPORATION FINANCE (1928).
of our study, share our observations and insights from this study, and outline future work.

I. IMPACT INVESTMENT

Impact investments—investments made with the intention of generating social and environmental impact alongside financial gains—account for more than $77 billion USD. While it is only a fraction of the more than $200 trillion financial market, impact investing is a growing investment strategy that is attracting major market players to the space. For example, in 2015, major private equity players—BlackRock Inc. and Bain Capital LP—launched new impact investment funds.

Financial industry groups and foundations have significantly contributed information about and knowledge of impact investment challenges, statistics, and trends. Several academic studies of social


12. MANUEL STAGARS, IMPACT INVESTMENT FUNDS FOR FRONTIER MARKETS IN SOUTHEAST ASIA 8 (2015).

13. For example, Zurich Insurance and AXA Group entered the impact investing market in the last several years. GIIN, 2016 SURVEY, supra note 10, at 4.


15. See, e.g., GIIN, BENCHMARK, supra note 9 (studying fifty-one impact funds and reporting financial returns and descriptive statistics); see also GREENE, supra note 9.
enterprise have been published in the last five years, but to date few have focused specifically on impact investment. Our academic study adds to the existing body of literature by focusing on impact investment contracting norms generally, and in this Article, specifically examining the role of and preference for employee ownership.

Impact investing describes an investment strategy, not an asset class. Impact investments avoid allocating capital to companies that “induce harm for society or the environment.” But negative screening, alone, is insufficient to qualify an investment as “impact.” Impact investing focuses on early-stage investing to bring companies with impact goals to economic viability and produce blended value. Investments typically achieve impact or blended value through product impact or operational impact. To illustrate the following, consider a company whose intended social benefit is embedded in its product and business model, for example a cook stove designed to reduce toxic exhaust in low-income households. Alternatively, a company’s impact could lie in its operations through higher wages paid to coffee pickers, through distribution of the product to the neediest, or through pricing it below top market rates. Stringent definitions of impact focus on benefit generated above what the


18. STAGARS, supra note 12, at 9. Impact investing has “animated a generation of entrepreneurs and captured the imagination of world leaders. It links the social consciousness of philanthropy with the market principles of business. It’s about how the power of markets can help to scale solutions to some of our most urgent problems.” U.S. NAT’L ADVISOR BD. ON IMPACT INVESTING, supra note 11, at 4.


21. BUGG-LEVINE & EMERSON, supra note 5, at 10 (“If impact investing is what we do, blended value is what we produce.”).

22. GREENE, supra note 9, at 4.

market would have otherwise produced, a concept coined *additionality*. While definitions and practices vary, impact investors generally seek business ideas that depart in an important and potentially measurable way from practices associated with maximizing profit. Common impact themes are job creation and quality, economic development through infrastructure, financial inclusion such as microfinance, sustainable living through access to healthy and environmentally friendly products, agriculture businesses, and education access and outcomes.

The provision of capital may, itself, be a benefit if the investment provides additional capital or capital at a lower cost than the portfolio company could get in the traditional financial market. Capital benefits include: (i) price—below market investments, (ii) pledge—loan guarantees, (iii) position—subordinated debt or equity positions, (iv) patience—longer locked-in terms before exit, (v) purpose—capital adaptable to the portfolio company’s needs, and (vi) perspicacity—discerning opportunities that traditional finance markets overlook.

Impact investments also pursue financial returns. The question is how much? Impact investments can seek concessionary returns—an intentional sacrifice of market-based returns to achieve greater social or environmental impact—or nonconcessionary returns attempting to match risk-adjusted market rates. A 2015 Global Impact Investing Network (GIIN) study of fifty-one benchmark impact funds launched between 1998 and 2004 reported 6.9% returned to investors. The same study results, when limited to funds under $100 million and launched between 1998 and 2010, reported a return of 9.5% (IRR) to investors. In a 2016 study issued by the Wharton Social Impact Initiative affiliated with the University of Pennsylvania, three co-authors of this Article reported that impact funds seeking market rate returns performed consistent (or nearly consistent)

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24. Additionality increases the quantity or quality of a portfolio company’s social outcomes beyond what it could have generated absent the investment. Brest & Born, supra note 20. Not all definitions of impact investment require additionality or the notion of but-for causality. See, e.g., Greene, *supra* note 9, at 39–40.

25. GIIN, *Benchmark, supra* note 9, at 3. Other impact sectors include renewable energy and climate change, small business finance, and fair trade.


28. GIIN, *Benchmark, supra* note 9, at i, 2 (noting that the funds studied sought to make risk-adjusted market-rate returns “with target net internal rate of return (IRR) of 15% or higher, and mezzanine funds with a target net IRR of 10% or higher”). The Internal Rate of Return (IRR) is the discount rate that makes the net present value of an investment equal to zero. The IRR reported in the study reflect actual returns to the limited partners, which are net of management fees and carried interest. *Id.* at 9.

29. *Id.* at 14; see also GIIN, 2015 *Survey, supra* note 10, at 32 (describing impact investors’ portfolio’s performing mostly in line with expectations).
with benchmark indices demonstrating financial competitiveness, on a gross basis, with other equity investments.\textsuperscript{30}

Impact funds’ social, environmental, and financial gains are achieved through investments—venture investing, private equity, and direct lending—in mission-aligned portfolio companies. Impact funds typically invest in small capitalization markets subject to friction and inefficiencies that deter traditional investors. "[T]he most capital-starved countries, sectors, and institutions are capital starved for a reason: they are the most difficult ones in which to make financially profitable investments."\textsuperscript{31} Limited investment opportunities in emerging economies, especially with mission-aligned investments, present challenges such as information asymmetries,\textsuperscript{32} small investment scale,\textsuperscript{33} difficulty in building a deal pipeline,\textsuperscript{34} and limited exit opportunities, which may deter traditional investors.\textsuperscript{35}

Impact fund investors commonly include private foundations, government entities, other financial institutions, and high net-worth individuals\textsuperscript{36} who can satisfy the Regulation D requirements for exempt private equity and VC offerings.\textsuperscript{37}

\section*{II. EMPLOYEE OWNERSHIP PLAN STRUCTURES AND ATTRIBUTES}

Our Article examines the relationship, if any, between impact investments and employee ownership. Employee ownership, also called shared capitalism in the sociology literature,\textsuperscript{38} includes stock ownership

\begin{itemize}
  \item \textsuperscript{31} Bugg-Levine \& Emerson, \textit{supra} note 5, at 31.
  \item \textsuperscript{32} Impact fund managers must acquire knowledge about existing investment opportunities in mission-aligned companies and then help those entrepreneurs develop the skills to successfully manage a business. \textit{Id.} at 34, 76.
  \item \textsuperscript{33} Small investments may affect the ability of funds to provide technical assistance, what some consider a key component of VC success, to portfolio companies. \textit{Id.} at 34.
  \item \textsuperscript{34} \textit{Id.} at 76 (noting the limited investment opportunities).
  \item \textsuperscript{35} Brest \& Born, \textit{supra} note 20. "[T]he goal of a private equity investor is to invest in portfolio companies with high growth potential or undervalued assets, work with management to improve performance of the business, and exit the investment to realize a significant gain." Hugh Manahan, \textit{Private Equity Investments in Microfinance in India}, \textit{4 Mich. Bus. \& Entrepreneurial L. Rev.} 293, 313 (2015).
  \item \textsuperscript{36} Stagars, \textit{supra} note 12, at 22–23.
  \item \textsuperscript{37} Stagars, \textit{supra} note 12, at 22; see also 17 C.F.R. § 230.501 (2013) (defining accredited investors); 17 C.F.R. § 230.505 (2013) (Regulation D Exemption for limited offers and sales of securities not exceeding $5,000,000); 17 C.F.R. § 230.506 (2013) (Regulation D Exemption for limited offers and sales without regard to dollar amount of offering).
  \item \textsuperscript{38} Douglas Kruse \textit{et al.}, \textit{Does Shared Capitalism Help the Best Firms Do Even Better?} 1 (May 2011) (unpublished manuscript), http://citeseerx.ist.psu.edu/viewdoc/download?doi=
plans, stock options, profit sharing, and stock bonus plans owned outright or through retirement accounts. An estimated 9,000 companies have various forms of stock ownership, profit sharing, and stock bonus plans affecting 36% of U.S. employees (approximately 38 million Americans).

Employee ownership schemes vary across three main aspects: rights in the stock, access to the stock, and payment for the stock. The first, rights in the stock, describes whether the employee owns the stock outright—a grant—or whether the employee holds the right to purchase company stock at a future date—an option. Access to the stock and the payment schemes are closely related and describe how the employee obtains the company stock—as a bonus, as a profit sharing plan, through a defined contribution plan (401k) as a retirement investment option, through an employee purchase plan, or as a traditional employee stock ownership plan (ESOP)—as well as whether the employee, a portion of the employee’s salary, or the company “pays” for the stock.


40. In 2014, the General Social Survey was repeated through the National Opinion Research Center. The analysis and questions were designed by Douglas Kruse and Joseph Blasi of Rutgers University and Richard Freeman of Harvard University for the National Bureau of Economic Research (NBER) Shared Capitalism Project. The General Social Survey sample size was 885 working adults who were asked very specific questions about their participation in these plans. Data Show Widespread Employee Ownership in U.S., NAT’L CTR. FOR EMP. OWNERSHIP, https://www.nceo.org/articles/statistical-profile-employee-ownership [https://perma.cc/HU46BLE5].

41. This estimate excludes government employers, nonprofits, partnerships, etc. See A Statistical Profile of Employee Ownership, NAT’L CTR. FOR EMP. OWNERSHIP (Dec. 2015), https://www.nceo.org/articles/statistical-profile-employee-ownership [https://perma.cc/HU46BLE5].

42. Louis Kelso and M. Adler introduced the modern employee ownership concepts in the 1950s. LOUIS O. KELSO & MORTIMER J. ADLER, THE CAPITALIST MANIFESTO (1958). They argued that capital, not labor, was the primary source of industrial wealth and that technology, as a form of capital, was the linchpin to economic productivity. They argued that survival of the capitalist economy depended upon sharing capital ownership with labor as a means to redistribute wealth and prevent unsustainable pay gaps. Id. at 28–29, 39–41, 171–72. For a brief and compelling history of Louis Kelso and the birth of the modern ESOP, see Andrew W. Stumpf, Fifty Years of Utopia: A Half-Century After Louis Kelso’s the Capitalist Manifesto, A Look Back at the Weird History of the ESOP, 62 TAX LAW. 419 (2009).


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also shape the reach of employee owners’ voting rights as full, restricted, or subject to statutory minimums.45

Employee ownership is a robust field in the study of law and subject to its own rich debate regarding purpose,46 appropriate structure,47 and policy implications.48 For purposes of this Article, we highlight the main structural components of common employee stock plans through which employees obtain company stock and become employee owners. The various structures matter immensely with regard to legal oversight, administration, accounting, and tax.49 For our Article’s discussion, we treat all of these plans equally as paths to shared employee ownership.50


46. See, e.g., Henry Hansmann, When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy, 99 YALE L.J. 1749, 1770 (1990) (describing potential benefits of worker ownership as “worker ownership promises some conspicuous efficiency advantages over investor ownership, including improved worker productivity, avoidance of the problems of opportunism associated with worker lock-in, less strategic behavior in bargaining, better communication of worker preferences, improved monitoring of management, and the further satisfactions that may arise from participation in the process of collective decision-making”); see also Justin Schwartz, Where Did Mill Go Wrong?: Why the Capital-Managed Firm Rather Than the Labor-Managed Enterprise Is the Predominant Organizational Form in Market Economies, 73 OHIO ST. L.J. 219 (2012) (proposing a theory why employee ownership is not more widespread given the benefits of such structures).

47. See, e.g., Corey Rosen et al., Every Employee an Owner. Really., HARV. BUS. REV., June 2005, https://hbr.org/2005/06/every-employee-an-owner-really [https://perma.cc/6G9V-3QPH] (arguing for widespread employee participation in ESOPs and other structural features of ownership plans such as participation and communication).

