



## **POLICY BRIEF: Growing and Preserving Jobs by Transitioning to Employee Ownership**

### **INTRODUCTION**

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New York State loses approximately 60,500 jobs a year when small businesses with fewer than 100 employees close their doors for good.<sup>i</sup> While many businesses close because of rising rents or failed business plans, in New York State we estimate that 3,700 businesses close each year simply because of the owner's retirement. As a result 13,260 New Yorkers lose their jobs annually.<sup>ii</sup>

New York City could avoid some of these job losses through a little-known but proven strategy to retain jobs and build assets for workers: transitioning to employee ownership. By providing assistance with the necessary financing—in the form of loans or guarantees—and by spreading the word to business owners about the benefits of transitioning to employee ownership at the time of their retirement, the city could bolster small business employment, empower employees, and provide a meaningful and rewarding exit for business owners.

Implementing these strategies could not come at a more necessary time. Sixty percent of businesses are owned by Baby Boomers,<sup>iii</sup> many of whom are nearing retirement, and job losses associated with businesses closing upon an owner's retirement are expected to grow.

### **THE NEED FOR IMPROVED SUCCESSION PLANNING**

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It is widely acknowledged that very few small business owners have articulated a succession plan for their business. One survey by Securian Financial Group found that only 14 percent of small business owners have a formal exit plan in place.<sup>iv</sup> The rate of succession planning is not much higher among those owners nearing retirement age. A study by Baker Tilly International found that 80 percent of Baby Boomer "family business owners" have yet to complete succession plans.<sup>v</sup>

There are many reasons why small business owners may not develop a formal succession plan. Succession planning is complicated and owners are busy with the day-to-day operations of their small business. The hard decisions inherent in succession planning are often put off for another day. Owners may also have an emotional

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attachment to what is often their life's work, and it can be difficult to let go and plan for the inevitable.

The majority of small business owners, whether they have a formal plan or not, say that they plan on transferring the business to a family member or selling to a key partner. That leaves 25 percent that say they will sell to a third party and another ten percent that say they plan to wind the business down.<sup>vi</sup> However, among current business owners who were not the company's original founder, 72 percent said they purchased the business, compared with 13 percent who said they inherited.

Regardless of a business owner's intention, succession planning is essential to ensure the survival of a business during and after an ownership transition. Business consulting firms warn about the high rate of failure among family business transitions. One oft-cited statistic states that only about 30 percent of family-owned businesses survive the transition to the second generation.<sup>vii</sup> Among owners that say they want to sell to a third party, finding a buyer may be difficult. Only one-third of businesses put up for sale in a given year find a buyer and finish the transaction, according to research from the University of Pepperdine Private Capital Markets Project. Of businesses up for sale in 2016, 16 percent closed before finding a buyer, and 44 percent were still on the market having yet to find a suitable buyer.<sup>viii</sup> U.S. Census data shows that 386,900 firms with paid employees ceased operations in 2012. Of these business closures, 46,700 (12 percent) closed because the owner was retiring. In some cases, this may have been the owner's intent, but in others it may represent a failure to find a suitable buyer.

### **EMPLOYEE OWNED ENTERPRISES**

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Broad-based employee ownership benefits employees, owners, and the economy as a whole. Because employees share in the profits, they tend to be motivated to work harder and increase productivity.<sup>ix</sup> Because employee owners obtain stock in the business, employee ownership allows workers to build equity and save for retirement. Studies have also shown that employee owned enterprises are more likely to offer their workers a secondary retirement plan like a 401(k). And research has shown how employee owned businesses are better able to handle economic downturns and maintain employment, leading to positive macroeconomic outcomes.<sup>x</sup> There are examples of low-wage workers in New York City who have formed worker cooperatives

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and have seen their hourly wages increase from \$10 to \$25 per hour within just a few years.<sup>xi</sup>

Employee Owned Businesses (EOBs) take several different forms, but the most common is the Employee Stock Ownership Plan (ESOP). In an ESOP, employees own shares in the company, which are held by a trust. At the time an employee retires from the company, the ESOP repurchases the shares and pays their value to the employee. ESOPs are defined as retirement plans under federal law and are governed by ERISA and therefore enjoy various tax benefits under federal law.

The most attractive benefit from the standpoint of the business owner is that under Section 1042 of the tax code, the capital gains from the sale to a co-op or an ESOP can be deferred indefinitely or completely avoided. Other tax benefits are geared toward the business itself. Employer contributions to the ESOP are generally tax-deductible up to a limit of 25 percent of covered payroll and businesses can deduct dividends paid on ESOP-held stock. Finally, for employees, they do not pay tax on stock allocated to their accounts until they receive distributions.<sup>xii</sup>

Other forms of employee ownership include Employee Ownership Trusts (EOTs) and worker cooperatives, though ESOPs are by far the most common form of employee ownership in the United States. In an EOT, employees are given a share of a company's profits, but are not paid a lump sum at the time of retirement. In worker cooperatives both profits and day-to-day decision making are shared amongst the employees.

