Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

MEMORANDUM

To:	Members, Committee on Small Business
From:	Nydia M. Velázquez, Chairwoman
Date:	February 12, 2020
Re:	Full committee hearing: "Challenges and Benefits of Employee-owned Businesses"

The Committee on Small Business will meet for a hearing titled, "Challenges and Benefits of Employee-owned Businesses." The hearing is scheduled to begin at **11:30 A.M. on Wednesday, February 12, 2020 in Room 2360 of the Rayburn House Office Building.** The hearing will allow Members to learn about the benefits of employee ownership for business owners, their employees, and their local economies. The witnesses will be:

Panel:

- Mr. Daniel Goldstein, CEO and President, Folience, Cedar Rapids, IA
- Mr. R.L. Condra, Vice President of Advocacy and Government Programs, National Cooperative Bank, Arlington, VA
- Mr. John Abrams, CEO and Co-owner of South Mountain Company, West Tisbury, MA
- Mr. Mark Gillming, Senior Vice President, Messer Construction Co., Cincinnati, OH

Background

Employee ownership is a term for any arrangement in which employees share in the profit and losses of a company, often owning shares of stock in the company.[1] Employee Stock Ownership Plans (ESOPs), business cooperatives, equity compensation plans and profit sharing plans (PSPs) are common forms employee ownership.[2] A central principle of all employee owned companies is that the interests of the employees and owners are aligned. As a business expands, generating more revenue and profits, a direct connection is drawn between an employees' work and how much she is compensated, thereby creating a culture of ownership. Employee-owned companies have many other benefits, including but not limited to building retirement security for employees, allowing business owners to successfully transition a business to new owners, and allowing employees a voice in management decisions.[3] This memo and hearing will focus on the two most common forms of employee ownership, ESOPs and cooperatives, the benefits and challenges they face, and legislation passed in 2018 to facilitate access to capital to these types of businesses.

---

[1] National Center for Employee Ownership (NCEO). "What Is Employee Ownership? | NCEO," Accessed January 20, 2020. https://www.nceo.org/what-is-employee-ownership [hereinafter "NCEO - What Is Employee Ownership"].
[2] NCEO What Is Employee Ownership, *supra* note 1.
[3] NCEO What Is Employee Ownership, *supra* note 1.

Types of employee-owned businesses

Employee Stock Ownership Plans (ESOPs)

The most common structure for employee ownership of business in the U.S. is the ESOP, which is a type of retirement plan, similar to a 401(k) plan, that invests primarily in company stock and holds its assets in a trust for employees. Employees who participate in ESOPs gain shares in the plan over time, and are paid out by having their shares bought back, typically after they leave the company.[4] ESOPs are often created during the sale of a business, as an ESOP can buy a departing owner's shares on terms that are highly favorable to the owner, the remaining employees, and the business itself. An ESOP may own 100 percent of a company's stock, or it may own only a small percentage. Approximately 6,500 U.S. companies have an ESOP, and approximately 14 million U.S. workers are ESOP participants.[5]

Cooperatives

There is no single definition of a cooperative but generally, cooperatives are businesses owned by its members, and common examples include farmer co-ops, credit unions, and rural electric cooperatives.[6] Because co-ops are member-owned, members get a say in the how the business is run and the values it supports. This usually includes voluntary and open membership, democratic control, cooperation among other cooperatives, and concern for the community.[7] According to the University of Wisconsin Center for Cooperatives, nearly 30,000 U.S. cooperatives operate at 73,000 places of business throughout the U.S., owning greater than $3 trillion in assets and generating over $500 billion in revenue and over $25 billion in wages.[8] Americans hold 350 million memberships in cooperatives which generate nearly $79 billion in total impact from patronage refunds and dividends.[9] Nearly 340 million of these memberships are in consumer cooperatives.[10]

Equity Compensation Plans

Another form of employee ownership in the U.S. is equity compensation, which is essentially a non-cash form of compensation representing ownership in the business. Equity compensation can take the form common stock, preferred stock (similar to common stock, but holders get paid dividends before common stockholders), and stock options (which convey the right, but not the obligation, to purchase stock at a future set price)4.[11] These equity compensation arrangements allow employees to share in profits as the company grows and encourages talented employees to stay with the company, especially if there are vesting requirements.