48. See. e.g., Richard L. Doernberg & Jonathan R. Macey, ESOPs and Economic Distortion, 23 HARV. J. ON LEGIS. 103 (1986) (arguing that ESOPs do not deliver the non-tax benefits claimed by proponents, and cause inefficient market distortions, particularly on the market for corporate control); see also Elana Ruth Hollo, The Quiet Revolution: Employee Stock Ownership Plans and Their Influence on Corporate Governance, Labor Unions, and Future American Policy, 23 RUTGERS L.J. 561, 594 (1992) (reviewing the policy goals and performance of employee ownership programs and concluding that “[t]he primary beneficiaries of ESOP tax subsidies appear to be the corporations which use ESOPs as takeover defenses or for other purposes”).

49. See. e.g., NAT’L CTR. FOR EMP. OWNERSHIP, THE ESOP READER: A PRIMER ON EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs) 1, 4 (Scott Rodrick & Corey Rosen, eds., 2003) (discussing tax, accounting, and finance benefits for participating companies).

50. We separate out the question of why grant employees ownership rights in firms from the question of how to do it, addressing the former, not the later in this Article. Bifurcating the questions leaves a significant piece of the puzzle on the sidelines, but is necessary for this Article. First, our small sample size of impact investment funds and responsive employee ownership contract provisions, as discussed infra at pages 22–28, prevents us from separately examining the question of why. Second, the firms in which the employees will receive ownership rights are located in different jurisdictions, which prevents a meaningful analysis of the how question under the current U.S. legal system, particularly as it relates to deferred compensation plans.
A. Employee Stock Option Plans

Stock option plans are contractual agreements between the company and the employees giving employees the right to buy a set number of company shares at a fixed price\(^\text{51}\) within a certain period of time after the grant (exercise window or vesting period).\(^\text{52}\) To exercise the right, the holder of the option must tender the exercise price.\(^\text{53}\) In other words, stock options give employees the right to purchase stock, \textit{with their own money} in the future and subject to additional conditions, usually continued employment and a lapse of time.\(^\text{54}\)

Employee stock option plans compensate employees when employees exercise the option to purchase stock and their fixed price is less than the current trading price or value of the stock.\(^\text{55}\) Subject to Internal Revenue Code Section 83(a), nonqualified stock option plans defer taxation until the time the holder exercises the option, not at the time of the grant.\(^\text{56}\) The Securities and Exchange Commission (SEC) requires registration of stock options with publicly traded companies and offers an exemption under Section 701\(^\text{57}\) for private companies with a written benefit plan or contract with the employee.\(^\text{58}\)

1. Nonqualified Employee Stock Option Plans

Nonqualified plans, also called nonstatutory plans, are largely matters of private agreement and are subject to few formation requirements.\(^\text{59}\) Participation in nonqualified plans is often concentrated

\(^{51}\) The strike price of the option can be set below, at, or above the market price, exchange price of publicly traded stock, or fair market value in private company stock. These three pricing options are called in, at, or out of the money, respectively. Matthew A. Melon, \textit{Are Compensatory Stock Options Worth Reforming?}, 38 GONZ. L. REV. 535, 539 (2003).


\(^{53}\) Melon, \textit{supra} note 51, at 540.

\(^{54}\) “Employee ownership may create some property rights in the individual that are realized only after the employee has achieved a long tenure or even retirement.” Bagchi, \textit{supra} note 45, at 308.


\(^{56}\) I.R.C. § 83 (2016); Melon, \textit{supra} note 51, at 542–43.

\(^{57}\) 17 C.F.R. § 230.701 (2016).


among upper management\textsuperscript{60} in contrast to the qualified plans, discussed below. Firms can also extend participation to non-employee directors and independent contractors, in contrast to qualified plans.

Nonqualified option plans are strongly associated with startup companies, especially in the tech industry. Stock options are one way a cash-strapped company in an early development stage can attract and retain talented employees while deferring their compensation and linking it to the success of the company.\textsuperscript{61}

2. Qualified Employee Stock Option Plans

Qualified plans retain the key features of stock options—employees use individual funds to purchase stock in the future subject to certain conditions—and add formation requirements, participation limits, and prohibitions against discrimination among different types of employees.\textsuperscript{62} The nondiscrimination requirements result in broad grants in which a large percentage of employees participate, rather than concentrating the option in upper management.

Qualified stock option plans may be classified as an “incentive stock option”\textsuperscript{63} and receive certain federal tax benefits.\textsuperscript{64} The difference between the stock option exercise price and the fair market value on the exercise date—the compensation—is not taxed under qualified plans, and taxation is deferred until the employee disposes of the plan stock.\textsuperscript{65} Qualifying requirements include that the option price reflect fair market value with a ten-year expiration date and subject to a $100,000 annual cap.\textsuperscript{66} A second form of qualified plans—“Employee stock purchase plans”\textsuperscript{67}—receive similar tax benefits by excluding gains. Qualification requirements include

\begin{itemize}
\item \textsuperscript{61} Thomas A. Smith, \textit{The Zynga Clawback: Shoring Up the Central Pillar of Innovation}, 53 SANTA CLARA L. REV. 577, 584 (2013) (discussing the role of stock option contracting and compensation in entrepreneur/startup firms).
\item \textsuperscript{63} 26 U.S.C. § 422 (2016); \textit{see also} 26 C.F.R. § 1.422-1 (2016).
\item \textsuperscript{64} Bodie, \textit{supra} note 52, at 547, 548.
\item \textsuperscript{65} 26 U.S.C. § 422 (2016); \textit{see also} Merlo v. C.I.R., 492 F.3d 618, 621 (5th Cir. 2007) (describing the tax benefits of qualified plans); Melon, \textit{supra} note 51, at 546.
\item \textsuperscript{66} 26 U.S.C. § 422 (2016); \textit{see also} Bodie, \textit{supra} note 52, at 547–48 (describing the qualification requirements for incentive plans under Section 422).
\item \textsuperscript{67} 26 U.S.C. § 423 (2014); \textit{see also} 26 C.F.R. § 1.423-2 (2009).
\end{itemize}
fair market pricing, expiration dates, and broad grants to all full-time employees with two years or more tenure at the company.68

B. Stock Grants

1. Nonqualified Stock Programs

Stock grants, unlike options, give the holder the stock immediately or nearly immediately, and usually as a performance incentive.69 These plans can be referred to as restricted stock plans because receiving the stock is contingent upon certain future events such as an employment anniversary or performance benchmarks.70 When the benchmarks are achieved, the promised stock vests with the employee.71 The employee now owns the stock. Restricted stock programs are a part of a compensation package and can be used, as with all forms of employee ownership, as a recruitment, retention, and alignment tool.72 Restricted stock program participation is concentrated in upper management and senior level employees.73

2. Tax-Qualified Stock Programs—Retirement Plans

Tax-qualified defined contribution plans also distribute company ownership through stock to employers. The most common form of employee ownership in the U.S. is the employee stock ownership plan (ESOP).74

As a regulated defined contribution plan, ESOPs were created under the Employee Retirement Security Act of 1974 (ERISA)75 and are subject to oversight through the Internal Revenue Service (IRS).76

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70. Gordon Klepper, Restricted Stock Units: The Practical Alternative in Equity Compensation for the U.S. Multi-national Employer, 20 J. COMP. & BENEFITS, no. 6, Nov.–Dec. 2004, at 14 (Restricted stock programs are contractual rights for an employee to achieve stock “at a scheduled future time or times, subject to the employee meeting certain employment-related conditions. The conditions typically require the employee’s continued employment, and also may include obligations not to compete with the employer, release confidential information, or engage in other misconduct.”).
71. Id.
74. How an Employee Stock Ownership Plan (ESOP) Works, supra note 44.
75. Id.
76. “[E]mployee stock ownership plan (ESOP) is an individually designed stock bonus plan, which is qualified under Internal Revenue Code Section 401(a) . . . designed to invest primarily in
of Labor,\textsuperscript{77} and the SEC.\textsuperscript{78} Companies sponsoring ESOPs\textsuperscript{79} contribute stock (or money to buy stock) to the plan in order to benefit the company’s employees. ESOPs must invest primarily\textsuperscript{80} in “qualifying employer securities,” offer pass-through voting to participants, permit diversification as participants approach retirement, and avoid discrimination in favor of highly compensated employees.\textsuperscript{81}

Employers commonly structure ESOPs as stock bonus plans\textsuperscript{82} or as a part of profit-sharing plans.\textsuperscript{83} ESOPs may comprise the sole retirement benefit or it may be a part of another plan, such as a 401(k).\textsuperscript{84} Each participating employee has an account in the ESOP that holds the vested stock on behalf of the employee.\textsuperscript{85} Under ERISA-governed ESOPs, workers receive stock grants without utilizing individualized cash savings to purchase the shares, thus overcoming an obstacle to employee

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\textsuperscript{77} The Department of Labor has investigative and enforcement authority under Sections 504 and 506 of Title I of the Employee Retirement Income Security Act, that authority was delegated to the Employee Benefit Security Administration subject to Secretary’s Order 01-2003, Delegation of Authority and Assignment of Responsibilities to the Employee Benefits Security Administration signed by Secretary Elaine Chao on January 23, 2003. Delegation of Authority and Assignment of Responsibilities to the Employee Benefits Security Administration, 68 Fed. Reg. 5374 (Feb 3, 2003).

\textsuperscript{78} Employee Stock Ownership Plans, supra note 52.

\textsuperscript{79} For a general discussion of ESOP requirements, regulations and components, see Rob Brown, Brian Hector & Scott Stitt, \textit{Overview of Employee Stock Ownership Plans}, 31 J. COMP. & BENEFITS no. 6, Nov.–Dec. 2015.


\textsuperscript{82} 26 U.S.C. § 401 (2014); David A. Pratt & Sharon Reece, ERISA and Employee Benefit Law: The Essentials 24 (2010) (“Stock bonus plans are profit-sharing plans under which contributions made in employer stock or, if made in cash, are then invested, wholly or partly, in employer stock.”).

\textsuperscript{83} Cantor & Marsala, supra note 81.

\textsuperscript{84} ESOPs must be either a qualified stock bonus plan or a combination of qualified stock bonus plan and money purchase pension plan. Pratt & Reece, supra note 82, at 24. Profit sharing plans give participating employers funding flexibility depending upon profit and tax benefits whereas money purchase pension plans require a minimum annual contribution on behalf of the employer sponsor. \textit{Id.} at 21–26.

\textsuperscript{85} Employee Stock Options Plans, supra note 52.
ownership: lack of capital to purchase stock.86 “ESOPs are most commonly used to provide a market for the shares of departing owners of successful closely held companies, to motivate and reward employees, or to take advantage of incentives to borrow money for acquiring new assets in pretax dollars.”87

Additionally, companies may list their stock as one of many investment options in the defined contribution plan menu. Under this approach, employees use earmarked retirement savings to purchase company stock through their defined contribution retirement plan, like a 401(k).88 This is a widespread practice and a common means by which U.S. employees acquire employer stock. “Thirty-three percent (or 8.1 million) of the 401(k) participants in the 2014 EBRI/ICI 401(k) database were in plans that offered company stock as an investment option.”89

The following chart depicts the structural differences described above.

III. THEORIES OF EMPLOYEE OWNERSHIP

Researchers from different backgrounds have studied companies’ motivations to offer employees ownership incentives. Theories supporting employee ownership are integrated in policy discussions regarding tax, employee benefit plans, and worker equality. We summarize the literature and policy debates in the following discussion, along with empirical predictions for the three main theories discussed in the existing literature.

87. How an Employee Stock Ownership Plan (ESOP) Works, supra note 44.
89. EBRI REPORT, supra note 39, at 31. Employees allocated approximately 7% of ERISA-governed defined contribution plans assets to company stock, a number that researchers documented as declining since its high-water mark of 19% in 1999. Id. at 1.
We then propose a new set of motivations for the inclusion of employee ownership policies at the fund level, and suggest empirical predictions for these theories as well. These predictions form the basis of our results discussion in Section VI.