In 2015, New York City launched the Worker Cooperative Business Development Initiative, which provides funding to partner organizations which then provide support and services to assist in the creation of worker cooperatives. In the two years since its inception the initiative has resulted in the creation of 27 worker cooperatives yielding 164 total hires.

However, the most common form of employee ownership is the ESOP model. There are approximately 375 employee owned enterprises in New York State, including 341 ESOPs with 1.1 million participants. There are 68 privately-held ESOPs with their headquarters in New York City, with 261,400 active participants.<sup>xiii</sup> The impact of ESOPs in New York City reaches further though, as some may have headquarters near the city and have establishments in the city itself. One example is clothes retailer Eileen

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Fisher, which offers its employees an ESOP plan and is headquartered in Irvington, NY but has several retail outlets across the city. A New York City-based ESOP may also have several locations outside of the city, such as Unity International Group, a Flushing-based firm that began with electrical contracting but has since expanded to include IT services and systems maintenance. Unity has locations in New Jersey and Florida.

### ***The ESOP process***

An owner that is interested in transitioning the business to employee ownership will first have to conduct a feasibility study. This can be done either in-house or may require a comprehensive analysis by an outside consultant. A comprehensive analysis is needed if there is any doubt about the ESOP's ability to pay back the necessary loan. Then, an independent third-party valuation analyst is required by law to assess the value of the business. The seller will need to hire a lawyer and a trustee. The lawyer helps design and create the ESOP trust and other transactional documents. The trustee is for the ESOP trust and has a fiduciary obligation to review the sale price and other terms of the sale. Depending on the nature of the transaction, the seller may need to hire two lawyers (one for the company and one for the trust), and may also need to hire a financial analyst to help structure the financial arrangements. Then funding must be found for the transition. ESOPs are generally 50 – 100 percent seller-financed. At some point, typically after the ESOP has been created, the business will likely want to hire an educator to teach the employees about their new status as owners.

### **ENCOURAGING TRANSITIONS TO EMPLOYEE OWNERSHIP IN NEW YORK CITY**

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New York City should encourage business owners nearing retirement to consider transitioning to employee ownership, as part of a broader effort to assist with transition planning. The city should also create a program that would provide financing for business owners that wish to transition to employee ownership. As more Baby Boomers reach retirement-age, these transitions will become an even more important job retention strategy. But these owners first must be aware that employee ownership is a viable option.

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Businesses that are appropriate for conversion into ESOPs typically have annual profits of over \$1 million and 20 – 300 employees. Other, smaller businesses may also be appropriate for conversion into other forms of employee ownership, such as a worker cooperative or Employee Ownership Trust (EOT).

In New York State, we estimate that, of the 110,390 firms with over \$1 million in sales, 252 close every year because the owner is retiring, based on survey data from the U.S. Census Bureau. New York State loses about 4,930 jobs each year because of these business closings. And since 45 percent of the state's firms with paid employees are in New York City, we can reasonably apply this percentage to the statewide totals. This means that 114 businesses with sales over \$1 million close each year in New York City because the owner is retiring, and that these businesses had at the time of closing 2,220 employees.<sup>xiv</sup> These businesses could have been converted into ESOPs instead of closing.

Businesses of all sizes can be successfully transitioned to employee ownership. Businesses not large enough to become an ESOP can still become an EOT or some other form of employee ownership that is less time and resource-intensive than that required of ESOPs.

## RECOMMENDATIONS

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### **1. Outreach and education: NYC Small Business Services “Succession Unit”**

Transitioning to employee ownership has many benefits, but it is not a simple process. Because of this, New York City should provide education and support for business owners as they consider such a transition. We propose that the New York City Small Business Services (SBS) create a Succession Planning Unit to monitor businesses with owners at or nearing retirement age and conduct outreach to this community with the aim of raising awareness about succession planning and services.

The Unit would be staffed by one or two individuals who would be in charge of monitoring and engaging business owners who are at or nearing retirement age. The Unit would be responsible for making these business owners aware of non-profit, city-led, and for-profit succession planning services that are available. The unit could perform basic feasibility analyses for businesses that would evaluate the best succession options for that business, including employee ownership. Among the

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information provided would be resources and materials about the prospects of an employee ownership succession.

