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:	September 30, 2021
RE:	Full Committee Hybrid Hearing: "Empowering Employee Owned Businesses and Cooperatives Through Access to Capital"

The Committee on Small Business will meet for a hybrid hearing titled "Empowering Employee Owned Businesses and Cooperatives Through Access to Capital." The hearing is scheduled to begin at **10:00 A.M. on Thursday, September 30, 2021, in person in 2360 Rayburn House Office Building, and virtually via the Zoom platform**. The hearing will educate Members on the challenges faced by employee-owned businesses in the post-COVID-19 economy, especially in accessing affordable capital. The hearing will also provide Members with a history of the Small Business Committee's legislative efforts to improve access to the Small Business Administration's (SBA) 7(a) loan guarantee program for employee-owned firms.

Panel

- Mr. R.L. Condra, Senior Vice President, National Cooperative Bank, Arlington, VA
- Ms. Tatia Cooper, President, Home Care Associates, Philadelphia, PA
- Mr. Gary Shorman, Chairman and Chief Development Officer, Eagle Communications, Hays, KS
- Ms. Alice Frazier, President and Chief Executive Officer, Bank of Charles Town, Charles Town, WV (*testifying on behalf of the Independent Community Bankers of America*)

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 they are 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

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

employees a voice in management decisions.[3] This hearing will focus on the two most common forms of employee ownership (ESOPs and cooperatives), the benefits they present for employees and owners, and the challenges they face in starting up and expanding. The hearing will also review legislation passed in 2018 to facilitate capital access for these types of businesses, and other proposals intended to remove barriers to SBA loan programs.

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 it 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% of a company's stock, or a smaller percentage. About 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 have 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 National Cooperative Business Association (NCBA), 1 in 3 Americans are co-op members, and approximately 65,000 cooperatives operate across the U.S., generating $75 billion in annual wages and $650 billion in revenue.[8]

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, giving each individual worker-owner direct control over their 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. According to the NCBA, worker cooperatives pay an average hourly wage of $19.67.[9] According to the Democracy At Work Institute (DAWI), on average, low-wage workers and workers of color who

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[3] NCEO What Is Employee Ownership, *supra* note 1.
[4] National Center for Employee Ownership (NCEO), "Forms of Employee Ownership in the U.S.; Employee Stock Ownership Plans (ESOPs)," 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;" https://ncbaclusa.coop/content/uploads/2019/02/Policymakers-Guide-2019.pdf.
[7] International Cooperative Alliance. "Cooperative Identity, Values & Principles | ICA;" https://www.ica.coop/en/cooperatives/cooperative-identity.
[8] National Cooperative Business Association, "Building An Inclusive Economy Together: 2019 Annual Report;" 2020; https://ncbaclusa.coop/content/uploads/2020/05/2019-Annual-Report-for-web.pdf [hereinafter "NCBA 2019 Annual Report"].
[9] NCBA 2019 Annual Report, *supra* note 8.

are employee-owners have 17% greater median household net worth and 22% higher median income from wages than their non-owner peers.[10] Furthermore, a study of a worker-owned grocery stores in the San Francisco Bay Area found that average compensation for the grocery's worker-owners was 40% higher than the average for unionized workers in California.[11] 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.[12] This translates to lower unemployment rates and helps insulate local economies during crises.

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.[13] They also tend to purchase locally more frequently and re-invest more in the local community than 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.[14]

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.[15] In 2010, as the U.S. economy was beginning to recover from the financial crisis, S-ESOPs[16] created or supported 1.4 million jobs, generated $77 billion in labor income, $246 billion in total output, and $27 billion in tax revenue.[17] 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