A. Existing Theories Centered on Portfolio Company Preferences

1. Aligning the Interests of Company Managers and Employees

Explanations for shared ownership plans have traditionally focused on what may motivate companies to implement such plans. A popular justification is that giving employees a stake in the company aligns their incentives with the firm, resolving frictions such as agency problems\(^9\) that might lead employees\(^9\) to be less productive than they could be.\(^9\) In testing this interest-alignment theory, studies overall have found improved workplace performance for firms with shared capitalism plans,\(^9\) but noted that positive effects are observed most strongly when combined with policies such as low supervision, employee participation in decision-making, and competitive pay\(^9\)—and with per-employee growth options\(^9\) and innovation.\(^9\) Others, however, argue that employee ownership is too expensive relative to incentive gains on their own to justify this approach.\(^9\)

\[^9\] An agency problem occurs when an agent (e.g., employee) has different incentives than the principal (e.g., manager) who hired her to do a task. See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

\[^9\] See Clifford W. Smith, Jr., *On the Market for Corporate Control*, 50 CASE W. RES. L. REV. 259, 261 (1999) (discussing agency problems and noting that employees “have fewer incentives to use company resources [more] efficiently than owners”).


\[^9\] Kruse, *supra* note 38, at 4–5 (summarizing more than ten studies on organization performance under shared capitalism policies and concluding that the correlation is overwhelmingly positive).

\[^9\] Id. at 6.


\[^9\] Xin Chang et al., *Non-Executive Employee Stock Options and Corporate Innovation*, 115 J. FIN. ECON. 168, 180 (2015) (“The positive relation between employee options and innovation is more pronounced in firms with higher employee treatment index or higher R&D per employee, confirming our conjecture that the positive effect of employee stock options on innovation productivity is stronger if employee inputs are more important and valued.”).

that employee ownership plans increase the incentive of employees to “swing for the fences” (i.e., take more risk) because of the asymmetry of the upside gain relative to the downside loss.98

Aligning Interests Prediction. If, consistent with the assumptions of economic literature, portfolio companies are driving inclusion of employee ownership provisions in our sample, we would expect to observe common features or clustering among those portfolio companies. For example, portfolio companies that propose employee ownership provisions should exhibit similar characteristics such as heavy reliance on employees for production or high potential for conflicts of interests between employees and owners. We may also expect employee ownership companies to be similar in size, as measured by the number of employees and the stage of company development.

2. Sorting Employees

Another prevalent theory of employee ownership plans is that they serve as a sorting mechanism by attracting employees who value a firm’s option grant most highly.99 This differs from the incentive alignment view in that it does not assume that employees will act differently, only that they have a different view of the company from the outset. Especially within the technology industry, some argue that these plans “help recruit [talent] in a company’s early days for in-demand workers.”100 Another way of framing this is that equity or options may be a means of providing value to employees without having to use cash.101 Indeed, empirical evidence suggests equity-based compensation plans are particularly popular with firms facing financial needs and constraints.102

98. See Kelly Shue & Richard Townsend, Swinging for the Fences: Executive Reactions to Quasi-Random Option Grants 1, 30–32 (Nov. 30, 2014) (unpublished manuscript) (finding that on average, “moderate increases in options lead to increased firm equity volatility”).

99. Oyer & Schaefer, supra note 97, at 131 (study demonstrating that “if workers are sufficiently optimistic about their employers’ prospects, stock options can be an efficient means of compensation”); see also Nittai K. Bergman & Dirk Jenter, Employee Sentiment and Stock Option Compensation, 84 J. FIN. ECON. 667, 671 (2007) (finding that “[o]ption compensation for non-executive employees is most common among firms with excellent prior stock price performance”).

100. Strom, supra note 4.


Sorting Employees Prediction. Similar to the interest-alignment prediction, this hypothesis predicts shared characteristics among employee ownership firms. If portfolio companies utilize employee ownership plans to sort potential employees and identify those who are optimistic about the company’s future prospects, these plans will be more prevalent when they make more of a difference in sorting. For example, ownership in an early-stage firm is riskier than ownership in a late-stage firm, so it is likely a more effective sorting tool in early-stage firms. As a result, the employee-sorting theory predicts that employee ownership firms should share common features such as size, industry, geographic focus, or development phase.

3. Retaining Employees

In addition to attracting the right employees, shared ownership plans may help firms retain employees by making it costly for them to leave in bad times when shares of the company are worth less.\textsuperscript{103} This is especially true where stock prices and labor market conditions are positively correlated, because it allows employees’ deferred compensation to vary along with their outside opportunities.\textsuperscript{104} Indeed, evidence suggests that employee ownership is associated with greater employment stability.\textsuperscript{105}

Employee Retention Prediction. If portfolio companies pursue employee ownership plans to retain talented employees, especially in the face of employee uncertainty or salary competition pressures, those companies should exhibit commonalities such as high turnover risk. To the extent that turnover risk is difficult to observe in this or other samples, portfolio companies facing high turnover risk should have identifiable

\textsuperscript{103} Oyer \& Schaefer, supra note 97, at 100, 110 (exploring a relationship between labor market conditions in a given industry and a positive correlation with firms’ share prices and hypothesizing that “then options [should] serve to index deferred compensation to employees’ outside opportunities”); see also id. at 123–25 (developing a model to test the options hypothesis).

\textsuperscript{104} Serdar Aldatmaz et al., The Option to Quit: Employee Stock Options on Turnover 18–19 (Jan. 2014) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1787169; see also Simi Kedia \& Shiva Rajgopal, Neighborhood Matters: The Impact of Location on Broad Based Stock Option Plans, 92 J. FIN. ECON. 109, 115 (2009) (positing that “local labor markets affect a firm’s option grants in four ways: (i) tight labor markets; (ii) Oyer’s (2004) wage indexation theory; (iii) enforceability of non-compete agreements; and (iv) employee sentiment that favors stock options”) (citing to Paul Oyer, Why Do Firms Use Incentives That Have No Incentive Effects, 59 J. FIN. ECON. 1619 (2004)).

commonalities such as the industry in which they operate, noncompete enforceability, age of the workforce, and local unemployment.

4. Other Explanations

Shared ownership may also be a way to address social inequality within the firm by reducing the gap between management and employees, both financially and socially. However, this may come at the cost of increased risk for workers. Additional explanations for the popularity of equity-based compensation include, favorable accounting treatment, though employees still need to value the equity highly enough for this to work; peer effects; and protection in cases of change of control.

B. New Theories Centered on Fund Preferences

Employee ownership schemes are widely acknowledged in industry-based venture capital and private equity materials, including discussion of valuation, the upsides (for entrepreneurs), the downsides (for investors), and administration tips. Portfolio companies—startups—are assumed to want employee ownership programs, and investors are presumed to be resistant. Relevant academic literature documenting

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106. Ittner et al., supra note 102, at 92; Strom, supra note 4; see also Hand, supra note 102, at 398.

107. “Employee ownership may have positive effects if employees value ownership in itself or perceive that it brings greater income, job security, or control over jobs and the workplace. On the other hand, it may have negligible or even negative effects if employees perceive no difference in their work lives, dislike the extra risk to their income or wealth, or have raised expectations that are not fulfilled.” Kruse Testimony, supra note 105.

108. These hypotheses are beyond the scope of our project, but included in this discussion for purposes of introducing readers to the existing literature.

109. See generally ESOP Tax Incentives and Contribution Limits, NAT’L CTR. FOR EMP. OWNERSHIP, https://www.nceo.org/articles/esop-tax-incentives-contribution-limits [https://perma.cc/AA7C-RKN4]; Core & Guay, supra note 102, at 255 (Employers can deduct contributions to the ESOP as well as dividends and rollovers; employees pay no tax on ESOP participation until distributions).

110. Oyer & Schaefer, supra note 97, at 112 (discounting the accounting advantages of employee ownership and arguing that firms incur “real costs of about $3,000 per middle manager per year in order to increase reported pre-tax income by about $9,000”).

111. Kedia & Rajgopal, supra note 104, at 109, 122 (investigating and demonstrating the social influence of option granting by showing that “option grants are increasing with the average broad based option grants of other firms located in the MSA”).

112. Gavis, supra note 101, at 1489 (“ESOPs . . . may play a significant role in providing employees with protection against risks associated with hostile takeovers.”).

venture capital and private equity terms and trends, however, is silent on employee ownership provisions from the perspective of investing funds.\textsuperscript{114}

Our Article bridges the gap between industry and academia, and between the portfolio company and the fund perspectives on employee ownership schemes. In our sample, we observe a clustering of shared ownership-friendly provisions at the fund level—rather than by company size or industry. This leads us to question whether funds themselves are exerting pressure on portfolio companies to adopt shared ownership plans, or at least are more permissive of shared ownership requests by portfolio companies than industry literature would suggest. Below, we propose five hypotheses broken into two categories: financial motivations and impact motivations. We offer alternative predictions based upon the assumption that employee ownership is not a costless proposition.\textsuperscript{115}

If employee ownership provisions are clustered in a fund that invests in diverse types of companies without observable commonalities among the portfolio companies, then it is likely that the funds, rather than the companies, are pursuing employee ownership schemes. Because diverse portfolio companies are unlikely to face the same employee challenges—aligning incentives, sorting, and retaining talent—diverse portfolio companies are likely to generate noisy results within and between the funds if there is no other explanation for the inclusion of employee ownership schemes. For example, we would expect to see employee ownership provisions distributed throughout the funds and fund families without a discernable pattern. If, however, funds are pursuing the employee ownership provisions, we would expect to see employee ownership provisions clustered within funds.

1. Financial Motivations

a) “Rolling Up” Company Preferences

First, it may be that funds view shared ownership plans as a financial best practice for companies, for any of the reasons listed in the previous section. Funds, as shareholders in the portfolio companies, may adopt the preferences traditionally attributed to portfolio companies (aligning interests, sorting, retention, accounting, etc.) in pursuing employee ownership.

\textsuperscript{114} See Steven Freeman, Effects of ESOP Adoption and Employee Ownership: Thirty Years of Research and Experience, 4–5 (U. Pa. Organizational Dynamics Working Paper No. 07–01, 2007), http://repository.upenn.edu/cgi/viewcontent.cgi?article=1001&context=od_working_papers [https://perma.cc/ME39-NLT0].

ownership programs. We call this the roll up hypothesis. Funds may act according to the roll up hypothesis if the portfolio companies lack the sophistication to negotiate for these provisions on their own behalf. As a result, they encourage portfolio companies to adopt employee ownership plans to maximize firm productivity and ultimately their own profit.

**Roll Up Prediction.** It will be difficult to directly observe funds’ preference for employee ownership schemes consistent with the roll up hypothesis—the desire to implement interest-aligning and employee-sorting and retention best practices as a means of protecting the fund’s investment in the portfolio company. If funds encourage or allow portfolio company ESOPs because they are acting in their best interests as shareholders in the portfolio company, then we would expect to observe other shareholder protective measures such as strong financial and governance contracting terms that traditionally protect investors’ financial interests in portfolio companies.

**b) Deflating Effective Price Per Share**

There has also been recent anecdotal evidence of funds using employee option pools as a way of decreasing the price per share of a prospective portfolio company. The scheme, sometimes called an “option shuffle,” works like this: funds agree to a pre-money valuation of a portfolio company, but (sometimes without the entrepreneur realizing) this pre-money valuation includes a substantial pool of new options issued out of the pre-money capitalization and set aside for future option compensation. This effectively dilutes the entrepreneur (in a Series A) or other pre-investment owners (in later funding).

To illustrate the impact of an option pool on pricing, consider an investment offer of $2 million into a company with an $8 million pre-money valuation and 6 million shares. Under the $8 million valuation, each share price is $1.33/share. If the investment contract contains language that the pre-money valuation includes an unallocated option pool equal to 20% of the post-financing, fully diluted capitalization, the 20% of $10 million post-financing capitalization creates $2 million in new options and reduces the founders’ stake to 6 million shares in a 10 million share company or 60% of the post-financing valuation. In this regard, the effective pre-money valuation of the company is $6 million and the price per share is $1.

**Option Shuffle Prediction.** If funds prefer employee ownership schemes as a means to discount the per-share price paid by the fund to...
enhance the fund’s financial position, then the employee ownership language in the term sheets and investment agreements should create the employee stock option pool based upon a pre-money capitalization. We would similarly expect these funds to seek market rate returns, rather than concessionary financial returns, and have strong finance contracting terms.