---

[4] National Center for Employee Ownership (NCEO). "Forms of Employee Ownership in the U.S.; Employee Stock Ownership Plans (ESOPs)," Accessed January 20, 2020. https://www.nceo.org/what-is-employee-ownership#_Toc529288093 [hereinafter "NCEO Forms of Employee Ownership"].

[5] NCEO Forms of Employee Ownership, *supra* note 4.

[6] National Cooperative Business Association. "Cooperation for a Better Tomorrow: What Are Cooperatives." Accessed January 29, 2020. https://ncbaclusa.coop/content/uploads/2019/02/Policymakers-Guide-2019.pdf.

[7] International Cooperative Alliance. "Cooperative Identity, Values & Principles | ICA." Accessed January 29, 2020. https://www.ica.coop/en/cooperatives/cooperative-identity.

[8] Deller, Steven, Ann Hoyt, Brent Hueth, and Reka Sundaram-Stukel. "Research on the Economic Impact of Cooperatives," June 19, 2009. Accessed January 29, 2020. http://reic.uwcc.wisc.edu/sites/all/REIC_FINAL.pdf [hereinafter "Wisconsin Center for Cooperatives"].

[9] Wisconsin Center for Cooperatives, *supra* note 8.

[10] Wisconsin Center for Cooperatives, *supra* note 8.

[11] National Center for Employee Ownership (NCEO). "What Is Employee Ownership? Equity Compensation Plans | NCEO," Accessed January 20, 2020. https://www.nceo.org/what-is-employee-ownership#_Toc529288094.

Benefits of employee-owned business

Cooperatives produce higher wages and promote job preservation

Each worker-owner of a worker-cooperative holds one voting share in the company, and so each individual worker-owner retains direct control over her own working conditions, wages, and job security. In many cases, this model of direct employee control produces higher wages for workers employed by worker-cooperatives than for those employed by conventional firms. One study of a worker-owned grocery in the San Francisco Bay Area found that average compensation for the grocery's worker-owners was 40 percent higher than the average for unionized workers in California.[12] Moreover, during times of economic distress, worker-owned businesses prioritize job preservation and have demonstrated they are more likely than conventional firms to temporarily reduce hours or adjust wages rather than cut jobs.[13] This translates to lower unemployment rates and helps insulate local economies during crisis periods.

Cooperatives reinvest more locally than conventional firms

Because ownership and labor are one and the same in worker-cooperatives, and because workers themselves make the company's strategic decisions, there is little danger of a worker-cooperative business unexpectedly leaving an area or being sold to outside investors and dissolved. Worker-owned cooperatives therefore create stronger local economies by rooting businesses in their communities. By effectively anchoring businesses in place, worker-cooperatives reduce the risk of retail desertification.[14] They also tend to purchase locally more frequently and re-invest more in the local community than do conventionally owned businesses. A study conducted by the National Cooperative Grocers Association compared the impact of food co-ops and conventional grocers on local economies, and found that $0.38 of every dollar spent at a food co-op is reinvested in the local economy, compared with $0.24 at conventional grocers.[15]

ESOPs are more resilient during recession

Employment levels at ESOPs fared better than the overall private sector U.S. labor market during the financial crisis, showing that ESOPs were more resilient in the face of economic distress.[16] In 2010, as the U.S. economy was beginning to recover from the financial crisis, S-ESOPs[17] created or supported 1.4 million jobs, generated $77 billion in labor income, $246 billion in total output,

---

[12] Rieger, Shannon. "Reducing Economic Inequality through Democratic Worker-Ownership," August 10, 2016. Accessed February 3, 2020. https://tcf.org/content/report/reducing-economic-inequality-democratic-worker-ownership/ [hereinafter "Reducing Economic Inequality"].

