Issues with SBA ESOP Loan Program Under the Main Street Employee Ownership Act

Corey Rosen, Founder, National Center for Employee Ownership

December 6, 2022

I am the founder of the National Center for Employee Ownership, a nonprofit 501(c)(3) organization focused on information services and research on all forms of broad-based employee ownership, with a special focus on Employee Stock Ownership Plans (ESOPs). We were founded in 1981 and now have a staff of 19. Our funding comes almost entirely from conferences, memberships, and publication sales. We do not set up plans and we do not lobby for or take official positions on legislation.

Prior to founding the National Center for Employee Ownership, I worked on Capitol Hill for five years, including three years on the Senate Small Business Committee staff, where, among other things, I drafted the predecessor to the Main Street Employee Ownership Act (MSEOA), the Small Business Employee Ownership Act of 1980. Prior to coming to the Hill, I taught political science at Ripon College and received a PhD in political science from Cornell. I have written a number books on employee ownership and participated in numerous research projects.

The Small Business Employee Ownership Act, like the MSEOA, was intended to make it easier for ESOPs to get SBA loans, but, as with the MSEOA, the SBA never took steps to make this practical and the law was rarely used. The MSEOA was intended to fix that. I participated in a number of discussions with committee staff at the time on the issues that needed resolution.

Unfortunately, the implementation of the MSEOA has also been very disappointing. The SBA's operating guidance on loans to ESOPs and worker cooperatives has been contradictory towards the intent and often the letter of the law. As the SBA itself has noted, only 17 loans have been made under the bill. Advisors and companies who have looked at it have decided he requirements the SBA has imposed are impractical, of reasons I will describe in this testimony. Noting in recent Affiliation and Lending Criteria for the SBA Business Loan Programs addresses any of the issues that have cause this lack of use.

Similarly, the SBA has not taken any meaningful steps to do the outreach the MSEOA envisioned. I understand that the pandemic and the government's response occupied the SBA's resources, but now that that is less of an issue, I hope the SBA can move forward on this. The good news on outreach is that it should not require the SBA to create a major new program or incur large expenses. There already is a substantial infrastructure of nonprofits in this field as well as companies and service providers, all of whom would be happy to provide unbiased materials explaining how employee ownership works, to organize live or virtual presentations, and to field introductory calls with potential employee ownership companies. The role of the SBA and SBDCs can focus on creating the forums for presentations, sending out mailings, and making sure small business advisors are aware of what employee ownership is and how to find support. The federal government has already provided substantial tax incentives for these plans; the trick is to make owners of companies thinking about business transition aware of them.

All of this is unfortunate because ESOPs have a remarkable track record of generating new jobs, preventing layoffs, retaining workers, keeping jobs in communities, and providing substantially more retirement wealth to employees than they would get in comparable companies. If companies are not

sold to ESOPs, they will usually be sold to larger companies or private equity, and, in many cases, jobs reduced or relocated.

Background on ESOPs

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

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

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

How do ESOPs Work?

ESOPs, by far the most common employee ownership approach, are a kind of employee benefit plan that can be used to buy out an owner and transfer ownership to employees in part or in whole, all while creating a qualified retirement plan at no cost to the employees. This is accomplished through the unique transaction structure that is available to ESOPs under law: the ESOP trust can borrow money to buy the shares of the departing owner(s), with the company making cash contributions to the plan to enable it to repay the loan over time. Alternatively, the company may contribute new shares of its own stock and/or use cash to buy existing shares without a loan. Regardless of how the plan acquires stock, company contributions to the trust are tax-deductible, within certain limits. Sellers can defer taxes on the gains made from the sale by reinvesting in stocks and bonds of U.S. companies.
Shares in the trust are allocated to individual employee accounts. Generally, all full-time employees are included after a year of service. When employees leave the company, they receive their stock, which the company must buy back from them at its fair market value (unless there is a public market for the shares). Private companies must have an annual outside valuation to determine the price of their shares.[iv]

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

Supporters across party lines in Congress have determined that ESOPs are good public policy, and as a result there are significant tax benefits to establishing and maintaining an ESOP. In order to qualify for

those benefits, ESOPs *by law* must be *broad-based*. They must extend to all employees meeting minimal employment requirements (with some exceptions that apply to all benefit plans), and they cannot excessively benefit highly compensated employees.

Currently, there are around 6,660 ESOPs in the United States holding total assets of nearly $1.4 trillion.[v] These plans cover 14.2 million participants.