2. Impact Motivations

a) Agency Costs

Traditional funds have a single goal: maximize financial returns. Impact funds balance two goals: financial profits and social or environmental impact. In pursuit of the latter, impact funds invest in benefit-oriented companies through which they pursue financial gains. Investors and portfolio company founders may agree or differ on what the ideal balance between these goals should be. Investors could try to impose their preferred balance through traditional contracting terms, but the absence of contracting norms, the relative infancy of the field, and the highly individualized needs of each portfolio company may render traditional contracting solutions impotent. Investors seeking the ideal balance between good and gold may, as a result, be more likely to rely on other contracting tools such as employee ownership to indirectly manage employees’ incentives.

Agency Costs Prediction. If funds prefer employee ownership schemes as a means of neutralizing expanding agency costs in a finance/benefit goal binary by encouraging employees to balance the dual goals, then funds may similarly contract for a balance of terms that protect both financial and nonpecuniary gains. For example, funds could also protect their preferred balance of goals by making cash flow contingent on meeting pre-set financial and impact goals. Alternatively, the parties may not be capable of directly contracting to impose the fund’s preferred balance and instead must rely upon indirect measures like shared ownership.

b) Mission Lock

Impact funds may also encourage the companies in their portfolio to share ownership with their employees (at least partially) as an alternative way of locking in mission. Early employees are often most wedded to the initial vision of the company. If the workforce is fairly stable, employee

118. Note that here we are talking about market rate-seeking impact funds.
ownership plans may ensure that part of the firm’s ownership remains invested in the firm’s mission, even after a change of control. If funds select target investments based, in part, on company mission, and some funds gauge their impact by sustained company commitment to mission, even after fund exit. Impact funds may be especially attuned to mission-aligning mechanisms with portfolio companies and prefer employee ownership as one means to pursue that end.

**Mission Lock Prediction.** If funds are implementing employee ownership as a way of aligning mission incentives, those funds may also have other provisions in place to protect company mission during the investment and/or after the fund’s exit. For example, fund exits that are not mission-aligned could be prohibited in the investment contract. For example, a fund may be prohibited, by a mission lock term in the agreement, from selling its equity position in the portfolio company to a non-impact committed investor such as a traditional private equity fund.

c) **Direct Impact**

Impact funds may also prefer employee ownership schemes if promoting employee ownership is consistent with the social impact mission of the fund. For some impact funds, employee ownership itself may be a goal, especially if the fund has a stated impact goal of, for example, job creation or economic empowerment. Shared ownership plans can build financial inclusion and add social impact value by offering options programs to all levels of employees, though the value of such a program will depend on employees’ preferences and beliefs. If funds are implementing employee ownership provisions to serve the fund’s impact mission, then funds that state a mission for social/individual economic empowerment (rather than environmental benefit, for example) should be more likely to implement employee ownership than other types of funds.

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120. This is similar to the argument in Gavis, supra note 101, at 1489. Consider, for example, that under the Delaware Benefit Corporation Act, only shareholders can bring derivative suits to enforce mission. DEL. CODE ANN. tit. 8, § 367 (2013) (authorizing shareholder derivative suits to enforce directors’ duties to “manage or direct the business and affairs of the public benefit corporation in a manner that balances the pecuniary interests of the stockholders, the best interests of those materially affected by the corporation’s conduct, and the specific public benefit or public benefits identified in its certificate of incorporation” consistent with § 365(a)).

121. See ACCION, supra note 113 (describing various methods for constructing employee ownership plans).
IV. DATA POOL AND METHODOLOGY OF REVIEW

The data described in this Article are generated from survey responses and documents submitted by impact investment funds as a part of a study administered by the Wharton Social Impact Initiative (WSII).\textsuperscript{122}

\textit{A. Wharton Social Impact Initiative Survey}

Our data come from a survey of impact funds administered by the WSII. WSII compiled an initial database of 437 possible impact PE funds via primary research and by working with organizations such as B Lab, the Emerging Markets Private Equity Association (EMPEA), and Anthos Asset Management, and referring to lists such as ImpactBase and Impact Assets 50. At the time of our document review, eighteen months after the first release of the survey, 342 fund managers were contacted and 47 had completed the survey, representing 64 separate funds and 656 portfolio companies.\textsuperscript{123}

The WSII survey covers a range of questions that can broadly be split into eight categories:

(i) General fund-level questions, such as fund focus, size, vintage year, and whether the fund self-identifies as an impact fund;

(ii) Fund-level impact questions, such as the nature of the fund’s impact mission and the rights and responsibilities of General Partners (GPs) with respect to the fund’s stated mission, if any. Funds also have the option to upload ratings from the Global Impact Investing Rating System (GIIRS) if applicable;

(iii) Fund-level contract questions, such as hurdle rate and initial fund term. Funds also have the option to upload Private Placement Memoranda (PPM), Limited Partner Agreements (LPA), and side letters;

(iv) Fund-level quarterly financial data, such as cash flows. Funds also have the option to upload audited financial documents;

(v) General portfolio company-level questions, such as industry, location, and size. Funds also have the option to upload term sheets;

\textsuperscript{122} Authors of this paper, Dr. Chris Geczy (Principal Investigator), Dr. David Musto (Principal Investigator), and Jessica Jeffers (Ph.D. Candidate) worked in conjunction with others at the Wharton Social Impact Initiative to design the survey study, solicit participants, and receive and track results. See Jacob Gray, et al., Great Expectations: Mission Preservation and Financial Performance in Impact Investing (Oct. 7, 2015) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2694620.

\textsuperscript{123} Because of the sensitive nature of the information, the WSII survey data is protected by a strict confidentiality agreement, and we cannot identify any of the funds discussed below.
(vi) Portfolio company-level impact questions, such as company impact focus;

(vii) Portfolio company-level financial questions, such as capital invested and pre-money valuation; and finally

(viii) Realization-level questions, such as realization type and whether the realization was mission-aligned. A sample of the survey questions reported upon in this paper is available at Appendix A to this Article.

B. Document Review

Twenty-three fund management companies, representing thirty-six impact investment funds, submitted documents and formed our sample. We reviewed 164 contractual documents reflecting organization of the funds and fund investment in portfolio companies. For our data discussion, fund-level documents mean legal documents regarding the formation of and investment into the fund. These documents are created for investors into the impact fund and include documents such as limited partnership agreements, operating agreements, investment agreements, and private placement memoranda. Portfolio company-level documents, on the other hand, refer to investment agreements and terms between the impact fund and the portfolio company in which the fund will invest. Portfolio company-level documents include preliminary term sheets, investment agreements, and subscription agreements.

Document review responses were verified or supplemented by survey responses when the contents of the document review and survey overlapped or were complementary.

Figure 1: Documents Reviewed
We frame our results discussion around four samples originating from survey participation. The first and largest sample captures all survey responses. Depending upon the survey question, we typically describe this sample as “all survey funds” or “all survey portfolio companies.” The second cut captures all fund-submitted documents by funds participating in the survey. This group is smaller than the all-survey responses simply because not all participating funds submitted legal documents in conjunction with the survey. Depending on the analysis, we often segment this sample into “all document review funds” or “all document review portfolio companies.” Our third grouping captures funds that include employee ownership provisions in some documents. Throughout the remainder of the Article, we refer to these funds as employee ownership-friendly or favorable funds (EO Funds) and focus our analysis on EO Funds or on all of the portfolio company documents of EO Funds. This third grouping is necessary because within the documents submitted by EO Funds, some, but not all, portfolio company documentation contains employee ownership provisions. For example, a fund may have submitted documents for fifteen portfolio companies, only seven of which include employee ownership provisions. We count this fund as an EO Fund, and include all portfolio companies of this EO Fund in the third sample. Finally, we created the fourth and smallest sample of the portfolio companies with employee ownership provisions in their investment documents, often referred to below as EO Fund responsive portfolio companies or EO portfolio companies. Returning to the example above, only the seven portfolio companies with employee ownership provisions are included as an EO Fund responsive portfolio company.

1. The Employee Ownership Sample

Twenty-three funds and fund families submitted documents for our review: twelve were stand-alone funds. Nine fund families have common managers and created two or more legally separate and distinct funds. Counting all participants—standalone and sub funds—thirty-six funds participated in the document review.

Funds provided investment documents detailing their investment in portfolio companies. Our total document sample contained 100 portfolio-level documents: 80 term sheets and 20 investment contracts.

124. We further analyzed survey responses by applying our next three data cuts (all document review, all EO funds/portfolio companies, and all EO Fund responsive portfolio companies, to the survey responses at both the funds and portfolio company levels. Our document review produced thirty-one EO Fund responsive portfolio companies. We were able to identify thirty EO portfolio companies in the survey responses by matching the funds, managers, and portfolio company identified in the survey responses; for one, we were not able to verify it sufficiently to include in the survey responses for EO portfolio companies.
such as subscription agreements, shareholder agreements, and loan agreements. We reviewed documents dated from 1996 to 2014, with the majority occurring between 2009 and 2014.

Out of our sample, thirty-one documents (31% of portfolio investment documents) contained references to employee ownership schemes and form the basis of one of our key samples discussed in this Article. Figure 2 presents employee ownership-favorable documents spanning from 2003 to 2014, with three documents undated.

![Figure 2: Employee Ownership Document Timeline](image)

Eight of the thirty-six, or 22%, impact investment funds participating in the document review included employee ownership provisions in their portfolio investment documents. Participating funds submitted between one and twenty-five documents at the fund and portfolio level for review, with an average of 4.6 documents per fund, and more than half of participating funds submitted three or fewer documents.

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125. If we look at the fund family level, six funds out of twenty-three contained employee ownership language representing 26% of the sample.

126. If we look at the fund family level, the average documents submitted per fund family is 7.3, but that number is skewed by the three fund families that submitted more than twenty documents.
Table 1: EO Fund Documents

<table>
<thead>
<tr>
<th>Participating Fund</th>
<th>Total Documents Submitted</th>
<th>Responsive Documents</th>
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</thead>
<tbody>
<tr>
<td>Fund 1</td>
<td>20</td>
<td>12</td>
</tr>
<tr>
<td>Fund 2</td>
<td>6</td>
<td>2</td>
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<tr>
<td>Fund 3(^{127})</td>
<td>10</td>
<td>1</td>
</tr>
<tr>
<td>Fund 4</td>
<td>10</td>
<td>8</td>
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<tr>
<td>Fund 5</td>
<td>5</td>
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<tr>
<td>Parent Total: 25</td>
<td>Parent Total: 10</td>
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<tr>
<td>Fund 6</td>
<td>4</td>
<td>1</td>
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<tr>
<td>Fund 7</td>
<td>13</td>
<td>1</td>
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<tr>
<td>Fund 8</td>
<td>12</td>
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</tbody>
</table>

Six of the employee ownership-favorable funds are limited partnerships—two organized in the U.S., one in Canada, and three in the Cayman Islands—plus one private trust organized in India and one investment company organized in Luxembourg. Non-U.S. funds (twenty-two) dominated our all document review sample (thirty-six) so U.S. funds may be over-represented in our EO-friendly sample.\(^{128}\) The responding funds were largely organized as limited partnerships or the equivalent in the country of organization. The target size of the employee ownership-favorable funds ranged from $10 million to more than $200 million, which was consistent with the distribution of fund sizes in the overall sample.\(^{129}\)

The EO Funds focused investment in targeted regions including India, Mexico, Asia, Latin America, and two distinct regions in the United States. Out of the all document review sample of funds, excluding the five funds with an unknown geographic focus, ten were focused in the U.S. and twenty-one outside of the U.S.: Africa (6), Asia (3), India (1), Mexico (1), and a combination\(^{130}\) of regions (10).

Impact funds also define their investment strategy by the industry, product, benefit, or development stage of companies in which they seek to invest. EO Funds targeted investment in such wide-ranging foci as “small firms in technology, handicrafts, renewable energy and agribusiness,”

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\(^{127}\) Funds 3, 4, and 5 share a common fund manager and target similar investments under similar criteria.

\(^{128}\) When collapsing the information to the fund family level, eighteen out of twenty-three fund families are organized outside of the United States. The state of incorporation is unknown for three funds in the document review sample.