[13] Reducing Economic Inequality, *supra* note 12.

[14] Reducing Economic Inequality, *supra* note 12.

[15] National Cooperative Grocers Association. "Healthy Foods Healthy Communities: Measuring the Social and Economic Impact of Food Co-ops," 2012. Accessed February 3, 2020. https://community-wealth.org/content/healthy-foods-healthy-communities-measuring-social-and-economic-impact-food-co-ops.

[16] Brill, Alex. "An Analysis of the Benefits S-ESOPs Provide the U.S. Economy and Workforce:" *Matrix Global Advisors (MGA).* July 26, 2012. Accessed January 29, 2020. http://esca.us/wp-content/uploads/2015/11/Brill_S_ESOP_Study_20121.pdf; *see also* Brill, Alex. "Macroeconomic Impact of S-ESOPs on the U.S. Economy:" *Matrix Global Advisors (MGA).* April 17, 2013, 13. Accessed January 29, 2020. http://esca.us/wp-content/uploads/2015/10/Macroecomic_Impact_of_S_ESOPs_study_4_17_13.pdf.

[17] National Center for Employee Ownership (NCEO). "ESOPs in S Corporations," Accessed February 11, 2020. https://www.nceo.org/articles/esops-s-corporations. (A creation of the tax code, S-ESOPs are Employee Owned Plans organized as S-Corporations. Operating as an S-corporation provides special tax benefits to these ESOPs and encourage their formation).

and $27 billion in tax revenue.[18] One researcher found that for the period 2006-2011, compared to employment among private U.S. firms, S-ESOPs showed more growth in the pre-recession period and, despite a slight decrease in employment for the surveyed firms during the recession, those firms regained momentum more quickly after the recession than non-S-ESOP firms.[19]

ESOPs exhibit strong wage and benefits performance

In addition to resilient employment performance, ESOP firms also enjoy strong performance in terms of workers' wages and benefits. Wages per worker in S-ESOP firms rose in 2008 by 5.9 percent, while overall U.S. earnings per worker grew by only 3.2 percent.[20] The average wage per worker in S-ESOP firms was $50,225 in 2008, compared to $31,600 for workers in the overall private sector.[21] Furthermore, the growth of benefits for S-ESOP firms was 11.0 percent in 2008, but only 1.9 percent for the overall economy.[22]

Conversion to employee ownership is an exit strategy for business owners

For business owners considering retirement, converting to an employee-owned structure is an effective succession plan to preserve a firm's continuity, foster employee commitment, and build lasting economic value in a community. S-ESOP conversions have averaged around 100 per year since 2002, ranging from 86 in 2002 to 149 in 2012.[23] S-ESOPs have been shown to have unique qualities, including greater firm longevity and higher wages, wage growth, job stability, retirement plan contributions, employment, and sales. S-ESOP conversions also compare favorably with other common exit strategies, particularly private equity buyouts. For example, a 2014 study in the *American Economic Review* found that firms acquired in a PE buyout experience 3 percent greater job loss two years post-buyout and 6 percent greater job loss five years post-buyout than comparable firms.[24] Similarly, owners looking to exit or transition a business may decide to convert to a cooperative for many of the same benefits that ESOPs provide. The conversion allows for a smooth exit for the business owner, recognizes the value of the employees, and creates wealth-building opportunities for employees, particularly in low-wage sectors of the economy.[25]

---

[18] Brill, Alex. "Macroeconomic Impact of S-ESOPs on the U.S. Economy:" *Matrix Global Advisors (MGA).* April 17, 2013, 13. Accessed January 29, 2020. http://esca.us/wp-content/uploads/2015/10/Macroecomic_Impact_of_S_ESOPs_study_4_17_13.pdf.

