Encouraging Inclusive Growth: The Employee Equity Loan Act[1]

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1. Introduction

Contemporary economic circumstances are characterized by a contradictory and troubled juxtaposition. A booming stock market and near full employment awkwardly coincide with an unfortunate triad of slow productivity and economic growth, lackluster job creation and ever widening economic inequality. The source of these problems is not a lack of ingenuity or opportunity available to American managers, engineers and workers. That source is instead a stubborn, legacy pattern of concentrated ownership and control of our productive assets, a pattern that continues to concentrate. Too few Americans benefit from economic opportunity because too few Americans participate in the ownership of those opportunities.

Concerns about distributive justice to the side, practical considerations about jobs and the stability of communities should be taken into account. Owing to demographic trends, in particular the approaching retirement of a bulge of baby boomer business owners, there also exists today an unusual opportunity to finance the transfer of high performing businesses to their employees. Approximately 39,000 privately held firms

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with annual revenues of $50M to $1B employ over 24 million people,[3] nearly one quarter of the United States labor force.[4]

A large percentage of these firms will turn over their ownership within ten to fifteen years[5]. These are the same firms that are being targeted by a combined treasure chest of two and one half trillion dollars of private equity funding available through approximately three thousand private equity funds. What finally transpires with the fate of those firms is described in detail below. Some survive and prosper in place. Many, far too many, are fed, in an assembly-line fashion, to financially engineered futures that needlessly rob communities of continuous, value-added employment. The opportunity therefore to help anchor this approaching 'silver tsunami' baby boom cohort of firms through the use of broad-based employee ownership must be seized quickly and decisively.

Broad-based employee ownership of private sector enterprise, brought about primarily through the use of Employee Stock Ownership Plans or ESOP's, is an idea with a thirty-five-year record of bringing economic inclusion to nearly 14 million citizen/employees in 7,000 companies. This first generation of ESOP practice provides a foundation to build upon. A second generation of ESOP practice is proposed here that promises a significantly larger impact. That second generation of ESOP practice will require policies that target capital deployment. In order to meet the challenges that exist, flawed and limiting assumptions regarding prevailing corporate finance practices that affect the ownership of assets must be confronted and corrected. After a discussion of both capital deployment and corporate finance challenges we will introduce an idea designed to begin to address them. That idea is called the Employee Equity Loan Program or EELP.

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[3] "The Market that Moves America." National Middle Market Institute Accessed July, 2019. https://www.middlemarketcenter.org/Media/Documents/the-market-that-moves-america-insights-perspectives-and-opportunities-from-middle-market-companies_the_market_that_moves_america_white_paper.pdf

[4] United States Labor Force Statistics. https://data.bls.gov/pdq/SurveyOutputServlet?graph_name=LN_cpsbref1&request_action=wh

[5] Biery, Mary Ellen, "Study Shows Why Many Business Owners Can't Sell When They Want To." Forbes. February 5, 2017. https://www.forbes.com/sites/sageworks/2017/02/05/these-8-stats-show-why-many-business-owners-cant-sell-when-they-want-to/#297561f544bd

2. **The Setting and the Problem: Overcoming the Economic Food Chain**

In the US economy there are two major institutional settings that deploy scaled capital; public capital markets and institutionally housed private equity. Both of these institutions presently divert a disproportionate percentage of corporate earnings through (a) dividends declared for concentrated shareholders and (b) buybacks of stock by the boards and management of large, publicly traded corporations.[6] Driven by assumptions regarding the primacy of short term shareholder returns,[7] these practices have lead over time to an emphasis on extractive rather than productive techniques and technologies along with a corresponding tendency to underinvest in human capital necessary to promote productivity. The result has been stunted economic growth, stagnating job skills for workers and managers and wealth concentration among stock and other financial asset owners that is beyond any reasonable measure of economic efficiency, social equity or sustainability. With the help of considered public policy, these adverse results can be reversed with much improved economic outcomes for the US economy and all of its citizens.

Long term, patient investment capital is the primary ingredient needed to address both the systematic underinvestment in the US economy and the economic disadvantages faced by an American workforce that relies primarily on inadequate wage and salary incomes for its livelihood[8]and economic security. The approach presented in this paper elaborates a new institutional structure and associated incentives to attract and deploy this patient needed capital. Properly implemented these incentives and structures will introduce a crucial missing ingredient in our economic infrastructure and better prepare our nation and its workforce to compete and prosper in the global economy.

Over 99 percent of US companies are privately held.[9] These companies produce about 50 percent of the US Gross Domestic Product.[10] They also account for the greater part

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[6] William Lazonick, "Profits Without Prosperity." *Harvard Business Review.* September 2014. https://hbr.org/2014/09/profits-without-prosperity

[7] Id.

[8] Gelzinis, Gregg and Madwitz, Michael, "The State of the U.S. Labor Market: Pre-September 2017 Jobs Release." *Center for American Progress.* October 2017. https://www.americanprogress.org/issues/economy/news/2017/10/05/440288/state-u-s-labor-market-pre-september-2017-jobs-release/

[9] U.S. Small Business Administration. Office of Advocacy. *Frequently Asked Questions*. June 2016. https://www.sba.gov/sites/default/files/advocacy/SB-FAQ-2016_WEB.pdf

[10] "The Impact of Small Business on The U.S. Economy." *Entrepreneurship Startup.* January 2017. https://www.startuprounds.com/impact-small-business-u-s-economy/

of all innovation, approximately 65 percent of job growth and most of the new wealth creation in the US economy.[11]

Historically, these privately held businesses, many of which were launched after the Second World War by beneficiaries of the GI Bill and other postwar public investment initiatives were classic entrepreneur-founded firms.[12] These firms were typically financed by individuals or small consortia out of their own savings, the savings of family and friends, sympathetic local community sources of capital, and/or governmental small business development programs such as the Small Business Administration ("SBA," more on which below).[13] These firms were the proving grounds for innovation; workforce training and advanced management techniques that helped grow the modern US economy into the most envied in the world.[14]

Throughout the life cycle of most private firms a lack of access to patient capital has limited the ability of entrepreneurs to grow their businesses. A mismatch can come to prevail between the one-to-five year time horizons for capital deployment required by most contemporary lenders and private equity investors on the one hand, against the five, ten or even twenty year time horizons that entrepreneurs require for the game-changing investment programs that grow their businesses to their next stage of development on the other hand.[15]