\(^{129}\) Note that the document review sample contained one fund size outlier with a target fund size of $500 million.

\(^{130}\) Combination regions included Latin America and Africa (1); Latin America, Africa & Asia (1); India, Asia & Latin America (3); World Bank countries (1); and OCED countries (3).
“essential products,” “low-carbon sector services and products,” “middle market” technology, finance and communications firms, and more generally “economic development” opportunities in targeted communities.

Impact funds seek different rates of financial returns: risk-adjusted, market-based returns (highest) or concessionary returns seeking either below market (middle) or capital preservation returns (lowest). Analyzing survey responses provided by EO Funds, we observed that seven out of eight EO Funds reported “targeting competitive, market rate returns,” a rate of 87.5% compared to 66% and 60% of responding funds in the document review and all survey response samples, respectively. Our fund sample seeks risk-adjusted market rate returns consistent with the results published in a 2016 GIIN impact investing study, with 59% market rate-seeking funds.131

| Table 2: Survey Response on Targeted Financial Returns |
|-----------------------------------------------|----------------|----------------|---------------|
|                                               | EO Funds       | All Doc. Rev.  | All Survey    |
|                                               |                | Funds          | Responding    |
| Total Responses                               | 8              | 27             | 55            |
| Targeting Competitive, Market Rate Returns    | 7 (87.5%)      | 18 (66%)       | 33 (60%)      |
| Targeting Below Market, but Close to Market Returns | 0              | 5 (18.5%)     | 10 (18.18%)   |
| Targeting Below Market, Close to Capital preservation Returns | 1 (12%)       | 4 (14.81%)    | 10 (18.18%)   |
| Not Applicable (Explain)132                  | 0              | 0              | 2 (3.63%)     |

V. EMPLOYEE OWNERSHIP (EO) RESULTS

A. Portfolio Company Characteristics

We coded and statistically analyzed fund-provided survey responses regarding portfolio company characteristics to gain insight on whether

131. GIIN, 2016 SURVEY, supra note 10, at 40.
132. Participants who selected “Not Applicable” were able to provide a textual description of why.
portfolio companies drive employee ownership provisions. We analyzed portfolio company data regarding the number of employees and development status.

On the first measure, development stage, all EO Fund portfolio companies and EO Fund responsive portfolio companies had a higher stage of self-reported development than that of all document review and all survey portfolio companies. None of the EO Fund portfolio companies and none of the EO Fund responsive portfolio companies reported being in the product development or beta stage. Later stage development is consistent with emerging norms in impact investment.133

Table 3: Portfolio Company Development Stage

<table>
<thead>
<tr>
<th></th>
<th>All Survey Portfolio Co.</th>
<th>All Doc. Rev. Portfolio Co.</th>
<th>All EO-Funds’ Portfolio Co.</th>
<th>All EO Portfolio Co.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(278)</td>
<td>(157)</td>
<td>(58)</td>
<td>(30)134</td>
</tr>
<tr>
<td>Product Development</td>
<td>14</td>
<td>7</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>5.03%</td>
<td>4.45%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Beta</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>&lt; 1%</td>
<td>&lt; 1%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Deploying Product or Service</td>
<td>94</td>
<td>67</td>
<td>21</td>
<td>11</td>
</tr>
<tr>
<td></td>
<td>33.81%</td>
<td>42.67%</td>
<td>36.20%</td>
<td>36.66%</td>
</tr>
<tr>
<td>Profitable</td>
<td>151</td>
<td>78</td>
<td>37</td>
<td>19</td>
</tr>
<tr>
<td></td>
<td>54.67%</td>
<td>49.68%</td>
<td>63.79%</td>
<td>63.33%</td>
</tr>
<tr>
<td>N/A</td>
<td>18</td>
<td>4</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>6.47%</td>
<td>2.54%</td>
<td>0%</td>
<td>0%</td>
</tr>
</tbody>
</table>

We analyzed survey responses regarding the portfolio companies’ targeted industry. Within the survey sample, fund managers reported on the industry focus of 282 portfolio companies in ninety-five different industries. The distribution was broad: seventy-seven identified industries had two or fewer responses. Survey respondents identified nine industries with five or more participating portfolio companies, which are listed in Table 4 below. Other cross-sectional analysis with less than five

133. STAGARS, supra note 12, at 23.
134. As discussed above, one portfolio company identified in the document review could not be linked back to the survey data and, thus, is excluded from the discussion of portfolio company survey data.
participating portfolio companies are marked in the table with a bracket. Fund managers reported on 161 portfolio companies included in the document review representing fifty-four industries, most of which had fewer than five participating companies. For all EO Fund portfolio companies, distribution was spread thinly across twenty-seven industries, with only two—healthcare and microfinance—representing five or more portfolio companies. Our sample of EO Fund responsive portfolio companies (thirty) covered eighteen industries, with highest participation in education, health care, housing, livelihood, and technology industries.

Table 4: Survey Responses—Portfolio Company Industries

<table>
<thead>
<tr>
<th>Industry</th>
<th>All Portfolio Co. Survey Responses (282)</th>
<th>All Document Review Portfolio Co. (161)</th>
<th>EO Fund All Portfolio Co. (57)</th>
<th>EO Fund Responsive Portfolio Co. (30)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Industries</td>
<td>95</td>
<td>54</td>
<td>27</td>
<td>18</td>
</tr>
<tr>
<td>Agriculture</td>
<td>34</td>
<td>27</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>Agribusiness</td>
<td>9</td>
<td>1</td>
<td>0</td>
<td>Ø</td>
</tr>
<tr>
<td>Consumer</td>
<td>6</td>
<td>5</td>
<td>0</td>
<td>Ø</td>
</tr>
<tr>
<td>Education</td>
<td>5</td>
<td>5</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Financial</td>
<td>37</td>
<td>7</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Healthcare</td>
<td>14</td>
<td>10</td>
<td>8</td>
<td>3</td>
</tr>
<tr>
<td>Housing137</td>
<td>10</td>
<td>7</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Livelihood</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>8</td>
<td>8</td>
<td>2</td>
<td>Ø</td>
</tr>
<tr>
<td>Microfinance</td>
<td>21</td>
<td>21</td>
<td>8</td>
<td>2</td>
</tr>
<tr>
<td>Mobile phone</td>
<td>10</td>
<td>Ø</td>
<td>0</td>
<td>Ø</td>
</tr>
<tr>
<td>Software</td>
<td>6</td>
<td>4</td>
<td>0</td>
<td>Ø</td>
</tr>
<tr>
<td>Technology</td>
<td>9</td>
<td>9</td>
<td>3</td>
<td>3</td>
</tr>
</tbody>
</table>

Portfolio companies employed workforces sized from zero to more than 10,000 employees. Seventy-five percent and 79% of all survey responses and all portfolio companies in our document review

---

135. Represented industries include: agriculture (2), clean water (1), education (2), energy (1), financial (1), government (1), health care (3), housing (3), internet (2), livelihood (3), micro/small loans (1), rural ban (1), specialty (1), technology (3), textile (1), and wireless (1).

136. One fund describes livelihood as one’s “means of support or subsistence” or the activities that economically support a person and his/her family.

137. The category “Housing” reflects two subcategories of housing in the survey, which are rolled up into a single industry for purposes of this table and our discussion.
respectively, employed between 1–249 employees. Employing between 1–248 employees decreased to 67% for all EO Funds’ portfolio companies and all EO Fund responsive portfolio companies. The variance is due to one additional EO Fund responsive portfolio company reporting in the 250–499 range (and therefore also included in the all EO Fund portfolio company grouping), a change that seems unremarkable given the small sample size responding to each employment category. For further descriptive results, see Table 5 below.

Table 5: Survey Responses—Portfolio Company Workforce Size

<table>
<thead>
<tr>
<th># of Employees</th>
<th>All Survey Portfolio Co. (245)</th>
<th>All Doc. Review Portfolio Co. (146)</th>
<th>EO Funds’ All Portfolio Co. (58)</th>
<th>All EO Responsive Portfolio Co. (30)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>16 (6.53%)</td>
<td>8 (5.47%)</td>
<td>0 (0%)</td>
<td>0 (0%)</td>
</tr>
<tr>
<td>1–19</td>
<td>56 (22.85%)</td>
<td>30 (20.54%)</td>
<td>8 (13.79%)</td>
<td>2 (6.66%)</td>
</tr>
<tr>
<td>20–99</td>
<td>80 (32.65%)</td>
<td>54 (36.98%)</td>
<td>18 (31.03%)</td>
<td>13 (43.33%)</td>
</tr>
<tr>
<td>100–249</td>
<td>48 (19.59%)</td>
<td>32 (21.91%)</td>
<td>16 (27.58%)</td>
<td>5 (16.66%)</td>
</tr>
<tr>
<td>249–499</td>
<td>15 (6.12%)</td>
<td>7 (4.48%)</td>
<td>6 (10.34%)</td>
<td>5 (16.66%)</td>
</tr>
<tr>
<td>500–999</td>
<td>12 (4.89%)</td>
<td>6 (4.10%)</td>
<td>6 (10.34%)</td>
<td>2 (6.66%)</td>
</tr>
<tr>
<td>1000–2499</td>
<td>6 (2.43%)</td>
<td>4 (2.73%)</td>
<td>3 (5.17%)</td>
<td>2 (6.66%)</td>
</tr>
<tr>
<td>2500–4999</td>
<td>3 (1.22%)</td>
<td>2 (1.36%)</td>
<td>1 (1.72%)</td>
<td>0 (0%)</td>
</tr>
<tr>
<td>5000–9999</td>
<td>3 (1.22%)</td>
<td>1 (&lt;1%)</td>
<td>1 (1.72%)</td>
<td>1 (3.33%)</td>
</tr>
<tr>
<td>10,000–24,999</td>
<td>3 (1.22%)</td>
<td>2 (1.36%)</td>
<td>2 (3.44%)</td>
<td>0 (0%)</td>
</tr>
</tbody>
</table>
B. EO Funds and Contracting

1. Funds’ Contracting for Financial and Governance Rights

Within our document sample, we reviewed common venture capital/private equity financial and governance terms, including the employee ownership terms that guide this study.

a) Common Financing and Governance Terms in Venture Capital/Private Equity Contracts

Table 7 highlights common venture capital/private equity terms included in portfolio company-level documents utilizing three of our four samples: all document review portfolio companies, EO Funds all portfolio companies, and EO Fund responsive portfolio companies.

These contract terms document financial interests and rights intended to protect investors’ financial stakes in the portfolio company, measures we later link to funds’ financial incentives to include employee ownership provisions. Consistent across all data samples there is a preference for equity investments over debt and a high occurrence of investor-protective exit measures such as put options, redemption rights, and tag along rights—all of which occurred more frequently in the EO Fund sample compared to the broader sample. Additional protective measures of investors’ equity stakes include rights of first refusals on third-party stock sales, and preemptive and anti-dilution rights—again with noticeable increases for EO Funds as shown in all of their portfolio company documents and, in particular, the EO Fund responsive documents.

EO Fund documents granted higher investor governance rights including guaranteed seats on the portfolio company board of directors, step in rights, and veto/approval rights. EO Funds were also more likely than the rest of the sample to have documented registration rights in the event of an IPO, noncompetes with the company entrepreneurs, and enhanced information rights (both quarterly performance and audited annual statements).

Impact funds were more likely than the rest of the sample to document preferred return rights—38.70% occurrence within the EO Fund responsive documents compared to 21% in the overall sample.


139. This section relies solely on data collected from the document review and therefore excludes the all-survey portfolio company sample.

140. Preferred returns are the minimum amount of profits shared with holders of preferred financial rights before profits are distributed to other investors.
Within the sample as a whole, funds infrequently used waterfall compensation arrangements as demonstrated by low-to-no occurrences of carried interest, catch up periods, or management fees paid by the portfolio company to the investor or its affiliates. The occurrence of hurdle rates is slightly greater for the sample generally (12%) than for EO Fund responsive documents (9.67%). The EO Fund responsive sample was also slightly more likely to include a commitment fee paid by the portfolio company to the investor—54.83% within the EO Fund responsive sample compared to 50% in all documents reviewed and 42.35% in all EO Fund portfolio company documents.