[19] Brill, Alex. "An Analysis of the Benefits S-ESOPs Provide the U.S. Economy and Workforce" *Matrix Global Advisors (MGA).* July 26, 2012. Accessed January 29, 2020. http://esca.us/wp-content/uploads/2015/11/Brill_S_ESOP_Study_20121.pdf.

[20] Swagel, Phillip, and Robert Carroll. "Resilience and Retirement Security: Performance of S-ESOP Firms in the Recession" *Georgetown University McDonough School of Business*, March 23, 2010. Accessed January 29, 2020. http://esca.us/wp-content/uploads/2015/11/ESCA_Performance_Study_-_final.pdf [hereinafter "Resilience and Retirement Security"].

[21] Resilience and Retirement Security, *supra* note 20.

[22] Resilience and Retirement Security, *supra* note 20.

[23] Brill, Alex. "Employee Stock Ownership Plans as an Exit Strategy for Private Business Owners:" *Matrix Global Advisors (MGA)*. March 2017. Accessed January 29, 2020. http://esca.us/wp-content/uploads/2017/03/ESCA_ExitStrategy_Final.pdf.

[24] Davis, Steven J, John C Haltiwanger, Kyle Handley, Ron S Jarmin, Josh Lerner, and Javier Miranda. "Private Equity, Jobs, and Productivity." Working Paper. National Bureau of Economic Research, September 2013. Accessed January 29, 2020. https://doi.org/10.3386/w19458.

[25] Democracy at Work Institute. "Case Studies: Business Conversions to Worker Cooperatives," April 2015. Accessed February 11, 2020. https://institute.coop/sites/default/files/resources/Case-Studies_Business-Conversions-to-Worker-Cooperatives_ProjectEquity.pdf.

Challenges and Current Issues facing employee-owned businesses

SBA administers programs to support small businesses, including loan guaranty programs designed to encourage lenders to offer loans to small businesses that may not be able to access affordable capital elsewhere on reasonable terms.[26] The 7(a) Loan Guaranty Program (the "7(a) program"), the agency's flagship loan program, is designed to provide small business with everything from working capital loans to financing options to support business transitions.[27] To further promote affordable access to capital for employee-owned businesses, Congress enacted the Main Street Employee Ownership Act of 2018 (the "Main Street Act") as Section 862 of the John S. McCain National Defense Authorization Act for Fiscal Year 2019.[28] However, both cooperatives and ESOPs still face challenges accessing the 7(a) program.

Cooperatives Access to SBA 7(a) program

Currently, SBA's 7(a) loan program requires a personal guarantee from any individual or entity who owns a 20 percent share or greater of the business.[29] This guarantee enables the lender to seize the personal assets of the guarantor to repay the loan if business assets are insufficient to cover loan payments. Given their unique ownership structure, providing this guarantee is particularly onerous on worker-owners, making access to 7(a) loans by cooperative businesses nearly impossible. In response to these challenges, the Main Street Act directed SBA to initiate a working group tasked with studying alternatives for cooperatives to secure or collateralize a 7(a) loan without being required to make a personal guarantee.[30]

The intent of the Main Street Act was to have SBA collect proposed alternatives for cooperative businesses to collateralize or otherwise secure a loan *without* requiring a personal guarantee. Furthermore, the Main Street Act directed SBA to submit to Congress a report setting forth those alternatives proposed by either the industry, other Federal agencies (in this case, the U.S. Department of Agriculture, whose Business & Industry Loan Guarantee program is open to cooperatives and *does not* require a personal guarantee of them), or the SBA itself.[31] However, SBA's report took issue with each industry and USDA proposal, and proposed no alternatives of its own.[32] Instead, SBA wrote that its' "recommendation is to better educate the public to the two options available to cooperatives to satisfy the personal guarantee requirement under SBA's current policies and procedures…", and in so saying, declined to offer any alternatives to the personal guarantee.[33] This remains an obstacle to cooperatives in accessing the 7(a) program.

---

[26] Congressional Research Service, *Small Business Administration 7(a) Loan Guaranty Program*, R41146 (Mar. 4, 2019).