ESOP and Corporate Performance

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

It is particularly noteworthy for our purposes here that the default rate (defined as defaults that impose losses on creditors) for loans for an ESOP to purchase the shares of existing owners in vanishingly small. In an NCEO analysis of over 1700 loans to ESOPs for business transition between 2009-2013 (which includes two recession years) the default rate was *two per thousand per year*. That means that any SBA loan guarantee program will not require significant expenditures for the SBA for loan losses.

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

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

ESOP companies tend to lay off employees at one-third to one-fifth the rate of other companies, depending on the year of the study. National surveys show that among employees at private firms both actual layoffs and the perceived likelihood of being laid off are lower for employee-owners than for nonowners.[x]

This increased job tenure translates into quantifiable benefits for workers in ESOPs. An ongoing analysis of panel data from the National Longitudinal Survey comparing younger workers with ESOPs to similar workers without such a benefit finds the median job tenure of employee-owners is 5.1 years, 46% greater than the 3.5 years for those without an ESOP. This translates into appreciably higher median household wealth for ESOP workers.[xi]

A 2022 study by the National Center for Employee Ownership found that employees in ESOP companies have dramatically better retirement assets than other employees. Drawing on objective data from 310,857 plan filings, NCEO analyzed retirement plan data from 2019 and 2020 from S corporation ESOPs and a comparison group of companies offering a 401(k) plan. Their analysis found that employee

ownership provided critical financial and retirement security for employees and resiliency for these S ESOP businesses when compared to non-ESOP companies.

NCEO's key findings include:

- Businesses with an ESOP in place provided greater financial security for employees heading into and during the pandemic, and job retention at the firm level compared to comparable conventional firms.
- The average ESOP account balance going into the pandemic was dramatically higher – more than double – than the average 401(k) account balance ($132,000 vs. $64,000) at a non-ESOP company.
- Controlling for size, industry, and location simultaneously, the S ESOP advantage is an estimated $67,000 more in retirement security – especially remarkable, given that just over half (50.5 percent) of American families have a retirement account at all. Among those that do, the median account value was $65,000.
- The average employer contribution to the S ESOP was more than 2.5 times that of companies offering only a 401(k), and 94 percent of total contributions to ESOPs came from the employer, compared to 31 percent for 401(k) plans.
- Notably, most ESOP companies also offer traditional retirement benefits such as a 401(k), in addition to providing employees with an ownership stake in the business as a benefit of employment.
- Using active participants as a proxy for employment, and controlling for company size, industry, and region, being an ESOP is associated with retaining or adding an additional 6 employees from 2019 to 2020, compared to non-ESOP employers.

Barriers to Growth

There are two primary barriers to ESOPs growing faster, both of which could be addressed by the MSEOA at a very low cost.

The first is that few business owners have a good understanding (or any understanding) of ESOPs. Many assume it means employees have to buy shares (they do not) and that this is impractical (as it is). Others are told by advisors that ESOPs are only for certain kinds of industries or that they do not work very well or are too complicated (they are complicated, but selling a business sot anyone is complicated). That may all be in good faith, but, unfortunately, too often it is because advisors believe that if their client does an ESOP, they will lose the client to other advisors specialized in the field or that they can make more money by getting them to sell to an outside buyer. I have been told by some M&A advisors that they will not advise a client to do an ESOP because of this. An SBA-led outreach effort could help address this issue for very little cost.

The second barrier is financial. Most ESOPs are financed in whole or in part with a seller note. Banks will only loan up to what the collateral the company can offer is, or perhaps somewhat more. Many sellers are perfectly happy with that. But others want or need the money upfront. To get more upfront, they would need to supplement the bank loan with mezzanine debt, which normally is priced several points or more higher than senior debt (often 14% to 18%). That burdens the company with more debt than it may be able to take on. An SBA loan guarantee would enable more of the loan to be priced at senior debt levels and make more transactions practical and appealing. Given the very low default rate on ESOP loans, there is little risk to the SBA.

Given the demonstrated track record of ESOPs to significantly improve retirement security, strengthen companies and communities, and impose extremely low default risks on lenders, it is not surprising that ESOPs have an unbroken record of virtually unanimous Congressional support. What perhaps is surprising is that the SBA has made it so difficult to use a program Congress created to help ESOPs become more common, a program that would be very low cost and very low risk.