141. A common profit allocation model in private equity funds is the distribution waterfall where profits are distributed first to limited partners in the amount of their original investment and second to limited partners to pay a preferred return (the hurdle rate). Thereafter the profits are usually split 80/20 between limited partners and the general partner, with the 20% share to the general partner referred to as the carried interest or carry. TOMAS KRÜGER ANDERSEN, PRIVATE EQUITY TRANSACTIONS, CONTRACTS AND REGULATION 71 (2015). Some agreements also include a catch up period where before profits are split 80/20, the general partner will be distributed profits up to a specified percentage.

142. Hurdle rates are linked to preferred returns and are a part of a waterfall financial arrangement common to private equity, particularly to limited partnerships. The preferred returns are called hurdle rates because the initial return on investment must be paid to investors because the general partner or fund founder gets paid the carried interest that is a part of the waterfall compensation arrangements. All hurdle rates are preferred returns, but not all preferred returns are hurdle rates if they simply reflect priority financial interests outside of additional payment schemes like carried interest. See, e.g., ANDERSEN, supra note 141, at 71. A recent study found in a sample of traditional venture capital funds that venture funds draw approximately 17.75% of committed investments as fees rather than the typically referenced 20%, and that 40% of venture funds have hurdle rates with a median of 8%. Andrew Metrick & Ayako Yasuda, The Economics of Private Equity Funds, 23 REV. FIN. STUD. 2303, 2310–12 (2010).
### Table 6: Investor Financial & Governance Contract Terms

<table>
<thead>
<tr>
<th>Contract Term</th>
<th>All Doc. Rev. Portfolio Co.</th>
<th>EO Funds All Portfolio Co. doc.</th>
<th>EO Funds Responsive Portfolio Co. doc.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Documents</strong></td>
<td>100</td>
<td>59</td>
<td>31</td>
</tr>
<tr>
<td>Equity Issued in Portfolio Co.</td>
<td>77</td>
<td>50</td>
<td>29</td>
</tr>
<tr>
<td></td>
<td>77.00%</td>
<td>84.75%</td>
<td>93.54%</td>
</tr>
<tr>
<td>Debt Issued in Portfolio Co.</td>
<td>21</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>21.00%</td>
<td>5.08%</td>
<td>3.22%</td>
</tr>
<tr>
<td>Call Option</td>
<td>12</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>12.00%</td>
<td>6.78%</td>
<td>9.67%</td>
</tr>
<tr>
<td>Put Options &amp; Redemption Rights</td>
<td>44</td>
<td>29</td>
<td>18</td>
</tr>
<tr>
<td></td>
<td>44.00%</td>
<td>49.15%</td>
<td>58.06%</td>
</tr>
<tr>
<td>Rights of First Refusal on 3rd P. Stock Sales</td>
<td>38</td>
<td>25</td>
<td>18</td>
</tr>
<tr>
<td></td>
<td>38.00%</td>
<td>42.37%</td>
<td>58.06%</td>
</tr>
<tr>
<td>Tag Along Rights</td>
<td>51</td>
<td>31</td>
<td>23</td>
</tr>
<tr>
<td></td>
<td>51.00%</td>
<td>52.54%</td>
<td>74.19%</td>
</tr>
<tr>
<td>Preemptive &amp; Anti-dilution Rights</td>
<td>66</td>
<td>44</td>
<td>28</td>
</tr>
<tr>
<td></td>
<td>66.00%</td>
<td>74.58%</td>
<td>90.32%</td>
</tr>
<tr>
<td>Investor Guaranteed BOD Seat</td>
<td>79</td>
<td>50</td>
<td>30</td>
</tr>
<tr>
<td></td>
<td>79.00%</td>
<td>84.75%</td>
<td>96.77%</td>
</tr>
<tr>
<td>Investor Step in Rights</td>
<td>20</td>
<td>13</td>
<td>8</td>
</tr>
<tr>
<td></td>
<td>20.00%</td>
<td>22.03%</td>
<td>25.80%</td>
</tr>
<tr>
<td>Investor Approval or Veto Rights</td>
<td>79</td>
<td>47</td>
<td>29</td>
</tr>
<tr>
<td></td>
<td>79.00%</td>
<td>79.66%</td>
<td>93.54%</td>
</tr>
<tr>
<td>Commitment Fee Paid to Investor</td>
<td>50</td>
<td>25</td>
<td>17</td>
</tr>
<tr>
<td></td>
<td>50.00%</td>
<td>42.37%</td>
<td>54.83%</td>
</tr>
<tr>
<td>Catch up Periods</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
</tr>
<tr>
<td>Hurdle Rate</td>
<td>12</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>12.00%</td>
<td>8.47%</td>
<td>9.67%</td>
</tr>
<tr>
<td>Carried Interest</td>
<td>1</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>1.00%</td>
<td>1.69%</td>
<td>0.00%</td>
</tr>
<tr>
<td>Preferred Return</td>
<td>21</td>
<td>14</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>21.00%</td>
<td>23.73%</td>
<td>38.70%</td>
</tr>
<tr>
<td>Registration Rights</td>
<td>33</td>
<td>20</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>33.00%</td>
<td>33.90%</td>
<td>38.70%</td>
</tr>
<tr>
<td>Management Fee Paid to Investor/Affiliate</td>
<td>4</td>
<td>4</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>4.00%</td>
<td>6.78%</td>
<td>0.00%</td>
</tr>
</tbody>
</table>
b) Employee Ownership (EO) Provisions

Of the thirty-one EO Fund responsive legal documents, twenty-four created new employee ownership programs, four enhanced existing programs, and three acknowledged existing programs without modifying them.

Figure 3: EO Terms in Documents

<table>
<thead>
<tr>
<th>Total Documents</th>
<th>All Doc. Rev. Portfolio Co.</th>
<th>EO Funds All Portfolio Co. doc.</th>
<th>EO Funds Responsive Portfolio Co. doc.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>100</td>
<td>59</td>
<td>31</td>
</tr>
<tr>
<td>Noncompete with Co. Entrepreneurs</td>
<td>40 (40.00%)</td>
<td>25 (42.37%)</td>
<td>18 (58.06%)</td>
</tr>
<tr>
<td>Confidential Agreement</td>
<td>61 (61.00%)</td>
<td>36 (61.02%)</td>
<td>21 (67.74%)</td>
</tr>
<tr>
<td>Information Rights: Quarterly Statements</td>
<td>64 (64.00%)</td>
<td>42 (71.19%)</td>
<td>28 (90.32%)</td>
</tr>
<tr>
<td>Information Rights: Annual Audited Financials</td>
<td>64 (64.00%)</td>
<td>41 (69.49%)</td>
<td>28 (90.32%)</td>
</tr>
</tbody>
</table>

Documents Discussing ESOPs

- Sum of ESOP in Term Sheet
- Sum of Create new ESOP
- Sum of Mention existing ESOP
- Sum of Enhance ESOP
All employee ownership provisions within our sample utilize an employee option pool; none contain stock grants or ownership programs as a part of a retirement benefit plan.

Employee ownership language in the reviewed contracts varied significantly. The option pool grants ranged from 5% or less (6), to 6%–10% (13), 11%–15% (7) on a post-money basis, or left the amount unstated and to be agreed upon with final documentation (5). Some contracts expressly stated the purpose of the plan as: “providing long-term incentives to current and future employees”143 or “to attract and incentivize current and future employees.”144 Three funds in eight documents indicated—either in language145 or the capitalization table—that the reserved option pool would be created out of the pre-money capitalization thus indicating founder share price dilution consistent with the option shuffle discussed above.146 Ten documents clearly established that the option pool would be created post-money investment, and thirteen were too unclear to be categorized for this Article. Of the three funds that documented founder dilution through the employee ownership plans, one was the sole EO Fund reporting below-market returns, while others reported seeking market returns consistent with the rest of the EO Funds.

2. Contracting for Funds’ General Impact

Impact investments target nonpecuniary returns, most commonly measured in environmental or social terms, in addition to financial gains. In our document review, we observed how investors and portfolio companies documented the commitment to and protections for these other gains. Overall, we observed significantly fewer contract terms regarding the other gains. Given the opacity of the nonpecuniary gains in the portfolio company-level contracts, we expanded our review to include fund-level documents such as limited partnership agreements and private placement memoranda that may better detail how the funds’ plan to generate the nonpecuniary gains.

143. Document on file with the authors.
144. Document on file with the authors.
145. “The Company will create an unallocated option pool representing 10% of the post investment fully diluted share capital of the Company for issuance to the Promoters, employees, officers and consultants of the Company. However, such an unallocated option pool shall be created prior to the investment by the Investors.” Document on file with the authors (emphasis added).
146. See The Option Pool Shuffle, supra note 116.
To further our understanding of fund commitment to nonpecuniary/impact gains, we reviewed survey responses for funds included in the document review sample. Two EO Funds reported having a GIIRS\textsuperscript{147} rating for the fund: a response rate of 25% that closely mirrors that of all funds included in our document review (22%). Funds reported on their general approach to creating social and environmental impact through their investments: (i) impact through improving the operations of the companies in which the fund invests, (ii) impact through investment in business models that specifically create social or environmental benefits, or (iii) other. Within the EO Funds, one reported focusing on improving portfolio company operations (compared to five in the overall sample),

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|c|c|}
\hline
 & & Co. & Doc. & Fund levels) & Doc. (Port. Co. & Fund levels) & Doc. \tabularnewline
\hline
Total Documents Available & 164 & 100 & 80 & 59 & 31 \tabularnewline
\hline
Social Metrics Addressed in Document & 29 & 10 & 8 & 4 & 1 \tabularnewline
& 17.69\% & 10.00\% & 10.00\% & 6.70\% & 3.22\% \tabularnewline
\hline
Environmental Commitment & 7 & 0 & 1 & 0 & 0 \tabularnewline
& 4.26\% & 0.00\% & 1.25\% & 0.00\% & 0.00\% \tabularnewline
\hline
Measure of Fund Social Impact & 7 & 1 & 2 & 0 & 0 \tabularnewline
& 4.26\% & 1.00\% & 2.50\% & 0.00\% & 0.00\% \tabularnewline
\hline
Impact Committee & 6 & 1 & 1 & 0 & 0 \tabularnewline
& 4.26\% & 1.00\% & 1.25\% & 0.00\% & 0.00\% \tabularnewline
\hline
External Monitoring of Impact & 10 & 2 & 2 & 0 & 0 \tabularnewline
& 6.09\% & 2.00\% & 2.50\% & 0.00\% & 0.00\% \tabularnewline
\hline
\end{tabular}
\caption{Benefit Contract Terms}
\end{table}

\textsuperscript{147} A third-party impact measurement for impact investing generated by B Analytics. For more information, see \textit{GIIRS Ratings, B ANALYTICS}, http://b-analytics.net/giirs-ratings [https://perma.cc/X59G-TY6N].
and four reported focusing on business models (compared to twelve in the overall sample). Five funds, including two EO Funds indicated a different approach.148

To further explore fund commitment to nonpecuniary/impact gains, we examined survey responses regarding fund-level documents that required, granted discretion, or were silent as to manager’s responsibility to consider nonpecuniary gains when making investment decisions. Six EO Funds disclosed that their fund-level documents (i.e., limited partnership agreements and PPMs) required the manager to consider social and/or environmental factors when making investment decisions; a 75% response rate that exceeds the 58% of all funds included in our document review. One EO Fund149 and one additional fund from the general sample reported that the fund-level documents were silent on a manager’s consideration of social and/or environmental factors when making investment decisions.

To explore fund commitment to mission lock, we analyzed survey responses regarding mission-lock at exit,150 rights of funds to exit if a portfolio company’s mission changes,151 and fund investment in portfolio companies legally structured to lock in mission.152 EO Funds’ survey responses indicate portfolio company exit consistent with exit rights in the other cross sections. Within the EO Funds, we observe low occurrence of mission-lock contracts, with the exception of one EO Fund reporting heavy reliance on mission-lock contract terms at exit. EO Funds were less likely than the all-survey and all-document review sample of funds to include investment contract terms facilitating early divestment if the portfolio company changed mission during the investment. EO Funds reported a higher occurrence of investment in portfolio companies where mission-lock was built into the legal structure of the portfolio company. Four EO Funds (57%) reported that 50% or more of its portfolio

148. Other funds described their general approach as investing in companies that produce products and services for low-income people, purchasing farmland for sustainable farming practice leases, creating value for others through company investment, promoting sustainable and stakeholder-oriented companies, and job creation.