### ***2. Financing: NYC Economic Development Corporation loan and loan guarantee program***

Access to capital can be a major obstacle to promoting employee ownership. Company shares must be purchased and set aside in a trust. To attend to this problem, Governor Mario Cuomo and the state legislature passed the Employee Ownership Assistance loan program. However, this program is currently unfunded and inactive. At the time, the program provided up to 40 percent of the total sale price in direct financing for employee ownership projects as well as loan guarantees to participating banks of up to 80 percent of the total sale price. In economically disadvantaged areas, the program provided up to 60 percent of the total sale price in direct financing.

Absent of state action, the work of acquiring and transitioning established enterprises to employee ownership could be greatly expanded through the provision of loan and/or loan guarantee financing from the New York City Economic Development Corporation (NYCEDC). NYCEDC currently has a similar loan program for small and micro businesses in certain industries, offering up to a 40 percent loan guarantee for lines of credit up to \$250,000. The agency should create a similar program for those businesses that are transitioning to employee ownership, though the value of the loan or loan guarantee will need to be higher because the financing needs for these types of transitions is higher.

### **CONCLUSION**

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Nearly half (45%) of New York City residents are poor or near poor according to the NYC Center on Economic Opportunity.<sup>xv</sup> They struggle to find good paying jobs with benefits in an economy where low-wage service sector jobs are usually the only options for those with only a high school education and without vocational skills. Those fortunate to have jobs are threatened with unemployment when the owner retires and is unsuccessful in selling the business. Everyone loses in this scenario, the workers, the retiring owners, the customers – and the City's economy.

ESOPs and other forms of employee ownership provide one option to help save

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thousands of jobs each year. These are often not just the typical minimum- or low-wage jobs, but higher paying jobs with benefits and retirement plans.<sup>xvi</sup> New York City should help support these types of good jobs, and work to preserve small businesses and employment, by conducting outreach and education to business owners, and providing reasonable loan options to facilitate successful business successions.

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<sup>i</sup> U.S. Census. 2007 Survey of Business Owners Public Use Microdata Sample.

<http://www.census.gov/data/datasets/2007/econ/sbo/2007-sbo-pums.html>.

<sup>ii</sup> Nationally, 0.8 percent of all firms with paid employees reported they ceased operations because the owner retired. On average these firms had 3.5 employees. These figures were applied to the total number of firms with paid employees in New York State. U.S. Census Survey of Business Owners 2012.

<sup>iii</sup> U.S. Census Survey of Business Owners 2007.

<sup>iv</sup> [https://www.securian.com/public/securian/Documents/research/F67615-8\\_pod.pdf](https://www.securian.com/public/securian/Documents/research/F67615-8_pod.pdf)

<sup>v</sup> <http://www.bakertillyinternational.com/media/1956606/succession-reset-usa-country-report-us-size-october-2014.pdf>

<sup>vi</sup> [https://www.securian.com/public/securian/Documents/research/F67615-8\\_pod.pdf](https://www.securian.com/public/securian/Documents/research/F67615-8_pod.pdf)

<sup>vii</sup> <https://www.forbes.com/sites/aileron/2013/07/31/the-facts-of-family-business/#35bf355f9884>

<https://hbr.org/2012/01/avoid-the-traps-that-can-destroy-family-businesses>

<sup>viii</sup> <http://bschool.pepperdine.edu/about/people/faculty/appliedresearch/research/pcmsurvey/content/2016-private-capital-markets-report.pdf>

<http://bschool.pepperdine.edu/about/people/faculty/appliedresearch/research/pcmsurvey/content/ppcm-report-2015.pdf>

<http://bschool.pepperdine.edu/about/people/faculty/appliedresearch/research/pcmsurvey/content/2013ppcmcapital-markets-report.pdf>

<sup>ix</sup> <http://www.nceo.org/articles/studies-employee-ownership-corporate-performance>

<sup>x</sup> [http://research.upjohn.org/cgi/viewcontent.cgi?article=1255&context=empl\\_research](http://research.upjohn.org/cgi/viewcontent.cgi?article=1255&context=empl_research)

<sup>xi</sup> <http://fpwa.org/wp-content/uploads/2014/10/Worker-Cooperatives-for-New-York-City-A-Vision-for-Addressing-Income-Inequality-1.pdf>

<sup>xii</sup> <https://www.nceo.org/articles/esop-tax-incentives-contribution-limits>

<sup>xiii</sup> Information provided to Public Advocate's Office by ICA Group

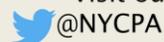
<sup>xv</sup> <http://www.nyc.gov/html/ceo/downloads/pdf/CEO-Poverty-Measure-2016.pdf>

<sup>xvi</sup> <http://fpwa.org/wp-content/uploads/2014/10/Worker-Cooperatives-for-New-York-City-A-Vision-for-Addressing-Income-Inequality-1.pdf>

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