The Main Street Employee Ownership Act and the Barriers to Implementation Raised by the SBA

On August 13, 2018, the Main Street Employee Ownership Act (MSEOA) became law. The law encourages the creation of ESOPs and worker cooperatives by facilitating transactions via loans supported by the Small Business Administration (SBA). It also directs the SBA's outreach infrastructure to encourage business owners to consider employee ownership.

Under prior law the SBA could make loans to help finance ESOPs, but the loans were subject to several requirements that made them impractical in most situations. The MSEOA eliminates five obstacles that were challenges under the old law.

1. **Before the MSEOA: The loan had to be made directly to the ESOP trust.** Now: SBA-backed loans can now be made to the company to reloan to the ESOP, as long as the transaction financed by the loan results in the trust owning at least 51% of the business. The loan from the company to the trust does not need to be on the same terms as the loan from the lender to the company. If the seller retains some ownership in the business following the transaction, she or he will be required to provide a personal guarantee for the loan.

2. **Before the MSEOA: The seller could not retain any role in the management or governance of the company following the transaction.**
   Now: The seller can retain a role in the company as "an officer, director, or key employee of the small business concern when a qualified employee trust or cooperative has acquired 100 percent of ownership of the small business concern."

3. **Before the MSEOA: There had to be a 10% equity investment in a business transaction loan.** Now: The law gives the SBA the discretion to waive the requirement for a 10% equity investment to accompany a business transaction loan.

4. **Before the MSEOA: The loan had to go directly through the SBA itself, a long and cumbersome process compared to the much easier approach of working with SBA preferred lenders.** Now: ESOP companies can work with banks under the preferred lender program, which provides SBA guarantees for loans up to $5 million (additional funding from other sources can be added).

5. **Before the MSEOA: SBA-backed financing could only be used to directly fund the transaction.** Now: SBA-backed loans can also be used for transaction costs.

In addition, the program provides that Small Business Investment Companies (SBICs) can make loans to ESOPs. SBICs receive two dollars in government-guaranteed debt for every dollar raised in equity, up to a limit of $150 million (see the SBA's SBIC overview for details). SBICs typically would provide unsecured debt in ESOP transactions.

Finally, the MSEOA requires the SBA to coordinate with investment funds licensed through the SBA's Small Business Investment Company program and intermediary lenders through the SBA's Microloan Program to promote employee ownership as an area to consider for investment and lending. It also directs Small Business Development Centers to provide outreach and training on ESOPs, and it directs the SBA to set an interagency task force to develop further recommendations for promoting employee ownership.

Issues with the SBA's Implementation

There are four prominent issues for companies wishing to use the revised SBA ESOP loan program. The **first** is that the lenders are unable to approve the loans under the Preferred Lender's Program, so the loans still must go through the SBA's Loan Guaranty Processing Center (LGPC) for approval. The drafters of the bill had intended for ESOP loans to be processed under the Preferred Lender's Program. Submission to the LGPC can slow the process substantially and add uncertainty. Many potential borrowers tell us they are unwilling to take these risks.

Second, the SOP for the program requires an unrealistic equity position outside the ESOP.

Specifically:

> b) Changes of ownership resulting in a new owner (complete change of ownership): **At a minimum, SBA considers an equity injection of at least ten (10) percent of the total project costs** (all costs required to complete the change of ownership, regardless of the source of funds) to be necessary for such transactions. Seller debt may not be considered as part of the equity injection unless it is on full standby for the life of the SBA loan **and it does not exceed half of the required equity injection**;

This effectively means that the ESOP must be structured with at least a 5% equity investor. This raises serious barriers.

Most ESOP transactions now are for 100% transfers. Because earnings attributable to an ESOP in an S corporation are not taxable, this allows the company to elect S status and, under federal tax law, effectively pay no tax (the tax is eventually paid by employees when they get distributions of their earnings). S corporation law, however, requires that any distributions made to owners be paid pro-rata to al owners.

So assume that an outside investor could be convinced to purchase a 5% equity interest. That owner will get a K-1 statement requiring that he or she pay taxes on their share of the company's earnings. S corporations will typically pay an earnings distribution equal to this amount. So the ESOP must get ***19 times*** that amount in its distribution, even though it does not pay the tax. That is not a workable scenario for any company. No investor will simply agree to pay the taxes on their own unless they were provided a substantial discount on the shares, but doing that would violate ERISA valuation rules because the ESOP cannot pay more than other investors for the same class of stock, and S corporations can only have one class of stock.