Despite such capital constraints, over the course of the post-Second-World War era, many privately owned companies have grown and prospered to reach scale in their industries.[16] The founders of such firms eventually age, begin planning for retirement, and accordingly look for liquidity. When this happens, the firms they have built typically either (a) are sold to the next generation of family ownership, (b) go public, or (c) are

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[11] Diliger, Robert, "Small Business Administration and Job Creation." pg. 5. *Congressional Research Service.* February 8, 2017. https://fas.org/sgp/crs/misc/R41523.pdf

[12] Dortch, Cassandria, "GI Bills Enacted Prior to 2008 and Related Veterans' Educational Assistance Programs." *Congressional Research Service.* October 22, 2012. https://fas.org/sgp/crs/misc/R42785.pdf

[13] U.S. Small Business Administration. Office of Advocacy. *Frequently Asked Questions*. June 2016. https://www.sba.gov/sites/default/files/advocacy/SB-FAQ-2016_WEB.pdf

[14] Small Business Management in the 21st Century. "Small Business in the U.S. Economy." *Saylor Academy.* 2012. https://saylordotorg.github.io/text_small-business-management-in-the-21st-century/s05-01-small-business-in-the-us-econo.html

[15] Jacobs, Michael and Shivdasani, Anil, "Do You Know Your Cost of Capital." *Harvard Business Review.* July-August 2012. https://hbr.org/2012/07/do-you-know-your-cost-of-capital

[16] Goodwin, Doris, "The Way We Won: America's Economic Breakthrough During World War II." *The American Prospect.* Fall 1992. http://prospect.org/article/way-we-won-americas-economic-breakthrough-during-world-war-ii

sold either to a private equity fund or a strategic buyer – often a US public company.[17] In recent decades, heightened rates of acquisition of these innovative private companies by larger firms have provided US public companies with the lion's share of their innovation and growth opportunities.[18] It has also led to a depopulation of the most richly innovative segment of the US business landscape.[19]

Over the course of the late twentieth and early twenty-first centuries, acquisition-led growth by US public companies has brought about an unintended but fateful consequence to the health and long-term viability of the US economy. These public companies have achieved dominant market share within their industry sectors, gradually becoming super-sized public companies.[20] From their dominant market positions, these new "mega-firms" have extracted larger profits from their markets while presenting formidable barriers to entry for prospective new entrants.[21]

Super-sized public companies have also become disproportionally influential in the political realm, influencing not only domestic laws and Federal and state tax and regulatory oversight but also foreign trade and government to government treaties.[22] These trends have accelerated to the detriment of smaller, "Main Street" privately-held companies, undermining the livelihoods and future earning potential of their skilled and unskilled employees, who are left with little or no recourse for alternative employment.[23] Communities that have traditionally been the hosts of these privately

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[17] "How to Choose an Exit Strategy." *Inc.* December 2017. https://www.inc.com/guides/2010/10/how-to-choose-an-exit-strategy.html

[18] Hakobyan, Margarita. "The Role of Entrepreneurship in Job Creation and Economic Growth." *Huffington Post.* November 15, 2016. https://www.huffingtonpost.com/margarita-hakobyan/the-role-of-entrepreneurs_b_12964394.html

[19] Id.

[20] Moffatt, Mike, "A History of American Economic Growth in the 20th Century." *ThoughtCo.* March 29, 2017. https://www.thoughtco.com/us-economic-growth-in-the-20th-century-1148146

[21] Thompson, Scott, "Examples of a Company Raising Barriers to Market Entrants." *Chron.* December 2017. http://smallbusiness.chron.com/examples-company-raising-barriers-market-entrants-75773.html

[22] Jacobs, Lawrence and Page, Benjamin, "Who Influences U.S. Foreign Policy?" *Institute for Policy Research, Northwestern University.* April 2015; Stiglitz, Joseph, "The secret corporate takeover of trade agreements." *The Guardian.* May 13, 2015. https://www.theguardian.com/business/2015/may/13/the-secret-corporate-takeover-of-trade-agreements

[23] Barrison, Steve, "Opinion: Study shows Walmart kills small biz." *New York Daily News.* May 4, 2011. http://www.nydailynews.com/new-york/brooklyn/study-proves-walmart-super-stores-kill-local-small-businesses-article-1.140129

held companies have been "hollowed out" by the loss of a tax base and tangible employment opportunities for the incoming generations of workers.[24]

Concurrent with the rise of the super-sized public company over the last thirty years has been the rise and evolution of the institutionalized private equity fund market.[25] Early in their development private equity funds met a very real need for either ownership succession or growth-equity capital on the part of privately held companies that could not tap the public or institutional capital markets.[26] These early private equity funds did invest with the expectation of a long term realization of return on their capital. Over time however, leaders of these funds recognized that their success was dependent upon maintaining a focus on public companies at the head of the economic food chain.[27] Those large publicly traded firms required a steady stream of innovative, fast growing private companies to perpetuate their growth. In order to respond to that need private equity funds have perfected and increasingly focused on a "farm league" investment model buy specializing in acquiring privately held firms that feed the growth appetites of their "major league" public company clients.

This transition in the function of the private equity fund industry has resulted in a sector dominated by firms whose capital investment models are nearly identical to their US public company 'partners' investment models. Just as public companies have increasingly focused on responding to the demands of Wall Street for short term returns, private equity firms have shifted to strategies that maximize short term returns demanded by limited partner institutional investors (e.g. pension and institutional funds) who constitute their investment base.[28] A significant number of the largest

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[24] Stone, Kenneth, "The "Wal-Mart Phenomenon" – Charting the Effect of Wal-Mart on Rural America A Long Range Iowa Study. Iowa State University. *West Kentucky Journal.* Accessed December 2017. http://www.westkyjournal.com/news.php?viewStory=178

[25] "Private Equity Industry Overview." *Street of Walls.* 2013. http://www.streetofwalls.com/finance-training-courses/private-equity-training/private-equity-industry-overview/