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[10] DAWI, "Economic Recovery and Employee Ownership," 2021, https://www.nlc.org/wp-content/uploads/2021/08/DAWI-Employee-Ownership-Report.pdf [hereinafter "Economic Recovery and Employee Ownership"].
[11] Rieger, Shannon, "Reducing Economic Inequality through Democratic Worker-Ownership," Aug. 10, 2016; https://tcf.org/content/report/reducing-economic-inequality-democratic-worker-ownership/ [hereinafter "Reducing Economic Inequality"].
[12] Reducing Economic Inequality, *supra* note 11.
[13] Reducing Economic Inequality, *supra* note 11.
[14] National Cooperative Grocers Association, "Healthy Foods Healthy Communities: Measuring the Social and Economic Impact of Food Co-ops," 2012; https://community-wealth.org/content/healthy-foods-healthy-communities-measuring-social-and-economic-impact-food-co-ops.
[15] Brill, Alex, "An Analysis of the Benefits S-ESOPs Provide the U.S. Economy and Workforce;" *Matrix Global Advisors (MGA).* Jul. 26, 2012; http://esca.us/wp-content/uploads/2015/11/Brill_S_ESOP_Study_20121.pdf.
[16] National Center for Employee Ownership (NCEO), "ESOPs in S Corporations," 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).
[17] Brill, Alex, "Macroeconomic Impact of S-ESOPs on the U.S. Economy;" *Matrix Global Advisors (MGA),* April 17, 2013, 13; http://esca.us/wp-content/uploads/2015/10/Macroecomic_Impact_of_S_ESOPs_study_4_17_13.pdf.

firms regained momentum more quickly after the recession than non-S-ESOP firms.[18] Similar trends were also observed during the COVID-19 pandemic. For example, a survey of ESOP employees and their non-ESOP peers showed fewer than 1 in 20 (4.5%) ESOP employees reported job loss or downsizing, compared to an alarming rate of nearly 1 in 3 (30%) among non-ESOP employees.[19] Not a single respondent among the ESOP employees reported being behind on their rent or mortgage, compared to more than a quarter (26%) of their non-ESOP peers.[20]

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%, while overall U.S. earnings per worker grew by only 3.2%.[21] 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.[22] Furthermore, the growth of benefits for S-ESOP firms was 11.0% in 2008, but only 1.9% for the overall economy.[23] Furthermore, according to DAWI, workers nearing retirement at employee-owned firms have an average of $147,522 in retirement savings from their ownership stakes, contrasted with more than one-third of all workers nearing retirement who have neither retirement savings nor a defined benefit pension.[24] Moreover, during the COVID-19 pandemic, majority-ESOP companies were far less likely to cut employee pay compared to other companies. Only about a quarter (26.9%) of ESOPs cut pay for any employee, compared to more than half (57.3%) of other firms.[25]

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. Since 2014, an average of 263 new ESOPs have been created each year.[26] 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% greater job loss two

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

[19] Employee-Owned S Corporations of America, "Employee Financial Health and Sentiments Amid the Pandemic," 2021, https://esca.us/wp-content/uploads/2021/06/JZS-Venn-ESCA-Covid-Financial-Health-Survey-2021.pdf [hereinafter "ESOP Employee Financial Health Amid the Pandemic"].

[20] ESOP Employee Financial Health Amid the Pandemic, *supra* note 19.

[21] 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; http://esca.us/wp-content/uploads/2015/11/ESCA_Performance_Study_-_final.pdf [hereinafter "Resilience and Retirement Security"].

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

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

[24] Economic Recovery and Employee Ownership, *supra* note 10.

[25] The Employee Ownership Foundation, "Employee-Owned Firms in the COVID-19 Pandemic: How Majority-Owned ESOP & Other Companies Have Responded to the COVID-19 Health and Other Crises," October 2020, https://cleo.rutgers.edu/wp-content/uploads/2020/11/EOF-REPORT-EMPLOYEE-OWNED-FIRMS-IN-THE-COVID-19-PANDEMIC.pdf.