Given that finding an outside investor is a tremendous challenge, the remaining option is for employees to put up the money, but this involves a security offering and may be more than employees can afford or are willing to risk. They also would end up in this untenable tax situation.

Even if the company is not a 100% ESOP S corporation, it still is very difficult in general to find minority investors at any level, even more than 5%, in an ESOP for companies the size of businesses that qualify for these loans. It is simply not usually worth the bother for companies to pursue SBA loans as a result.

The Main Street Employee Ownership Act of 2018 allows for the SBA Administrator to waive the mandatory equity requirement. It states: "(G) With respect to a loan made to a qualified employee trust under this paragraph, or to a cooperative in accordance with paragraph (35), the Administrator may, as deemed appropriate, elect to not require any mandatory equity to be provided by the qualified employee trust or cooperative to make the loan." However, the SBA does not seem inclined to waive the requirement, based on loan submissions in 2019. A better solution is to allow the seller note to qualify for the entire equity commitment.

Research by the National Center for Employee Ownership shows that ESOP companies default on acquisition loans at a rate of two per thousand per year, a rate that no doubt is considerably better than SBA loans in general. The law was intended to make it easier for companies to use the SBA program for ESOP. The procedures now in place, however, continues to make it very difficult.

Third, the SBA has further stated that the ESOP loan cannot be disbursed until the IRS determination letter has been issued and received from the IRS, acknowledging that the ESOP qualifies under the Internal Revenue Code. The IRS determination letter can take up to 12 months to get issued and could cause significant delays in completing the transaction. An opinion letter from a qualified ESOP attorney should be permitted as a substitute for the determination letter so that the loan transaction can be completed timely. Banks do not require a determination letter, and it is exceedingly rare (as in close to zero %) for a plan not to get one.

The SBA's Standard Operating Procedure should be updated to clarify these three obstacles. Further, a policy notice should be issued so that the changes could be effective more quickly. There has been significant interest in Employee Ownership facilitated by an SBA guaranteed loan, however the obstacles above will discourage many lenders and small businesses from considering SBA financing as an option. The inability to have an SBA loan as a financing option means that many of the ESOP transactions won't get done. These simple changes will remove the major impediments and allow for more ESOP transactions to get the necessary financing.

Finally, the SBA requires its own valuation for every transaction. So does a sale to an ESOP (this is not true for coops, but you should get one). If the SBA valuation is lower, than what is a trustee to do? The seller may not then sell at the lower price. Can the trustee ignore the SBA valuation because it is done to a different and much less rigorous standard than the ESOP valuation under ERISA? And why impose this needless additional cost anyway when there is a high-quality valuation anyway?

Resolving the Issues

Other witnesses can better address issues concerning worker cooperatives. I will focus in ESOPs.

Resolving the issues raised here is straightforward. The SBA should include ESOPs under Section 7(a), drop requirements for an equity infusion, not require an unneeded wait for a determination letter, and drop the superfluous requirement for an additional valuation. Working with SBDCs, the SBA should set up an outreach program focusing on providing materials and meetings to companies and companies and their advisors. These are changes that would reduce bureaucratic impediments and make the program more what Congress clearly intended.

---

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

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

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

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

[v] https://www.nceo.org/articles/esops-by-the-numbers

[vi] See https://www.nceo.org/Guide-Research-Employee-Ownership/id/125/ for an detailed summary of academic research findings.

[vii] For example, in the 2017 NCEO Repurchase Obligation Survey, 72% of the ESOP respondents *strongly agreed* that they intend "our ESOP to be permanent". https://www.nceo.org/ESOP-Repurchase-Obligation-Survey-2017-Full-Report/m/926/

[viii] See for example, https://www.fcltglobal.org/research/reports/article/measuring-the-economic-impact-of-short-termism

[ix] Author's calculations using the Survey of Consumer Finances (2016). For additional data on the state of Americans' retirement savings see, https://www.nceo.org/assets/pdf/articles/NCEO-S-ESOPs-Retirement-Dec-2018.pdf

[x] The General Social Survey (GSS) is a nationally representative, face-to-face survey covering a broad range of behavior and attitudes conducted by the National Opinion Research Center (NORC) at the University of Chicago. The General Social Survey does not break out ESOPs. Employee-owners are identified based on the GSS variable *ownstock*, which asks respondents if they own any shares of stock in the company where they now work, either directly or through some type of retirement or stock plan.

[xi] See the full results at https://www.ownershipeconomy.org/