[26] "The Development of Private Equity and Venture Capital." *HVCA.* Accessed December 2017. http://www.hvca.hu/pevc-explained/private-equity/the-development-of-private-equity-and-venture-capital/; Colin, Nicolas, "A Brief History of the World (of Venture Capital)." May 2016. *The Family.* https://salon.thefamily.co/a-brief-history-of-the-world-of-venture-capital-65a8610e7dc2/

[27] "The Development of Private Equity and Venture Capital." *HVCA.* Accessed December 2017. http://www.hvca.hu/pevc-explained/private-equity/the-development-of-private-equity-and-venture-capital/

[28] Barber, Felix and Goold, Michael, "The Strategic Secret of Private Equity." *Harvard Business Review.* September 2007. https://hbr.org/2007/09/the-strategic-secret-of-private-equity

private equity funds have themselves become public companies further focusing their management on providing short term returns for their shareholders.[29]

The pressure on private equity firms to conform to short term returns has increasingly meant that these firms are no longer aligned with the needs of the privately held business market populated by founding owner/entrepreneurs. Those owner/entrepreneurs, their management teams and their workers and the communities who depend upon them are instead being sacrificed to an "assembly line," "food chain" model that after an increasingly short term of private equity stewardship delivers them to the hands of large publicly traded companies. Privately held businesses which took twenty, thirty, forty or more years to build are usually sold by the private equity funds within three to five years of their purchase.[30] During that increasingly brief interval of ownership, private equity firms introduce short term "fixes" that all too often provide a short term boost to the earnings of the company but produce long term negative consequences for workers and for the communities where those companies are located.

Were this newly sped up cycle – a cycle by which private equity funds first buy, then make short term fixes to a business and then sell to public companies or other private equity funds – to produce a superior long term outcome for the US economy, and its working citizens there would be no reason to complain. Evidence is consistent however that this short-term maximizing shareholder value approach has resulted in a systematic underinvestment in innovation, in new technologies, in worker training and in the health of host communities in which these businesses reside. It has also contributed to an increasing concentration of economic and political influence on the part of super-sized public companies to the detriment not only of innovative private companies but to the economy and society as a whole. It is time to consider new alternatives for the deployment of capital and credit in our economy.[31]

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[29] Barber, Felix and Goold, Michael, "The Strategic Secret of Private Equity." *Harvard Business Review.* September 2007. https://hbr.org/2007/09/the-strategic-secret-of-private-equity

[30] Dowd, Kevin. "Private equity goes public: A history of PE stock performance." *Pitchbook.* May 2016. https://pitchbook.com/news/articles/private-equity-goes-public-a-history-of-pe-stock-performance

[31] Applebaum, Eileen and Batt, Rosemary, Private Equity at Work: When Wall Street Manages Main Street, Russell Sage Foundation, 2014

3. **A Promising Exception - Patient Capital and Employee Ownership**

Beginning in 1974 with an amendment introduced by Senator Russell Long (D-LA) to the Employee Retirement Security Act (ERISA), and strengthened by tax incentives introduced by both Republicans and Democrats in subsequent decades, an exception to the trends described above has taken root. Over this period of time a modestly scaled sector of US businesses consisting of over 7,000 companies have prospered under an innovative form of broad-based employee ownership built into ERISA[32] These 7,000 plus companies are owned in whole or in part by their employees through Employee Stock Ownership Plans or ESOPs. The overwhelming majority of these companies are privately held “Main Street” employers that average 150 employees. This sector operates with an alternative model of ownership – and hence of both governance and finance.

ESOPs collectively employ over 14 million workers, a number that some commentators stress now exceeds the number of workers represented by unionized collective bargaining. Approximately 600 publicly traded companies with relatively modest ESOP plans complicate the data. Backing those companies out of the sample, about 6,400 companies that collectively cover approximately 3 million employees remain.[33] These companies range in size from Publix Supermarkets based in the Southeast with 188,000 employees to 50 employee Midwest based machine shops.

The approximately 1,000 public company ESOPs including industry leaders such as Procter & Gamble typically hold less than 5% of the company’s outstanding stock. Prominent publicly traded companies also implement broad based stock ownership through a variety of stock sharing mechanisms. Examples of companies with significant, non-ESOP employee shareholding include Google, Apple, Amazon, Facebook, Microsoft, Gilead Sciences and QUALCOMM. None of these programs in publicly-traded companies result in anything close to a control position for employee shareholders.

Research on ESOPs in the 6,400 company privately held sector describes a broad class of businesses that create more jobs and grow at higher rates than comparable

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[32] “ESOP (Employee Stock Ownership Plan) Facts.” *National Center for Employee Ownership.* Accessed December 2017. *https://www.esop.org/*

[33] “ESOP’s by the Numbers.” *National Center for Employee Ownership.* Accessed January 2018. https://www.nceo.org/articles/esops-by-the-numbers and “A Statistical Profile of Employee Ownership”. https://www.nceo.org/articles/statistical-profile-employee-ownership. Accessed January 2018.

companies.[34] Not only do the ESOP companies perform at higher levels in terms of sales growth and job growth but they are more stable in economic downturns. They default at substantially lower rates and they share the wealth they create more broadly and equitably than comparable non-employee owned companies.[35] As a group, these firms are the very model of what transpires when "patient capital" governs business growth.

Historically, the circumstance that has led to the introduction of most broad-based employee ownership plans in the United States has been succession planning by business owners. Private owners seek liquidity for their long-term investments in companies they have often founded and now need to sell for their retirement. The ERISA Federal tax framework that created Employee Stock Ownership Plans or ESOPs encourages the sale of these businesses internally to legal trusts whose beneficiaries are their management and employees.

Because prospective employee owners, i.e. the management and employees, generally have limited equity capital to enable their purchase of the selling business owner's interests, these transactions are often dependent upon a combination of (a) bank leverage using company assets as collateral and (b) sellers taking back substantial subordinated, long term notes. The seller in these transactions must often wait for five to ten years to fully realize the cash proceeds of the sale of their business to an ESOP. This time dimension of most ESOP transactions operates as a significant obstacle to employee buy-outs of entrepreneur-founded firms.