149. One EO Fund reported that fund-level documents both allowed managers to consider environmental factors when making investment decisions and that the fund-level documents were silent as to the issue. As a result, that fund’s responses are not included in the discussion above.

150. Funds responded to the question: “For what % of your divestments/exits has there been a contract with the acquirer regarding the ongoing social and environmental performance of the company? Choose N/A only if your fund has not had any exits.”

151. Funds responded to the question: “What % of the fund’s invested capital has included language or a covenant in the investment agreement that allows the fund to divest early if the mission of the investment or business model changes during the investment lifetime?”

152. Funds responded to the question: “What % of the total fund is invested in companies that have a written legal governance structure that locks in the mission, requiring consideration of its stakeholders (community, environment, suppliers, employees)?”
companies had legal structure mission-lock compared to 39% of all survey funds and 47% of all document review funds.

Table 8: Survey Responses—Mission Lock

| For what % of your divestments/exits has there been a contract with the acquirer regarding the ongoing social and environmental performance of the company? Choose N/A only if your fund has not had any exits |
|---|---|---|
| | All Survey Funds (33) | All Doc. Rev. Funds (19) | EO-Funds (7) |
| N/A | 19 | 12 | 4 |
| 0 | 8 | 4 | 2 |
| 1–24% | 2 | 1 | 0 |
| 25–49% | 0 | 0 | 0 |
| 50–74% | 0 | 0 | 0 |
| 75+ | 4 | 2 | 1 |

| What % of the fund’s invested capital has included language or a covenant in the investment agreement that allows the fund to divest early if the mission of the investment or business model changes during the investment lifetime? |
|---|---|---|
| | All Survey Funds (33) | All Doc. Rev. Funds (19) | EO-Funds (7) |
| 0/blank | 18 | 9 | 4 |
| 1–24% | 1 | 1 | 1 |
| 25–49% | 0 | 0 | 0 |
| 50–74% | 1 | 1 | 0 |
| 75+ | 14 | 8 | 2 |
What % of the total fund is invested in *companies that have a written legal governance structure that locks in the mission*, requiring consideration of its stakeholders (community, environment, suppliers, employees)?

<table>
<thead>
<tr>
<th></th>
<th>All Survey Funds (33)</th>
<th>All Doc. Rev. Funds (19)</th>
<th>EO-Funds (7)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0/blank</td>
<td>17</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>45%</td>
<td>45%</td>
<td>53%</td>
<td>43%</td>
</tr>
<tr>
<td>1–24%</td>
<td>2</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>6%</td>
<td>6%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>25–49%</td>
<td>4</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>11%</td>
<td>11%</td>
<td>11%</td>
<td>0%</td>
</tr>
<tr>
<td>50–74%</td>
<td>4</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>11%</td>
<td>11%</td>
<td>11%</td>
<td>14%</td>
</tr>
<tr>
<td>75+</td>
<td>11</td>
<td>7</td>
<td>3</td>
</tr>
<tr>
<td>31%</td>
<td>37%</td>
<td>37%</td>
<td>42%</td>
</tr>
</tbody>
</table>

C. Portfolio Companies and Funds’ Employee-specific Contracting Terms

We analyzed contract provisions relating to employees in our document review. In our initial review of the 164 documents, six documents originating from five separate funds (13.8% of our sample of funds) specifically addressed employee wages, safety, or nondiscrimination as an intended outcome of the investment fund. All employee-specific statements were included in fund-level documents such as limited partnership agreements, shareholder agreements, or private placement memoranda. Only one document corresponded to an EO Fund. Two EO funds self-reported that they specifically target or have a preference for investments that impact employees;¹⁵³ a 25% response rate that mirrors that of all funds included in our document review (27.78%).

The survey responses do not demonstrate notable trends inside or outside of the EO Funds and EO Fund portfolio companies. EO Funds reported low occurrences of employee-specific goals in portfolio companies and responsive portfolio companies where the numbers matched or were lower than the survey sample as a whole. Portfolio company commitment to employees and employment issues consolidated to the fund level adds nuance to the story. Twenty-five percent of EO

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¹⁵³ Funds answered whether the fund explicitly targets or has a preference for investment in companies with social impact in employment generation (emphasis added).
Funds reported portfolio company commitment to income impact, compared with 11% in our document-review sample and 20% for the survey responses generally. Thirty-seven percent of EO Funds reported portfolio company commitment to job creation compared with 19% in our document-review sample, and 27% for the survey responses generally.

<table>
<thead>
<tr>
<th>Table 9: Survey Responses—Portfolio Company Employee, Income and Job Goals</th>
</tr>
</thead>
<tbody>
<tr>
<td>EO Fund Responsive Portfolio Co.</td>
</tr>
<tr>
<td><strong>Total Responses</strong></td>
</tr>
<tr>
<td>8 funds reporting</td>
</tr>
<tr>
<td><strong>Portfolio Co. Employee Impact</strong></td>
</tr>
<tr>
<td>0.00%</td>
</tr>
<tr>
<td>(0 funds reporting)</td>
</tr>
<tr>
<td><strong>Portfolio Co. Income Impact</strong></td>
</tr>
<tr>
<td>16.66%</td>
</tr>
<tr>
<td>(2 funds reporting)</td>
</tr>
<tr>
<td><strong>Portfolio Co. Job Creation Impact</strong></td>
</tr>
<tr>
<td>13.33%</td>
</tr>
<tr>
<td>(2 funds reporting)</td>
</tr>
</tbody>
</table>

VI. HYPOTHESES, PREDICTIONS AND RESULTS DISCUSSION

We organized our inquiry into employee ownership as expressing portfolio company or fund preferences; we discuss the results reported above consistent with that organization.

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154. One EO-friendly portfolio company was not identified in the survey responses.
155. One EO-friendly portfolio company was not identified in the survey responses.
A. Are Portfolio Company Preferences Driving EO Provisions?

We did not observe common features among our portfolio companies—shared industrial foci, heavy reliance on employees for production, or a workforce size conducive to influencing company outcomes—which we would expect if portfolio companies drove inclusion of employee ownership provisions in our sample to align interests with, sort, or retain employees. Portfolio company characteristics within our small sample (thirty-one companies), however, do not explain the preference for employee ownership provisions.

Portfolio Company Industry & Location. Portfolio company characteristics that would be expected to influence contracting norms include the industry and geography in which the company operates. In particular, industry reliance on human capital should influence the use of shared ownership plans for incentive-aligning purposes and local labor market conditions for their appropriateness for retention purposes. Within our sample, however, we observed that the portfolio companies participated in diverse industries and in diverse locations. Thirty funds participated in eighteen different industries, with two or more participating in the education, health care, housing, livelihood, and technology industries. The thin distribution across many industries was consistent with our sample as a whole. However, EO Fund portfolio companies, as compared to survey responses for all portfolio companies, underrepresent investments in the agriculture business and general financial services but overrepresent participation in technology, livelihood, and education industries. It is possible that the employee demands of these industries drive preferences for employee ownership provisions in a way not captured by the survey or document review.

Portfolio Company Development Stage. In our results, we noted some difference between the development stage of EO Fund responsive portfolio companies (slightly more likely to report that they were deploying product/services or profitable) and the development stages of all companies in the document review or survey samples. None of the EO Fund portfolio companies reported that the company was in a product development or beta stage. We find these observations insufficient to form a compelling motivation for employee ownership preferences. We note that the document review and survey samples had low response rates

156. Chang, supra note 96, at 180.
158. Represented industries included: agriculture (2), clean water (1), education (2), energy (1), financial (1), government (1), health care (3), housing (3), internet (2), livelihood (3), micro/small loans (1), rural ban (1), specialty (1), technology (3), textile (1), and wireless (1).
159. See supra text accompanying note 136.
(under 5%) for early development stages, and a focus on later development stages is consistent with emerging impact investment norms. Additionally, product development and beta stages conjure images of new product development and enterprise that may not be consistent with the industry-focus or business models of the relevant portfolio companies if they are leveraging existing products or skilled labor to a new market.

**Workforce.** Our study noted some differences in portfolio company workforce sizes, but these differences offer weak explanations for company-level preferences for employee ownership. EO Funds reported that 67% of their portfolio companies employed between 1–249 workers as compared to 75% of all survey respondents. The EO Fund portfolio company sample contained several larger employers with five companies employing between 249–499 employees, two employing 500–999, two employing 1000–2499, and one employing 5000–9999. The lower concentration of workforces with less than 250 employees cuts against the prediction of a smaller workforce with greater ability for employee owners to impact outcomes that we might expect to see under the employee-focused hypothesis. The small size of the sample, however, makes the differences easily discountable due to the similar distribution patterns within the EO Fund portfolio companies and all survey portfolio companies.

The patterns of portfolio company characteristics we observe in this study are not consistent with the hypothesis that portfolio companies drive inclusion of employee ownership provisions. Diverse companies without observable commonalities are unlikely to face the same employee challenges aligning incentives, sorting, or retaining talent. We did not observe common features or clustering of portfolio companies throughout our sample, as we would expect to see if their preferences—whether to align interests, sort, or retain employees—were driving employee ownership. Two documents stated employee-focused reasons for including the employee ownership provisions: “providing long-term incentives to current and future employees” or “to attract and incentivize current and future employees.” This suggests that some impact

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160. See, e.g., STAGARS, supra note 12, at 23.
161. Industry and location may indicate unique challenges aligning interests between employees and the portfolio company, as would variables such as number of employees and stage of company development.
162. Again, industry and location may indicate unique macro conditions with sorting challenges conducive to employee ownership provisions.
163. Our portfolio workforce information is incomplete, but industry and development stage may produce conditions conducive to retention concerns.
164. Document on file with authors.
165. Document on file with authors.
investment portfolio companies act consistent with the literature-based expectations, but we did not observe a pattern across our sample.\footnote{Admittedly, our portfolio company information is limited in its scope. Additional data points in the form of more survey participants providing portfolio company responses and more portfolio company documents submitted by funds would enhance our inquiry into portfolio company motivations for employee ownership. Additional workforce information such as turnover risk, workforce age, employment rates, education and noncompete enforceability would all shed additional light on the topic. Seeing no observable pattern within our sample; however, we turn to examine fund-level motivations for employee ownership.}

**B. Are Fund Preferences Driving EO Provisions?**

Next we look to fund-level characteristics to explain the inclusion of employee ownership provisions. Fund organizational features alone do not explain the preference for employee ownership provisions. Five EO Funds were organized as a limited partnership (or the equivalent) in their country of organization but are organized in a variety of countries. The funds also exhibited diverse geographic focus of investments.

We therefore turn to the hypotheses proposed in Section III(B) that fund preferences may promote employee ownership provisions.

1. Financial Motivations

   We observe fund-level patterns consistent with, but inconclusive of, funds’ financial motivations for employee ownership.

   \(a)\) Roll Up

   Funds may be motivated to include employee ownership provisions as a way to protect financial investment by promoting best practices in the portfolio companies through aligned interests, sorting, and/or retaining talented employees. Including employee ownership provisions may be a way to protect financial investments and promote financial returns through strong portfolio company performance. We have no direct evidence of this motivation in our sample. Instead, we observed the strength of the EO Fund’s contract terms protecting traditional venture capital financial and governance rights. Within our sample overall we observed that impact funds were likely to include contract terms that traditionally protected financial interests and guaranteed governance rights to the investor. As compared to our sample as a whole, EO Funds consistently demonstrated higher occurrences of such terms including protective exit measures (put options, redemption rights, and tag along rights), protective equity position terms (rights of first refusals on third party stock sales, and preemptive and anti-dilution rights), and governance rights (guaranteed seats on the portfolio company board of directors, step in rights and veto/approval
Additionally, we observed a slightly higher occurrence of commitment fees paid by portfolio companies to EO Funds. Bolstering the hypothesis that employee ownership may be one of many provisions intended to protect investors’ financial interests, we also observed that 87% of EO Funds sought market-rate (rather than concessionary) returns compared to 60% in our sample as a whole.

b) Discounting Through Option Shuffles

Some examples of employee ownership contract language support the price discount hypothesis that EO Funds’ financial interests motivate employee ownership provisions. Three out of seven EO funds allocated options out of pre-money capitalization in one or more investment contracts. This supports the theory that employee provisions can be a means to discount the per-share price and protect the fund’s financial investment. We observed ten responsive documents, or roughly 30%, contained the discounting language. It is possible that our sample included a higher (or lower) rate of discounting because an additional thirteen term sheets (41%) contained incomplete information regarding how the option pool would be created.

