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, Subcommittee on Oversight, Investigations, and Regulations
FROM:	Dean Phillips, Chairman
DATE:	December 6, 2022
RE:	Subcommittee Hybrid Hearing: "Building Sustainable Businesses through Employee Ownership at SBA"

The Committee on Small Business Subcommittee on Oversight, Investigations, and Regulations will meet for a hybrid hearing titled "Building Sustainable Businesses through Employee Ownership at SBA." The hearing is scheduled to begin at **10:00 A.M. on Tuesday, December 6, 2022, in person in 2360 Rayburn House Office Building, and virtually via the Zoom platform**. The hearing will allow Members to examine the challenges faced by employee-owned businesses in accessing affordable capital from the SBA, and SBA's efforts to address those issues. The hearing will also provide Members the opportunity to receive feedback on two bills that aim to improve access to the Small Business Administration's (SBA) 7(a) loan guarantee program for employee-owned firms. The measures are as follows: H.R. 9347, the "Main Street Employee Ownership 2.0 Act of 2022" and H.R. 9345, the "Improving SBA Engagement on Employee Ownership Act".

Panel

- Ms. Mo Manklang, Policy Director, United States Federation of Worker Cooperatives
- Mr. Corey Rosen, Founder, National Center for Employee Ownership
- Mr. Keith D. Butcher, Partner, Mosaic Capital
- Mr. Scott Lockard, President, Hampton Enterprises

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), worker 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

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

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]

Types of Employee-owned Businesses

Employee Stock Ownership Plans (ESOPs)

The most common structure for employee ownership of businesses 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 fair terms, 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 worker co-ops, 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 National Cooperative Business Association (NCBA), worker cooperatives pay an average hourly wage of $19.67.[9] And, according to the Democracy At Work Institute (DAWI), on average, low-wage workers and workers of color who are employee-owners have 17% greater median household net worth and 22% higher median income from wages than their non-owner peers.[10]

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[3] *Id.*
[4] *Id.*
[5] *Id.*
[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.
[9] *Id.*
[10] DAWI, "Economic Recovery and Employee Ownership," 2021, https://www.nlc.org/wp-content/uploads/2021/08/DAWI-Employee-Ownership-Report.pdf.

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.

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 Corporation ESOP (S-ESOP) firms rose in 2008 by 5.9%, while overall U.S. earnings per worker grew by only 3.2%.[11] 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.[12] Furthermore, the growth of benefits for S-ESOP firms was 11.0% in 2008, but only 1.9% for the overall economy.[13] 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.[14]

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. 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.[15] With the retirement tsunami upon us it is essential that the federal government examine innovate ways to facilitate the transfer of ownerships, such as ESOPs.

Challenges and Current Issues Facing Employee-Owned Businesses

SBA's 7(a) Loan Guarantee Program (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 (Main Street Act).[16] However, both cooperatives and ESOPs still face challenges accessing the 7(a) program. In fact, from FY 2018 through FY 2021, SBA has only approved 17 7(a) program loans to assist an ESOP in acquiring 51% or more of a business.[17] SBA has even acknowledged that its current policies are not achieving its goals of increasing employee ownership of businesses.[18]

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[11] 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.

[12] *Id.*

[13] *Id.*

[14] *Supra* note 10.

[15] 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.

[16] Pub. L. No. 115-232, § 862.

[17] 87 Fed. Reg. 64724 (Oct. 26, 2022).

[18] *Id.*

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.[19] 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. 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. 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.[20] However, SBA's report disagreed with each industry and USDA proposal, and proposed no alternatives of its own.[21] This recommendation was another obstacle to cooperatives in accessing the 7(a) program.

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.[22] 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.[23] In response to the Notice of Proposed Rulemaking,[24] then-Ranking Member Nydia M. Velázquez filed a public comment letter urging 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. 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.[25]

Furthermore, the Main Street Act granted SBA the authority to waive the mandatory equity requirement on a case-by-case basis for loans that finance change of ownership to employees. However, SBA continues to require a mandatory equity injection of at least 10 percent of the total project costs. Moreover, seller debt may not be considered part of the equity injection unless it is on full standby for the life of the 7(a) loan and does not exceed half of the required equity injection. This effectively requires ESOPs to be structured with at least a 5 percent equity investor. Due to the challenges associated with finding a private equity investor willing to own a share as small as 5 percent of a closely held company (many of which are structured as S-corporations), and the concomitant tax complexities, ESOPs report it is not worth pursuing a 7(a) loan to finance the transition to employee ownership.

Proposed Legislation
To address the issues raised above, the Chairwoman Velázquez and Subcommittee Chairman Phillips has introduced two bills to increase 7(a) program loans to employee-owned businesses. H.R. 9347, the "Main Street Employee Ownership 2.0 Act of 2022", introduced by Chairwoman

[19] 13 CFR § 120.160.
[20] Pub. L. No. 115-232, § 862(g)(2)(B).
[21] 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).
[22] Pub. L. 115-232, § 862(b)(2).
[23] 83 Fed. Reg. 189 (Sep. 28, 2018).
[24] *Id.*
[25] 85 Fed. Reg. 27 (Feb. 10, 2020).

Velázquez and Subcommittee Chairman Phillips reinforces the efforts of the Main Street Act by eliminating burdensome lending requirements put in place by SBA. Specifically, the legislation prohibits SBA from requiring cooperatives to provide a personal or entity guarantee for a 7(a) loan, and from requiring the seller of a business being purchased with a 7(a) loan for conversion to employee ownership to provide a seller guarantee for the loan. It also requires SBA to permit 7(a) lenders in the Preferred Lenders Program to process 7(a) loans to ESOPs using their delegated authority. Furthermore, the legislation eliminates the requirement that ESOPs provide any mandatory equity, submit an IRS determination letter, or provide a second valuation if a primary valuation was already obtained to get a 7(a) loan. Finally, it makes cooperatives explicitly eligible for SBA's Disaster Assistance programs.

H.R. 9345, the "Improving SBA Engagement on Employee Ownership Act", introduced by Subcommittee Chairman Phillips and Chairwoman Velázquez would improve SBA's outreach and engagement on employee ownership and cooperative development by including SBIC limited partners and sponsors of SBIC funds in the outreach and education requirement of the Main Street Act. It also would require SBA to attend all working groups or other engagements hosted by other federal entities with respect to employee ownership or cooperatives.

<u>Conclusion</u>

This hearing will highlight how SBA has struggled to deliver access to capital to certain businesses based solely on their ownership structure. It will also examine policy options that can be adopted by SBA to increase lending to employee-owned businesses. Finally, the hearing will examine efforts by Congress to ensure that SBA is implementing the law as intended, and efforts to remove barriers to employee ownership. 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, it is imperative that Congress and the federal agencies make it easier for more businesses to adopt an employee-owned model.