Moreover, because the seller's subordinated notes are issued by their very own companies, the seller will be subject to unforeseeable financial risks associated with their businesses and the notes they hold - again for typically five-to-ten years.[36] When competing to purchase a retiring owner's business, therefore, an employee group without capital to fund a buyout is in a non-competitive position relative to a public company or a private equity fund buyer. Buyers of the latter kind will offer the same

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[34] "ESOP Statistics." And "Employee Ownership & Corporate Performance." *The ESOP Association.* Accessed December 2017. *http://www.esopassociation.org/explore/employee-ownership-news/resources-for-reporters#statistics*

[35] "Employee Ownership & Corporate Performance." *The ESOP Association.* Accessed December 2017. http://www.esopassociation.org/explore/employee-ownership-news/resources-for-reporters#statistics; Radogna, Patrice, "ESOPs as an Exit Opportunity for Professional Service Firms." *Valuation Research.* January 12, 2017. https://www.valuationresearch.com/pure-perspectives/esops-exit-opportunity-professional-service-firms/

[36] "A Detailed Overview of Employee Ownership Plan Alternatives." *National Center for Employee Ownership.* Accessed December 2017. https://www.nceo.org/articles/comprehensive-overview-employee-ownership

market value for the business but fund their offers with cash at closing. Even when there is an expressed preference by selling owners to pass ownership on to management and employees and keep businesses in their communities, it is this lack of capital to support cash consideration that results in by far the greatest percentage - in excess of 90 percent - of these high performing privately owned firms being sold to public companies or private equity funds.[37]

If alternative capital funding sources cannot be found to compete against the combined resources of the public company and private equity industry, we will witness a continuation of the short-term investment pattern targeted to maximizing shareholder returns previously described. Productive and well managed independent businesses that must be sold will be acquired by either public companies or private equity funds. Continued underinvestment in new products and services, new technologies and workforce training will follow. Communities will accordingly continue to be hollowed out, and wealth will continue to concentrate in the hands of financial instrument owners, principally the top 5 percent by level of wealth of US households rather than in the households of US workers. Without decisive action now the US economy will witness a future of economic underperformance that is less equitable even than the one we know now.

4. Building on Precedent: The Employee Equity Loan Guarantee Program (EELP)

The scale of the opportunity and associated challenge just outlined is large. A generational transfer of wealth and expertise in our country's privately held business sector is about to occur under conditions of slow productivity and economic growth, inadequate job creation, stagnant wages and widening economic inequality. In order to meet a challenge of this scale, we need to reach back to a time when Federal policy responded to a comparable challenge.

At a time of crisis produced by the Great Depression, when a growing American population was in need of assistance to either retain or acquire homes to live in, a Republican President, Herbert Hoover, introduced the Federal Home Loan Act of 1932 ("FHLA"). The FHLA put the borrowing power of the Federal government at the service of American working citizens. More specifically, the FHLA established the Federal Home Loan Bank Board ("FHLBB"), which soon came to be supplemented, via the Federal

[37] "3Q 2017 M&A Report," pg. 7. Pitchbook. 2017.

Housing Act ("FHA") and additional legislation, by a host of complementary federal institutions including the Federal Housing Authority ("FHA") in 1934 and Fannie Mae in 1938.[38] What started under Republican initiative with Herbert Hoover was joined by the Democratic Roosevelt administration. Taken together, these initiatives were thoroughly bipartisan in motivation and support.[39]

From the 1930's until the financial deregulation of the late 1990's, these institutions functioned effectively and efficiently, actually turning a profit for the Federal government rather than a loss. They provided credit insurance, quality controls, standardized mortgage instruments, and market liquidity so effectively that they converted the nation from a below 40% to an above 65% home ownership rate and ushered in a massive expansion of homebuilding that created millions of new construction and service jobs in the US economy.[40] Today, home equity remains the largest contributor by far to benefiting the net worth of US households.[41]

We believe that a scaled US Government loan guarantee and secondary market-making program focused on the privately held business sector similar in scope to the federal home loan programs can address the challenges of scaled capital deployment and its concentration in the hands of a few that we have described. A new program focused on the large cohort of baby-boomer-owned high performing privately held businesses that will soon change hands could help deliver ownership of a meaningful percentage of those businesses to broad based employee ownership. Such an initiative could serve as a game changer in bringing about both the deployment of needed patient capital to the most innovative and growth-oriented part of the US economy, its closely-held business sector and a movement toward more equitable and rapid economic growth.

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[38] "A Brief History of the Housing Government-Sponsored Enterprises." *Federal Housing Finance Agency. Office of Inspector General.* Accessed December 2017. https://www.fhfaoig.gov/Content/Files/History%20of%20the%20Government%20Sponsored%20Enterprises.pdf

[39] Butkiewicz, James, "Reconstruction Finance Corporation." University of Delaware. Accessed December 2017. https://eh.net/encyclopedia/reconstruction-finance-corporation/

[40] "Historical Census of Housing Tables Ownership Rates." *United States Census of Housing Tables Ownership Rates.* Accessed December 2017. https://www.census.gov/hhes/www/housing/census/historic/ownrate.html

[41] "Homeownership as a Key Driver of Wealth," *HuffPost.* April 19, 2017. https://www.huffingtonpost.com/entry/homeownership-as-a-key-driver-of wealth_us_58f66a5de4b0c892a4fb7319

We accordingly propose the creation of an Employee Equity Loan Program ("EELP") enabled by a new Federal law, the Employee Equity Loan Act ("EELA") scaled to this task.

5. **Realizing the Employee Equity Loan Act: Targets and Process**

The Employee Equity Loan Program (EELP) would operate in a similar fashion to current US government loan guarantee and secondary market-making programs.[42] These programs all share a similar structure descended from their formation, including home loan programs, under the auspices of the New Deal era Reconstruction Finance Corporation ("RFC").

Within today's US Government agency structure, the EELP most closely resembles the full array of programs presently housed in and administered by the Small Business Administration ("SBA") – itself a creature of the RFC.[43] The SBA currently provides guarantees for qualifying loans made to small business startups and established business expansions.[44] SBA loan guarantees are typically small. The size of guarantees is determined by industry group. Using gross revenue as a qualifying number, the maximum revenue or "ceiling" for companies applying for SBA loan guarantee support range from $750,000 to $38.5M depending upon the industry with most loan guarantees clustered at the lower end of that range.