The strong traditional financial protections coupled with high occurrence of targeted market-rate returns and observable pricing discount through employee ownership plans suggest EO funds’ financial interests may motivate the inclusion of employee ownership provisions in portfolio company investment agreements.

2. Impact Motivations

The need to achieve nonpecuniary goals and balance those interests with financial returns may create unique preferences for employee ownership provisions among impact investment funds. We observe fund-level patterns consistent with, but inconclusive of, fund impact motivations for employee ownership.

a) Neutralizing Agency Costs

Funds may be unable to contract for their idiosyncratic preferred balance between financial and nonpecuniary interests and seek to strike the right balance through indirect contracting measures like aligning employee interests through ownership plans. Our study was not structured to directly observe this possible motivation. One can employ a model along the lines of Bénabou & Tirole (2016)\textsuperscript{167} to show that when

employees have a higher utility for the firm’s mission than the VC does (even if the VC also has utility from the mission goal), this drives the VC to allocate a greater fraction of the company to share with employees.

b) Mission Lock on Portfolio Company

Our study observations offer some limited support for the mission lock hypothesis. Impact investment funds screen investments, in part, based upon portfolio company mission. Funds may want to ensure that the mission is served during and after investment both to protect the fund’s investment strategy and to achieve the fund’s nonpecuniary goals. Within our EO Fund sample we observed a higher occurrence of investment in portfolio companies structured to legally lock in the company’s mission: 57% compared to 47% and 39% in all document review and all survey responses, respectively. The presence of legal structure lock may account for the lower EO Fund occurrences of contract rights protecting mission during investment or after exit. The higher incidence of legal mission lock supports the hypothesis that employee ownership provisions are a means for funds to serve nonpecuniary interests by giving mission-locked employees partial ownership.

c) Measurable Fund Impact

Our final impact hypothesis states that funds with an express mission to generate benefits related to employment (like income, ownership, job creation, etc.) should be more likely to implement employee ownership provisions than other types of funds. The low occurrence of observable social metrics in our document review generally confounded our efforts to support this hypothesis. We report mixed results. Only one EO Fund documented employee-specific outcomes in fund-level documents included in our review. We expanded our inquiry by reviewing fund survey responses. EO Funds reported that 25% specifically target investments that impact employees, a rate that mirrors the 27% of all funds included in our document review.

On the other hand, EO Fund managers, when compared to the sample of funds in our document review, were more likely to report that they were required to consider social or environmental factors, as opposed to merely given discretion to consider such factors. We also found support for this hypothesis when analyzing portfolio company-intended impact. Twenty-five percent of EO Funds reported portfolio company commitment to income impact, compared with 11% of funds in our document review sample and 20% of funds in the survey responses as a whole. Thirty-seven percent of EO Funds reported portfolio company commitment to job creation compared with 19% in our document review.
sample, and 27% for the survey responses generally. Thus, EO funds tended to be more focused on income impact through their portfolio companies. This is consistent with arguments that EO plans are a way to address social inequality.168

C. Framing Observations, Implications and Next Steps

Our results as presented in this Article are limited in the following respects. First, our sample size was relatively small. Second, our instruments—both the survey and the document review—were constructed based upon established contracting norms in private equity and venture capital. This instrument may be too blunt to capture the full scale of nuance of these contracts, omit emerging norms unique to this space, or seek to measure a field that is too new to have norms around which contracts can coalesce. Second, with regard to the “impact” investment terms, these may be more opaque in the contracting process due to a variety of reasons. Opacity of impact terms may reflect the nascence of the field and the lack of standardization; lack of sophistication with portfolio companies; greenwashing by funds; difficulty of creating contract terms/benchmarks around individualized measures and context-dependent outcomes; the negotiation phase (term sheets, not final agreements), etc. To this last point, we think our study is particularly relevant to informing the contracting norms and related literature. Third, our document review relied heavily upon term sheets, which only cover high level deal terms and provide neither a complete nor a thorough description of the final contractual agreement. Thus, the sample of EO Fund responsive documents may underrepresent the total number of employee ownership provisions and other relevant contract terms analyzed in this study in the final agreements. Finally, for survey responses, the funds self-reported for themselves and on behalf of the portfolio companies—a process which can be subject to bias and errors.169

Acknowledging these caveats, we believe that this is a pioneering review of contract terms in the impact investment space. Through this study we gained unparalleled access to private agreements and a rare window under the hood of an emerging investment product largely shielded from public view. We report our findings with the aim of identifying contract norms and motivations for private ordering solutions

168. Strom, supra note 4; Ittner, supra note 102, at 92; see also Hand, supra note 102, at 398; Gavis, supra note 101, at 1486 (“[I]t is apparent that Congress established leveraged ESOPs in order to address perceived inequities in the distribution of capital throughout the economy.”).

documented in our study and with the hope of beginning a concrete discussion of practices in the impact investing space. 170

CONCLUSION

We reviewed a unique sample of contracts pertaining to private equity impact funds and their portfolio companies. We observed EO funds’ consistent utilization of traditional private equity and VC contracting terms to protect their financial interests in portfolio companies through strong governance, exit, anti-dilution, and financial rights. Contracting norms regarding nonpecuniary interests were harder to observe with the methods employed in our study, and will be the subject of future work in the space.

The clustering of employee ownership provisions within some impact funds, but not others, formed our main inquiry in this Article. Employee ownership plans emerged as a recurring condition for joint agreements between impact funds and portfolio companies. Given the unique context of impact investment’s dual goals, we wanted to explore the role of employee ownership in this type of private contracting. We began by reviewing existing theories for why companies may wish to implement these shared ownership plans. We then proposed a new set of hypotheses for why funds might request employee ownership plans, relating to both financial and impact goals.

Our document review did not yield any striking patterns among EO responsive portfolio companies or portfolio companies invested in by EO Funds, in terms of their location, development stage, industrial focus, and size. This supports company-level theories of EO plans. The lack of clustering of these companies around common characteristics suggests that fund-level considerations may have been drivers of EO inclusion in our sample.

Fund-level patterns provided some limited support for new theories of EO plans, although the size of the sample prevents any definitive conclusions. As compared to our sample as a whole, EO Funds consistently demonstrated higher occurrences of such terms including protective exit measures, protective equity position terms, and governance rights, and were more likely to seek market-rate returns, suggesting that fund-level financial considerations may have played a role.

170. In future research generated from this same set of impact investment documents, we hope to explore more broadly contracting norms in impact investment. We are particularly interested in provisions related to social and environmental benefit contracting and in documenting the ways in which impact investment documents conform to or deviate from contracting norms in traditional private equity and venture capital agreements.
Additionally, the structure of some of the employee ownership plans was consistent with dilution of the entrepreneur, bolstering the idea that EO Funds acted in a financially savvy fashion.

There was also evidence of less cynical motives for employee ownership plans. In particular, contractually binding mission lock was more common among EO Funds, raising the possibility that impact funds see employee ownership plans as another way to lock in mission. Another remarkable pattern was the higher incidence of income and job-creation focus among EO Fund portfolio companies, along with survey responses that EO Fund managers were required to consider social or environmental factors. EO Fund managers may see employee ownership plans as a tool to fulfill their impact goals directly. That being said, we note that only one EO Fund documented employee-specific outcomes in fund-level documents, and EO Funds were no more likely to specifically target investments that impact employees than the overall sample.

Our results do not eschew portfolio company motivations for employee ownership plans. Companies may want them to align, sort, and retain employees. In the unique context of impact investments where investors and portfolio companies are balancing financial and nonpecuniary interests, we did not observe portfolio company patterns that, alone, explain the inclusion of these provisions. Employee ownership provisions were not randomly strewn throughout our document review but were clustered within several funds, suggesting that fund-level motivations might explain or contribute to the motivations for employee ownership provisions. In the expanded matrix of motivations at play—financial and benefit for both investor and company—we observed patterns that suggest fund-level motivations for employee ownership provisions serving financial and impact goals.
APPENDIX A: SELECTED SURVEY QUESTIONS

Survey Variable 33: Whether the fund has GIIRS rating data and is willing to share it with the WSII?
*Answer option(s):*
- Yes
- No

Survey Variable 36: The statement that best describes the fund's financial return goals:
*Answer option(s):*
- Targeting competitive, market rate returns
- Targeting below market, but close to market returns
- Targeting below market, close to capital preservation returns
- Not Applicable (Explain)

Survey Variable 37: Text explanation of a 'Not Applicable' response.
*Answer option(s):* text

Survey Variable 39: The statement that best describes the fund's approach to creating social and environmental impact.
*Answer option(s):*
- We aim to create social or environmental impact by improving the operations of the companies in which we invest.
- We invest in business models that specifically create positive social or environmental impact.
- Neither of the above (Explain)

Survey Variable 40: Text explanation of a 'Neither' response.
*Answer option(s):* text

Survey Variable 41: Whether the fund's Private Placement Memorandum, side letter, Limited Partner Agreement, or other comparable investment agreements include specific language that “Requires fund manager to consider social and/or environmental practices when making investment decisions”:
*Answer option(s):*
- Yes
- No
Survey Variable 42: Whether the fund's Private Placement Memorandum, side letter, Limited Partner Agreement, or other comparable investment agreements include specific language that “Explicitly allows the fund manager to consider social practices when making investment decisions”:
Answer option(s):
- Yes
- No

Survey Variable 43: Whether the fund's Private Placement Memorandum, side letter, Limited Partner Agreement, or other comparable investment agreements include specific language that “Explicitly allows the fund manager to consider environmental practices when making investment decisions”:
Answer option(s):
- Yes
- No

Survey Variable 44: Whether the fund's Private Placement Memorandum, side letter, Limited Partner Agreement, or other comparable investment agreements include specific language that “Does not reference social and/or environmental issues”:
Answer option(s):
- Yes
- No

Survey Variable 112: What % of the fund's invested capital has included language or a covenant in the investment agreement that allows the fund to divest early if the mission of the investment or business model changes during the investment lifetime?
Answer option(s):
- 0
- 1–24%
- 25–49%
- 50–74%
- 75%+
Survey Variable 113: What % of the total fund is invested in companies that have a written legal governance structure that locks in the mission, requiring consideration of its stakeholders (community, environment, suppliers, employees)?

Answer option(s):
- 0
- 1–24%
- 25–49%
- 50–74%
- 75%+

Survey Variable 115: For what % of your divestments/exports has there been a contract with the acquirer regarding the ongoing social and environmental performance of the company? Choose N/A only if your fund has not had any exits.

Answer option(s):
- N/A
- 1–24%
- 25–49%
- 50–74%
- 75%+

Survey Variable 166: The industry of the Company

Answer option(s): text

Survey Variable 167: The number of full-time employees of the company:

Answer option(s):
- 0
- 1–19
- 20–99
- 100–249
- 250–499
- 500–999
- 1000–2499
- 2500–4999
- 5000–9999
- 10,000–24,999
- 25,000–49,000
- 50,000–99,999
- 100,000+
Survey Variable 168: Which of the following best reflects the development status that company has attained?

Answer option(s):
- Product Development
- Beta
- Deploying Product/Service
- Profitable
- Not applicable (Explain)

Survey Variable 182: Describe the social impact focus of the company: Employment generation

Answer option(s):
- Yes
- No

Survey Variable 188: Describe the social impact focus of the company: Income/productivity growth

Answer option(s):
- Yes
- No

Survey Variable 189: Describe the social impact focus of the company: Job creation

Answer option(s):
- Yes
- No