Rethinking Options for Retiring Entrepreneurs

by Desiree Hatcher

This article was written to explore the longstanding issue of succession challenges faced by retiring baby boomer entrepreneurs. Since its writing, the issue has been made even more complex by the COVID-19 pandemic, by threatening lives, as well as the intrinsic value of many types of businesses. Nonetheless, the author summarizes options other than sale or dissolution for business owners to consider as they prepare to transition into retirement.

Introduction

This article describes the issues businesses and, thus, employees may face as a result of the wave of retiring baby boomers, sometimes referred to as the "silver tsunami." The article also considers the role of the Community Reinvestment Act (CRA) and recent Small Business Administration (SBA) legislation in encouraging banks to finance business purchases in certain instances. In addition, the SBA provides an additional tool for leverage against defaults from loans to employee-owned business startups and conversions. The SBA Main Street Employee Ownership Act of 2018 expands the authority of the SBA to guarantee loans for qualified employee trusts of a small business to purchase the stock of that business.

How big is the "silver tsunami?"

An article in *The Washington Post,* citing research done by the nonprofit Project Equity, notes that there are about 2.34 million businesses owned by the "baby boomer" generation that generate more than $5 billion in sales and employ 24.7 million people, approximately one-sixth of all U.S. workers. As the current owners retire, their options are few: close the business, sell (six out of ten business owners plan to do this in the next decade), or transfer the company to their children. In the article, Project Equity's co-founder, Alison Lingane, states that a third of business owners in this generation who want to sell are having a hard time finding a buyer. Many owners are being bought-out by out-of-area buyers that are consolidating ownership and wealth,[1] but do not necessarily consider the interests of staff employed at the time of sale a high priority. Keeping a business in the family comes with its own set of challenges. Only a third of family-owned businesses survive the transition to the second generation.[2]

Though this wave of exiting business owners provides potential challenges for workers, options other than dissolution or sale may be available that can preserve jobs, build wealth for employees, and create a more diverse management structure.

Opportunity to change the structure of ownership

According to Malik Nevels, executive project manager, Safer Foundation, "the priority is to keep the business in existence for the employees." Nevels referenced a study commissioned by the nonprofit Manufacturing Renaissance that found that companies rarely had succession plans, which put employees at risk when owners retired. This finding motivated the creation of Re/Cast (formerly known as the Ownership Conversion Project), a partnership between Manufacturing Renaissance, Safer Foundation, the Chicago Federation of Labor, Local Initiatives Support Corporation (LISC) Chicago, World Business Chicago, Cook County Bureau of Economic Development, and the Illinois State Treasurer.[3] Re/Cast's objective is to identify manufacturing companies with a succession challenge and match the company with a qualified buyer for the company offering market-based pricing and terms for the owner. Re/Cast can assist in sourcing capital for identified deals. A subordinated debt fund that will be managed by LISC is in development.[4]

However, the nonprofit attempts to go further by making the business acquisition a transformational opportunity. In developing its pool of qualified purchasers, there is a particular interest in identifying minority entrepreneurs and late(r)-career, minority professionals who may want to assume ownership of these manufacturing businesses. Re/Cast intends to shift the profile of manufacturing ownership to one that is more diverse, and potentially offers ownership opportunities to employees. Re/Cast leadership hopes this may ultimately alter the management values of the manufacturing sector from those that focus on private accumulation of wealth to ones that value social returns in addition to traditional measures of return on investment.[5] Bob Christian, managing director of Re/Cast, stressed that organization leadership has a vision of creating a model that could be scaled to other cities, like Detroit, where manufacturing companies are facing similar succession challenges.[6]

Safer Foundation's Nevels indicated that in addition to the transfer of wealth, the nonprofit also has an interest in exploring the potential for employee ownership through the cooperative model or through an Employee Stock Ownership Plan, where employees are both willing and able to do so.