EELP would target a different and larger group of companies – what is commonly referred to as the "middle-market" - of closely held firms.[45] Their numbers include a universe of approximately 39,000 companies with revenues ranging from $50-$1B that collectively employ over 24 million employees, nearly one quarter of the United States labor force. This cohort of firms represents a scaled niche of the American economy that presently does not enjoy the same targeted Federal loan guarantees afforded to small businesses.[46]

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[42] "Fannie Mae, Freddie Mac, and the Federal Role in the Secondary Mortgage Market" *Congressional Budget Office.* Accessed December 2017. https://www.cbo.gov/publication/21992

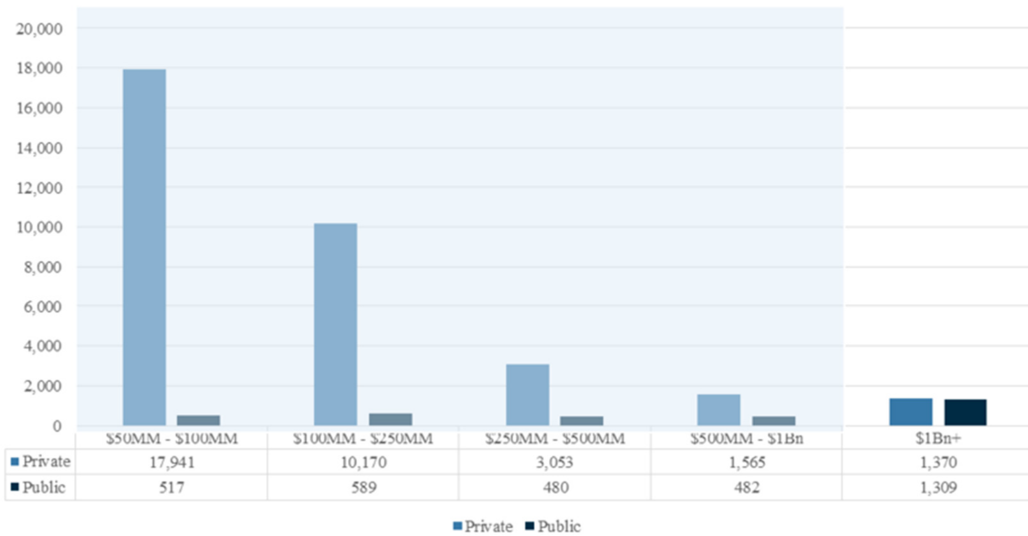
[43] History of the U.S. Small Business Administration. *U.S. Small Business Administration.* Accessed December 2017. https://www.sba.gov/about-sba/what-we-do/history

[44] Id.

[45] Definitions of the "Middle-Market" of closely held firm vary. For our purposes, we are defining this market as firms with between $50M-$1B in annual revenue.

[46] Andrew S. Weinberg, Fueling the US economy's middle market growth engine, World Economic Forum, April 12, 2018 - https://www.weforum.org/agenda/2018/04/fueling-the-us-economys-middle-market-growth-engine/

Figure 1 Private and Public Companies Revenue $50M and Higher – Dun & Bradstreet 2018



	$50MM - $100MM	$100MM - $250MM	$250MM - $500MM	$500MM - $1Bn	$1Bn+
Private	17,941	10,170	3,053	1,565	1,370
Public	517	589	480	482	1,309

We contend that a serious reckoning with wealth and income inequality demands that the use of Federal loan guarantees break out of the nearly exclusive 'only for small business' mentality that dominates the conduct of current economic policy. Leaving aside the long-established use of loan guarantees for housing and agriculture, the only exception to be found for American businesses of scale is the use of guarantees by the Export-Import Bank.[47] Without questioning the value that Export-Import Bank guarantees provide to large exporting and importing employers, it is fair to state that those guarantees are not targeted toward the mission of sharing the wealth of enterprise ownership with American employees.

To help distinguish the work of the Employee Equity Loan Program, two alternative government homes should also be explored. One would be the Department of Treasury of the IRS. A second would be the United States Department of Commerce, likely within the Economic Development Administration.[48]

Functionally, qualifying loans supported by the EELP would be sized and priced to compete with buy- out funds operating in the lower middle market that presently function in the private equity industry. Loans would be sized to provide structured

[47] The official website of the United States Export-Import bank describes provides an account of its policies and procedures - https://www.exim.gov/

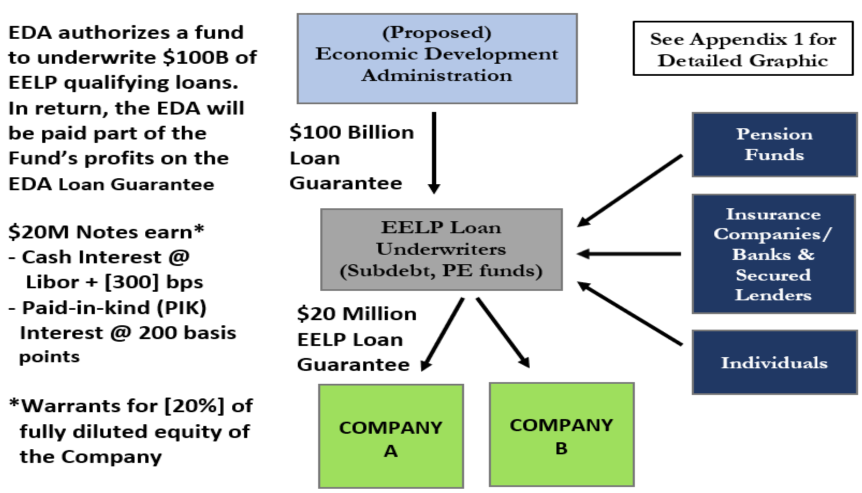
[48] History of the U.S. Department of Commerce, Economic Development Agency. *History of EDA*. Accessed May, 2019. https://www.eda.gov/archives/2016/50/history/

equity to complement senior secured bank debt and priced to compete in the private equity subordinated debt market. These loans would be sourced through a large established network of financial institutions that have trained staff to administer the current SBA loan programs. The training of those staffs would be supplemented to include expertise relevant to middle market capital sourcing.

The SBA also currently provides direct capital to a range of subordinated debt and equity funds.[49] The EELP would provide this same network with a new government backed capital investment program targeted to the middle market that would have a set of new underwriting standards - not unlike the standards of current and past federal loan guarantee programs - to which the borrower would have to comply. Adding to that existing SBA network, EELP would invite new participants; both the existing, scaled private equity and subordinated debt community and a network of newly formed investment funds specializing in broad based employee ownership financing.