[26] National Center for Employee Ownership (NCEO), "Employee Ownership by the Numbers: How is the ESOP Universe Changing Over Time?," March, 2021, https://www.nceo.org/articles/employee-ownership-by-the-numbers#6.

years post-buyout and 6% greater job loss five years post-buyout than comparable firms.[27] 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.[28]

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. The 7(a) Loan Guarantee 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. 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.[29] However, both cooperatives and ESOPs still face challenges accessing the 7(a) program.

Cooperatives' Access to SBA's 7(a) Program

Currently, SBA's 7(a) loan program requires a personal guarantee from any individual or entity who owns a 20% share or greater of the business.[30] 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.[31]

The intent of the Main Street Act was to have SBA propose alternatives for cooperatives to collateralize or otherwise secure a loan *without* requiring a personal guarantee. Furthermore, the Main Street Act directed SBA to submit a report to Congress delineating 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 SBA itself.[32] However, SBA's report disagreed with each industry and USDA proposal, and proposed no alternatives of its own.[33] Instead, SBA wrote that its' "recommendation is to better educate the public to the two options available to cooperatives to

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[27] Davis, Steven J, *et al*., "Private Equity, Jobs, and Productivity," Working Paper, National Bureau of Economic Research, Sep. 2013; https://doi.org/10.3386/w19458.

[28] DAWI, "Case Studies: Business Conversions to Worker Cooperatives," April 2015; https://institute.coop/sites/default/files/resources/Case-Studies_Business-Conversions-to-Worker-Cooperatives_ProjectEquity.pdf.

[29] Pub. L. 115-232, § 862.

[30] 13 CFR § 120.160.

[31] Pub. L. 115-232, § 862(g)(2)(A).

[32] Pub. L. 115-232, § 862(g)(2)(B).

[33] 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"].

satisfy the personal guarantee requirement under SBA's current policies and procedures…", and in sum, declined to offer any alternatives to the personal guarantee.[34] This recommendation is another obstacle to cooperatives in accessing the 7(a) program. In response to SBA's long-standing insistence on requiring a personal (or entity) guarantee from cooperatives to access a 7(a) loan, the Small Business title of the Build Back Better Act included $500 million in funding for a "Cooperative Lending Pilot" within the 7(a) program for eligible cooperatives and employee-owned businesses to access 7(a) loans without the requirement of a personal or entity guarantee.

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.[35] 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.[36] In response to the Notice of Proposed Rulemaking,[37] 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.[38] 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.[39] On February 10, 2020, SBA published an interim final rule maintaining its position that 7(a) loans to ESOPs must continue to be processed on a non-delegated basis.[40]

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% 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 hurt 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 growing concern for business owners who may not have enough money on which to retire, and for their employees, who struggle with the uncertainty of their boss' future retirement plans. As this trend accelerates in the coming years, it is crucial that those employees are empowered to transition the firm to an employee-owned model, preserving its independence and protecting it from the risk of bankruptcy, buyout, or outright closure.

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[34] SBA Cooperative Lending Report, *supra* note 33.
[35] Pub. L. 115-232, § 862(b)(2).
[36] 83 Fed. Reg. 189 (Sep. 28, 2018).
[37] 83 Fed. Reg. 189 (Sep. 28, 2018).
[38] 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"].
[39] Velázquez Comment Letter, *supra* note 38.
[40] 85 Fed. Reg. 27 (Feb. 10, 2020).

Conclusion

As Congress continues to seek ways to improve capital access for small firms, it is important to ensure the federal agencies who deliver capital access programs do not exclude certain business based solely on their ownership structure. Because these businesses have proven to be a net positive on local economies, create real wage growth for workers, and helped stabilize their workers' financial positions amid the COVID-19 pandemic, it is imperative that Congress and the federal agencies make it easier for more businesses to adopt an employee-owned model. Accordingly, this hearing will explore the benefits of employee ownership for workers, families, and communities. The hearing will also explore how the federal government can remove barriers to employee ownership by following through on the Congressional intent to increase access to capital to cooperatives and ESOPs.