[27] 15 U.S.C. § 636(a); *see also* Congressional Research Service, *Small Business Administration 7(a) Loan Guaranty Program*, R41146 (Mar. 4, 2019).

[28] Pub. L. 115-232, § 862.

[29] 13 CFR § 120.160.

[30] Pub. L. 115-232, § 862(g)(2)(A).

[31] Pub. L. 115-232, § 862(g)(2)(B).

[32] U.S. Small Bus. Admin., "Cooperative Lending – Personal Guarantee Requirement," Report to the United States Senate and United States House of Representatives (2019) (on file with the House Committee on Small Business) [hereinafter "SBA Cooperative Lending Report"].

[33] SBA Cooperative Lending Report, *supra* note 32.

ESOP Access to SBA's 7(a) program

The Main Street Act also authorized 7(a) lenders to make loans to ESOPs under a lender's delegated authority.[34] However, the proposed rule implementing the legislation provided, in contravention of Congressional intent, that 7(a) loans to ESOPs could not be made under a lender's delegated authority.[35] In response to the Notice of Proposed Rulemaking,[36] then-Ranking Member Nydia M. Velázquez filed a public comment letter arguing that in light of the impending wave of Baby Boomer retirements, SBA ought to enhance its programs so that businesses may use them in transitioning to an employee-owned model, as opposed to selling the business to a larger company or shutting down.[37] The letter urged SBA to follow the clearly-articulated Congressional intent to increase the availability of capital to ESOPs and other employee-owned business models by allowing lenders to process and issue these loans under their delegated authority.[38] As of February 3, 2020, that regulation has not been finalized.

Other challenges – Impending retirements

Nearly half of all privately held businesses in the U.S. are owned by individuals who are at or near retirement age, representing more than 2.3 million companies, and employing close to 25 million workers in total (one in six workers nationwide). Though more than half of these small business owners expect to retire within the next ten years, fewer than 15 percent have a formal exit plan in place. Only a small percentage of these businesses will be passed on to family members or bought by another local company. Instead, many of these businesses could be bought out by competitors or even close due to a lack of planning or inability to find a buyer; both of which result in damage to local communities from lost jobs and revenue. This has been referred to as the "Baby Boomer Cliff" or the "Silver Tsunami," and it is a very real concern for the business owner who may not have enough money on which to retire, and for the employees of those businesses, who struggle with the uncertainty of their boss' future retirement plans. As this trend accelerates in the coming years, it is crucial that those small business employees are empowered to transition the business to an employee-owned model, preserving the firm's independence and protecting it from the risk of bankruptcy, buyout, or outright closure.

Conclusion

As Congress continues to seek ways to enhance access to capital for small businesses, it is important to keep in mind the many different business ownership structures that have become more popular during the first two decades of the 21st century, including ESOPs and cooperatives. Equally important is Congress' charge to ensure the federal agencies who deliver capital access programs do not discriminate against certain business based solely on their ownership structure. Because these businesses have been proven to be a net positive on local economies and creating real wage growth for workers, it is incumbent upon Congress and the federal agencies it oversees to make it easier, not harder, for businesses to operate in an employee-owned model. Accordingly, this hearing will explore the benefits employee ownership delivers to individual workers, families, and local economies. The hearing will also explore how the federal government can remove

[34] Pub. L. 115-232, § 862(b)(2).
[35] 83 Fed. Reg. 189 (Sep. 28, 2018).
[36] 83 Fed. Reg. 189 (Sep. 28, 2018).
[37] Rep. Nydia M. Velázquez, Comment Letter on Express Loan Programs; Affiliation Standards, (Sep. 12, 2018) available at https://www.regulations.gov/contentStreamer?documentId=SBA-2018-0009-3948&attachmentNumber=1&contentType=pdf [hereinafter "Velázquez Comment Letter"].
[38] Velázquez Comment Letter, *supra* note 37.

barriers to employee ownership, by following through on the Congressional intent to increase access to capital to cooperatives and ESOPs.