The principal difference from SBA loan programs currently in effect would be that EELP would require businesses applying for loan guarantees to use the *proceeds* of EELP loans to purchase stock from either the selling owner or from the company making the loan application. The stock purchased would be required to be contributed to a company formed legal trust *for benefit of its management and employees*. The mechanics are summed up in the following diagram:[50]

Figure 2 – Mechanics of EELP Process



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[49] History of the U.S. Department of Commerce, Economic Development Agency. *History of EDA*. Accessed May, 2019. https://www.eda.gov/archives/2016/50/history/

[50] Diagram produced by David Light, Partner, American Working Capital, LLC

The underlying economics of a scaled EELP program would not eliminate financial competition from the community of approximately 3,000 private equity and subordinated debt funds. Much as happened in the case of the federal home loan program with national and local banks and the housing industry, the EELP would instead complement these funds by attracting and incenting these private equity funds to adopt this same broad-based employee ownership investment model in their company acquisition planning.

More importantly, EELP would empower the management and employees whose efforts contributed significantly to the growth and development of the 39,000 privately held companies that will be sold in the near term to be able to compete with Wall Street and private equity funds for ownership. Instead of watching helplessly as company ownership changes hands, management and employee stakeholders can initiate discussions with business owners and with local, regional and national financing sources in both the public and private markets to compete for a right to own part of the business for which they work. Selling owners would be able to entertain credible, fully funded cash offers by their management and employees which they can compare to bids offered by Wall Street and institutional private equity.

Realizing the Employee Equity Loan Guarantee Program: Policy Implementation

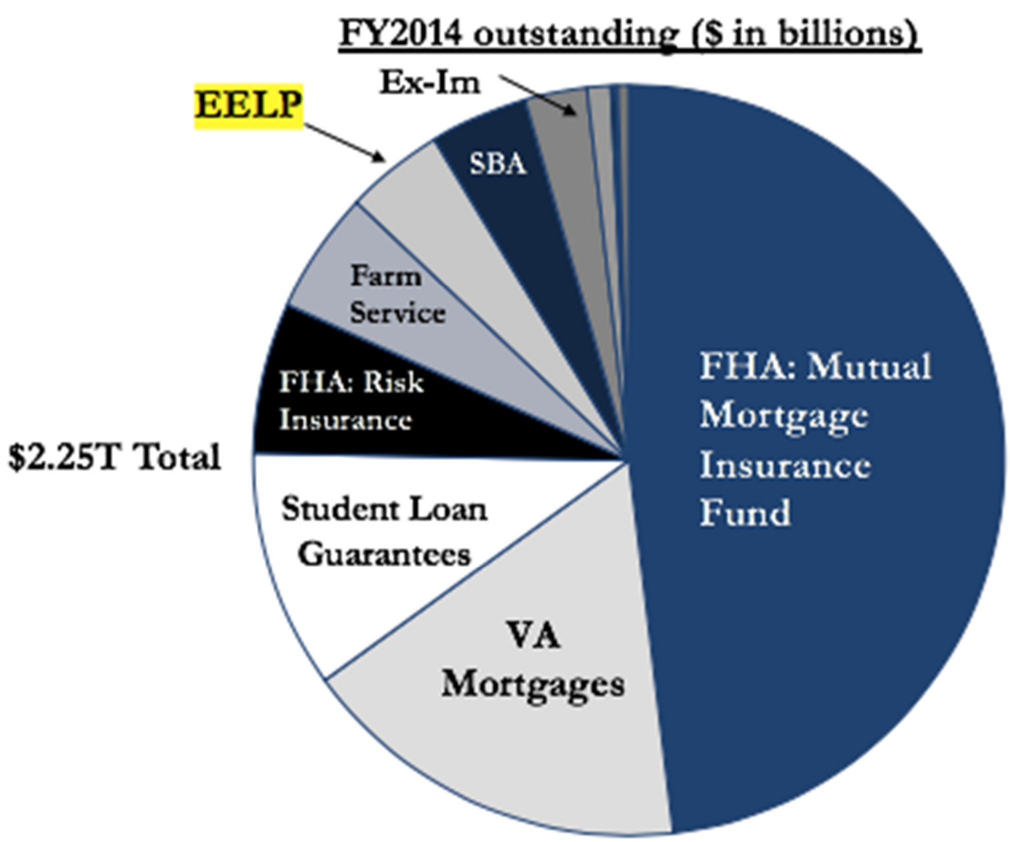
We estimate that in order to bring about desired impact, EELP guarantees should be targeted in the range of $100 Billion dollars renewed annually.

To put that figure in context, Figure 3 on the subsequent page lists the range of major Federal loan guarantee programs by size. Using FY 2014 figures, total outstanding Federal loan guarantees amount to $2.25 Trillion dollars. Adding the proposed $100 Billion annual allocation would raise the total guarantee ceiling to 2.35 Trillion. Using these assumptions, the Employee Equity Loan Program (EELP) would rank 6th among Federal loan guarantee programs, just above the allocation presently dedicated to the SBA. The specific contrast with the SBA is meaningful. The hypothetical ranking of EELP just above the SBA helps to distinguish the targeted work of EELP from the historic accomplishments of the SBA.

Stated more specifically, if measures for reducing wealth and income inequality in US households remain a priority of policy makers, then the historically effective work of using credit guarantees should not stop at the water's edge of "small business." EELP seeks to build on SBA achievements in a materially larger economic niche – the middle market of the American economy.