Other models can help employees build wealth

Selling a business to employees can be a viable option for retiring entrepreneurs. According to Deborah Groban Olson, founder of The Center for Community-Based Enterprise, Inc., selling a business to an employee stock ownership plan (ESOP) or worker cooperative can help to ensure that the company can continue to thrive with the people who helped build it.[7] Both models enable business ownership to be shared among a broad base of employees. The two key differences between ESOPs and worker cooperatives are: 1) worker cooperatives are by definition democratically governed by workers, whereas ESOPs have only minimal requirements for worker voice (although they can be governed democratically); and 2) worker cooperatives are largely unregulated, whereas federal law governs many aspects of how ESOPs are administered, including allocation, vesting, valuation, distribution, and more.[8]

ESOPs and worker cooperatives are valuable in promoting inclusion and providing competitive wages. There are over 6,600 ESOPs in the United States, holding total assets of nearly $1.4 trillion.[9] Wages at ESOP firms are on average 5 percent to 12 percent higher than those at comparable non-ESOP firms. ESOP employees also have more than double the retirement savings. Also impressive is that, in the recent recession, ESOP workers were one-fourth as likely to be laid off.[10]

Though not as numerous as ESOPs, worker cooperatives also have an impressive track record. According to the '2019 State of Worker Cooperatives in the U.S.' report there are 465 worker cooperatives in the US. The report found that the average wage paid at 106 responding cooperatives was $19.67 per hour. In addition, worker co-ops that distribute surplus profits to members offered an average distribution of $8,241 per year to each worker owner, in addition to wages.[11]

As previously indicated, ESOPs are a potential way that Re/Cast may address succession issues. A key component of their model is ensuring that current ownership is committed to assisting with the leadership/ownership transition over a period of multiple years. Current ownership is also asked to assist with financing the purchase – be it by employees or others outside of the company – to ensure that incentives are aligned around the long-term success of the business.[12]

What is the role of financial institutions in succession planning?

There is opportunity for regulated financial institutions to assist in business acquisitions and also meet their responsibilities under the CRA.

The CRA was enacted to encourage banks to meet the credit needs of their assessment areas, including low- and moderate-income communities, consistent with safe and sound banking operations. Specific qualified loan, investment, or service activities for which banks may receive CRA credit include activities that promote economic development by financing businesses or farms that meet the act's "size eligibility standards" (as set by the Small Business Administration Development Center [SBDC] or Small Business Investment Company [SBIC] programs, or have gross annual revenues of $1 million or less) and "purpose test" (promote economic development through permanent job creation, retention, and/or improvement for low- or moderate-income persons; in low- or moderate-income geographies; in areas targeted for redevelopment).[13]

Understanding and managing risk with ESOPs

There are several types of ESOPs, but one of the most popular is a leveraged ESOP. In a "leveraged" ESOP, the ESOP borrows money and buys the owner's stock. The company usually guarantees the loan, and contributes enough money each year to enable the ESOP to repay the loan.[14] However, some banks may be reluctant to finance ESOPs due to a perception of higher risk.

Limited information was found that specifically addresses the default rates for ESOPs. A 2014 study by the National Center for Employee Ownership (NCEO), titled "Default Rates on Leveraged ESOPs, 2009-2013," focused on concerns that ESOPs are excessively risky and that appraisals tend to be too aggressive, causing ESOPs to overpay for the shares of stock. These concerns suggest that the default rates on ESOP loans would be high. However, the study found that based on an analysis of 1,232 leveraged ESOP transactions generated by JP Morgan Chase, Fifth Third Bank, and an anonymous bank, active between 2009 and 2013, only 1.3 percent experienced defaults during the study period. In a parallel analysis, the NCEO asked ESOP appraisal firms to provide data on defaults among the ESOP companies whose stock they appraised between 2009 and 2013. Eighteen firms responded, providing data for loans to 845 companies. Of these, nine loans resulted in losses to the creditor.[15]