Figure 3 Existing Federal Loan Guarantee Programs by Size

Program	FY2014 Appropriation ($ in billions)
1. FHA Mutual Mortgage Insurance Fund	1,130
2. VA Mortgages	398
3. Federal Student Loan Guarantees	242
4. FHA General & Special Risk Insurance Fund	153
5. Farm Service/Rural Development	124
6. Proposed EELP Loan Guarantee	100
7. SBA Business Loan Guarantees	99
8. Export-Import Bank	63
9. International Assistance – State Department	24
10. Commodity Credit Corporation Export Loan Guarantees	4



Politically, implementation of EELP would require a continuation of the kind of bi-partisan cooperation that has characterized ESOP legislation in the past. There is reason for optimism that a similar approach could be embraced for EELP. Beginning in 1974 and extending up through the contemporary political moment with pending legislation, both Republicans and Democrats have found common ideological ground. [51] Both parties cooperated on the original Employment Retirement Security Act (ERISA) legislation that introduced the necessary legal infrastructure of Trusts i.e. Employee Stock Ownership Trusts (the "ESOT") and subsequent amendments and regulations governing that law. Existing law has established oversight and fiduciary duties required of trustees to ensure that these Trusts are implemented and maintained for the exclusive benefit of their employee owners. These laws and regulations have been enforced for over forty years by the US Treasury and Labor Departments and by US Federal courts.

Similarly, the underwriting standards for evaluating applicants for federally guaranteed loans have been successfully administered by the SBA for over sixty years[52] Those standards should be continuously updated to conform to prevailing market conditions but most importantly a professional SBA capital lending infrastructure with its 3,800 lenders and $99 Billion current congressional authorization already exists. Capacity to implement EELP should augment these existing capabilities. With guidance from a different administrative home – we are partial to the Economic Development Administration of the United States Department of Commerce - this same community of lenders can be trained to underwrite loans for the middle market companies and their management and workers. Those lenders would be joined by the community of established middle market lenders in larger financial institutions distributed across the country. Together these two groups of lenders can provide the necessary private sector infrastructure for the underwriting of EELP loans.

For the first time in US business history, the introduction of EELP can provide a level playing field for management and employees in the privately held middle market to compete with public companies and private equity funds when the businesses for which

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[51] As of this writing, the 116th Congress is considering S 177, The Promotion and Expansion of Employee Ownership Act introduced by Senator Pat Roberts (R-KN), co-sponsored by Senator Ben Cardin (D-MD). The most recent Federal legislation approved by Congress was S. 2786 The Main Street Employee Ownership Act, co-sponsored by Senator Kirstin Gillibrand (D-NY) and Senator Todd Young (R-IN).

[52] Bischoff, Dan, "History of the Small Business Administration (SBA)." September 21, 2011. https://www.lendio.com/blog/small-business-tools/infographic-history-small-business-administration-sba-1/

they work are to be sold. Today the principal competition in both of these markets comes from private equity funds with over $2.5 trillion dollars in committed capital and includes five individual private equity funds of $75 billion or larger in size.[53]

We estimate that over a ten year time period the $100 billion dollar annual EELP loan guarantee commitment should be able to help create an additional 13 million employee owners for the US workforce, add 1 million new jobs to the US economy and contribute more than $1.7 trillion in additional wealth to US workers with its impact spread over ninety percent of US households.[54] This is wealth that would either not have been generated or, if generated, would have been concentrated in the hands of a small group of financial professionals, namely the private equity fund managers, and the top five percent in wealth holdings of US families who are the principal investors in their respective private equity funds[55]

Realizing the Employee Equity Loan Act: Cost

A surprising answer regarding the cost to US Treasury of a scaled EELP program follows from evidence supplied by similar Federal loan and loan guarantee programs to be found in housing, agriculture and export trade. There is reason to believe that the cost could be zero. It is also reasonable to presume that the US Treasury could make significant profits through the administration of the EELP. The preponderance of empirical economic evidence regarding the performance of companies that have significant employee ownership indicates that the loans guaranteed through EELP, if well-disciplined through rigorous underwriting standards, will create both current positive earnings but also will materially improve US economic growth, job creation, job stability and worker wealth.

Government loan guarantee programs have been a part of United States public policy for over a hundred years.[56] Those pioneered under the aegis of the RFC – including

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[53] Maverick, J.B., "World's Top 10 Private Equity Firms (APO, BX)." January 11, 2016. https://www.investopedia.com/articles/markets/011116/worlds-top-10-private-equity-firms-apo-bx.asp. Davies, Jessica, "Private Equity Assets Near $2.5." February 1, 2017. https://www.fnlondon.com/articles/private-equity-assets-near-2-5-trillion-20170201

[54] "Dun & Bradstreet and Small Business Growth." *Dun & Bradstreet.* October 18, 2017. http://www.dnb.com/perspectives/government/dnb-assists-sba-loan-approvals.html; "ESOPS by the Numbers." *National Center for Employee Ownership.* March 2017. https://www.nceo.org/articles/esops-by-the-numbers

[55] "Who exactly are the 1%?" *The Economist.* January 21, 2012. http://www.economist.com/node/21543178

[56] The Editors of Encyclopedia Britannica, "Reconstruction Finance Corporation." *Encyclopedia Britannica.* Accessed December 2017. https://www.britannica.com/topic/Reconstruction-Finance-Corporation

home loan programs, agricultural loan programs, and our small business loan programs – have been with us for nearly as long. All of these programs are still with us and highly successful.

Two of these programs that apply respectively to agriculture and housing were specifically designed to aid US citizens to grow their wealth.[57] Economically these loan guarantee programs make money for the government – partly because the US government borrows today, and for the foreseeable future, at close to zero cost and then lends to a borrower at a higher cost, i.e. at a spread, which if the loan is payed back on time will always make money for the government. The same results can be expected with EELP. Additionally, because of the structure of the EELP loans, which will have much higher expected yields than other government loan guarantee programs, the host agency for EELP will be in a strong position to negotiate higher returns for its guarantees.

The US workforce comprised of managers, engineers, technical, production and service workers who would make use of EELP would benefit from the program directly in two important ways

- First, EELP will require the government to do a better job of utilizing its credit rating to earn returns for its citizens and thereby reduce the cost of government. It will do so while stimulating an important economic sector, private sector business growth and job creation in local communities that are substantially under-served by the capital markets today.
- Second, the program will provide urgently needed capital to directly assist the growth of management and employee ownership in US based companies which would allow the US workforce to earn an ownership stake in the businesses in which they work.