In addition, the SBA provides an additional tool for leverage against defaults from loans to employee-owned business startups and conversions. The SBA Main Street Employee Ownership Act of 2018 (the Act) provides additional encouragement for banks to meet the credit needs of employee-owned startups and conversions. Enacted in August 2018, the Act amends the Small Business Act to expand the authority of the SBA to guarantee loans for qualified employee trusts of a small business to purchase the stock of that business. Specifically, the Act allows the guaranteed loan to also cover transaction costs associated with purchasing the stock. In addition, it allows loans to a small business to be guaranteed if the loan proceeds will: 1) be used to provide loans to a qualified employee trust of the small business to purchase the business's stock, and 2) result in the trust owning at least 51 percent of the business' stock. The SBA must also guarantee loans to cooperatives in which employees are eligible for membership for such stock purchases. The Act also requires that the SBA provide outreach and educational materials to licensed small business investment companies to increase investment in transitions to employee-owned businesses, and establish a Small Business Employee Ownership and Cooperative Promotion Program to offer technical assistance and training on the transition to employee ownership through cooperatives and qualified employee trusts.[16]

Partnership opportunities

Lenders who do not have the expertise or resources to devote to employee ownership conversions may obtain CRA credit by providing loans and investments to nonprofits, community development finance institutions (CDFIs), and other organizations that have expertise in providing technical assistance, underwriting, and financing to these businesses. For example, the Center for Community-Based Enterprise (C2BE), a Detroit-based nonprofit, provides legal help, technical assistance, education, and collaboration to individuals interested in developing employee-owned businesses and other community-based enterprises.[17]

Conclusion

A retiring business owner does not have to equate to job loss for the business' employees. A viable exit strategy can instead lead to a profitable exit for the owner and continued employment for current and future employees. Resources exist to assist retiring business owners. However, a successful transition takes time and planning, and should be made part of the discussion as older entrepreneurs prepare for their well-earned retirement.

Notes

1. Marks, Gene, "Why the looming 'Silver Tsunami' could put 25 million jobs at risk," *The Washington Post*, retrieved April 4, 2019.
2. Berner, Courtney, Michaela Holmes, Anne Reynolds, and Joe Rinehart, "Successful Cooperative Ownership Transitions: Case Studies on the Conversion of Privately Held Businesses to Worker Cooperatives," available at https://resources.uwcc.wisc.edu/CaseStudies/Successful-Coop-Ownership-Transitions.pdf.
3. Phone interview with Malik Nevels, executive project manager, Safer Foundation, June 20, 2019.
4. The Chicago Ownership Conversion Project: Transition to Transformation, December 19, 2017, available at https://d4937ac3-176d-43e2-b62d-fb4a5b456873.filesusr.com/ugd/a1c52b_3615c085664346c392a030b6d038a4fb.pdf.
5. Ibid.
6. Interview with Bob Christian and Dan Swinney, managing director and board member respectively of Re/Cast, November 26, 2019.
7. Interview with Deborah Groban Olson, founder of the Center for Community-Based Enterprise, Inc., March 4, 2019.
8. See https://www.project-equity.org/financing-faqs.
9. See https://www.nceo.org/articles/employee-ownership-by-the-numbers.
10. Kelly, Duncan and Dobbs, 2019, "Broad-Based Ownership Models as Tools for Job Creation & Community Development," The Democracy Collaborative, January.
11. See https://institute.coop/resources/2019-worker-cooperative-state-sector-report.
12. Interview with Bob Christian and Dan Swinney, managing director and board member respectively, of Re/Cast, November 26, 2019.
13. Interagency Questions and Answers Regarding Community Reinvestment, Federal Financial Institutions Examination Council, June 2016, § __.12(g)(3).
14. Groban Olson, Deborah, "How Do ESOPs Work," available at https://www.esoplaw.com/about-esops/how-do-esops-work.
15. Rosen, Corey, and Loren Rodgers, 2014, "Default Rates on Leveraged ESOPS, 2009-2013," National Center for Employee Ownership, July 2.
16. Congress.gov; H.R. 5236 – Main Street Employee Ownership Act of 2018, available at https://www.congress.gov/bill/115th-congress/house-bill/5236.
17. Center for Community-Based Enterprise, Inc., available at https://www.c2be.org/mission.

Biography

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