Higher employee ownership of US businesses has been shown to materially improve the business's economic performance.[58] The evidence is clear that employee-owned businesses out perform their non-employee owned peers in critically important

[57] Butkiewicz, James, "Reconstruction Finance Corporation." University of Delaware. Accessed December 2017. https://eh.net/encyclopedia/reconstruction-finance-corporation/

[58] "ESOP (Employee Stock Ownership Plan) Facts." *National Center for Employee Ownership.* Accessed December 2017. https://www.esop.org/

economic measures including revenue growth, job creation, employee wealth creation and job security.[59]

6. Conclusion and Next Steps

The Employee Equity Loan Program represents a policy initiative of scale and substance, conceived to materially help repair the loss of wealth suffered by middle class US workers and their families since the 2008 recession. It promises to begin to reverse worrisome trends in wealth inequality that presently afflict the US economy and its working families. Those trends have produced sluggish productivity and economic growth, lackluster job creation, stagnant wages and widening economic inequality.

The EELP aims to begin to reverse these trends not through divisive 'after the fact' redistribution measures and not through a reliance on traditional income enhancement measures but rather through a bi-partisan and empirically proven 'pre-distributive' program of employee ownership of private sector enterprise where wealth is shared as it is earned.[60]

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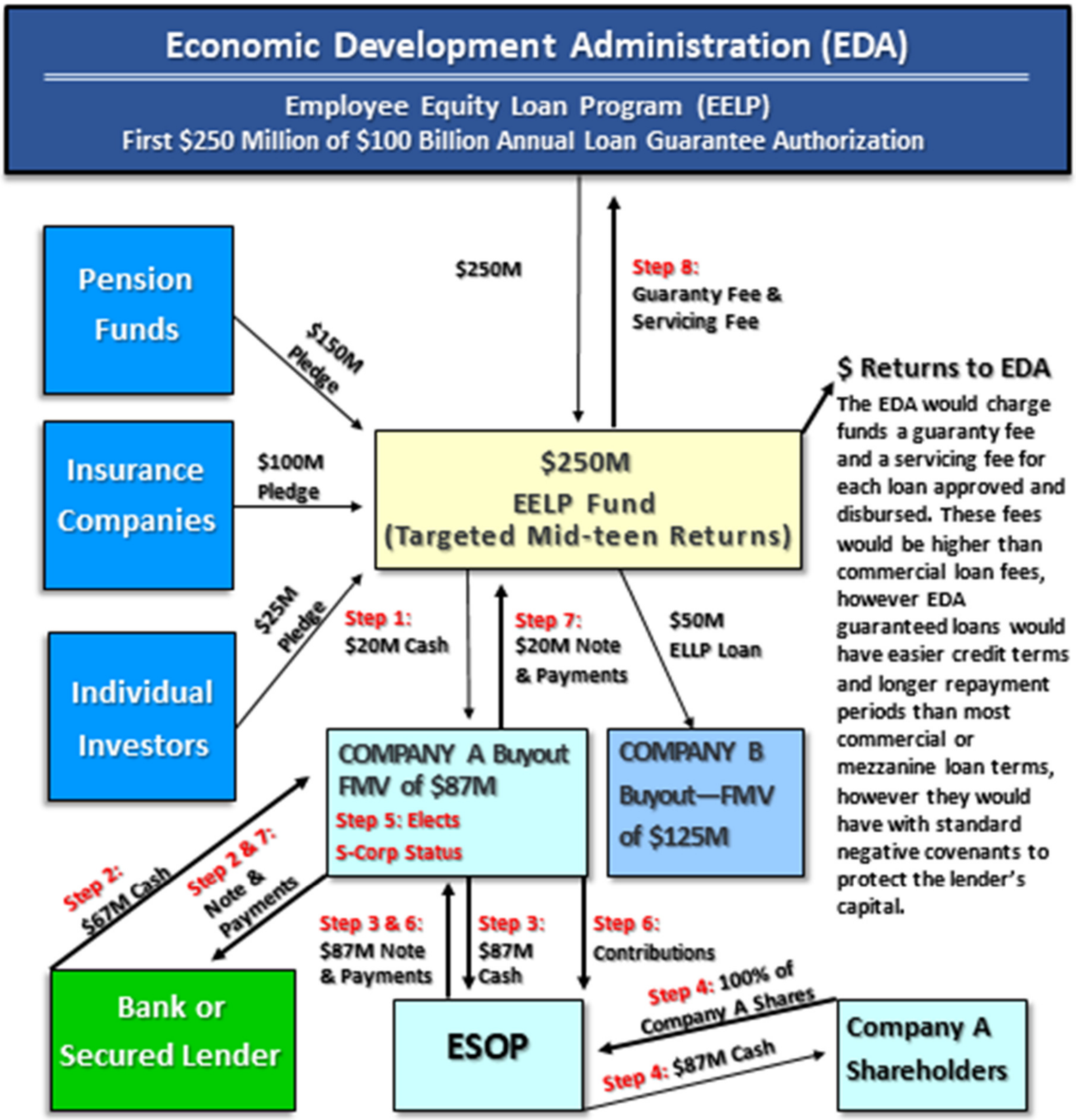
[59] Dahl, Daren, "Are Employee-Owned Companies the Best Investment Around?" *Forbes.* July 16, 2016. https://www.forbes.com/sites/darrendahl/2016/07/19/are-employee-owned-companies-the-best-investment-around/#28be839950be

[60] Bernstein, Jared, "Employee Ownership, ESOPs, Wealth, And Wages." January 2016. http://esca.us/wp-content/uploads/2016/01/ESOP-Study-Final.pdf

Appendix 1 – Detailed EELP Graphic



AN EXAMPLE EELP FUND TRANSACTION SEQUENCE: (Step Numbers)

1. Company A's shareholders agree to an $87M sale to an ESOP and to obtaining a $20M EELP loan from an EELP Fund in exchange for a $20M note and warrants.
2. Company A simultaneously applies and is granted a $67M loan from a Bank or Secured Lender in exchange for a $67M note secured by Company A's qualifying assets.
3. Company A's ESOP exchanges an $87M note to Company A for $87M in cash.
4. Company A's ESOP then exchanges $87M in cash for 100% of Company A's outstanding stock.
5. Company A elects S-Corp status and as an 100% ESOP it is not subject to Federal Income Taxes.
6. Company A makes retirement benefit contributions to the ESOP which the ESOP returns to the company to amortize the ESOP's $87M loan.
7. Company A with its tax-free cash flow amortizes both the $67M Bank and $20M EELP loans.
8. EELP Fund reimburses EDA for its loan guarantee and processing fees as the Company A loan amortizes.