Businesses of all sizes struggle to stay afloat during recessions, with some eventually having to close. But small, family-owned businesses can sometimes close even during good times for the general economy when the owner retires. Such closures can have a major, negative impact on a rural community.

Whether or not these businesses continue to operate after being sold may not be a primary concern to many retirees. If the owner’s grown children are not interested in keeping the family business in operation, an outsider may purchase the enterprise and decide to cease the operations there. Typical buyers of small businesses are competitors seeking more customers and inventory. They may want to consolidate rather than increase their business locations.
A net loss for rural communities

Businesses that acquire other businesses will likely close the new operating locations they’ve acquired when the cost reduction of closure is larger than the expected loss in revenue. This result depends on serving the same customer base with fewer operating locations.

The acquiring business may even gain from closing operating locations that, prior to the acquisition, were economically self-sustaining. Yet, from the standpoint of the local economy, this benefit for a business from closing newly acquired locations is likely far outweighed by the costs of job losses and less convenient service for local customers.

In many rural areas the former employees of a closed business cannot find jobs without moving out of the area. For local customers in rural communities the closing of a business is often not merely a reduction in consumer choice, but a major inconvenience when it means having to travel much farther distances for shopping. If retiring owners care about the survival of the business they built, they can take preparatory steps to accomplish this result prior to their retirement.

Worker co-ops and ESOPs can help keep doors open when business owners retire

Succession planning

An alternative to selling small businesses to competitors is for owners to develop a succession plan as a component of their retirement plan.

When the owners’ children are interested in keeping the family business, a relatively simple succession plan can be worked out. When their children or other family members are not interested, retiring owners often neglect to initiate the process of succession planning before they retire.

If owners want their business to survive but are considering a sale to non-family members, succession planning is more complex. The original owner and potential new owners (often the employees) must have a plan for management that will keep the business operated as effectively as it was under its former family-owners.

Some small business owners may not be aware of potential tax savings from selling their businesses to employees. A well-designed succession plan is essential to transferring ownership to employees in a way that will qualify for tax savings.

1042 Rollover

Changes in federal tax laws in 1984 created a special incentive for owners who sell their company to its employees. Capital gains taxes on stock sold to employees can be deferred by using the sales proceeds to purchase stock in some other U.S. company. This opportunity for tax deferral on the sale of a business is dubbed the “1042 rollover.” It creates an incentive for proprietors or owners in a closely held business to develop a succession plan of transferring ownership to their employees.

The 1042 rollover has been predominantly applied to ownership transfers under the terms of Employee Stock Ownership Plans (ESOPs). It has been infrequently applied to transferring ownership to worker cooperatives. One reason for this is that many cooperative incorporation statutes require 100-percent ownership by employees within a relatively brief period of transition.

Accomplishing a 100-percent purchase of a company by employees can take three to five years and be financially prohibitive. Whether organized as an ESOP or a worker cooperative, 30 percent of the stock must be purchased in the first year as the minimum amount to qualify for a 1042 rollover. But ownership by a worker cooperative as compared to an ESOP would require a larger loan, due to the 100-percent equity requirement.

The ESOP is flexible in this regard because if outside investors own 70 percent of a company, they can gradually transfer more ownership to employees and take the tax deferral on all incremental sales transfers. However, ESOPs involve more administrative cost because of their regulatory linkage to the Employee Retirement Income Security Act (ERISA). Such costs include the appointment of a trustee to administer the reporting requirements for holding employee shares as part of their retirement plan and having an annual appraisal of the firm’s value.

A worker cooperative is not subject to ERISA regulations, so it is a cost-effective form of ownership for businesses with relatively small employment and modest earnings.

Financing employee ownership

To be an employee-owned firm, a majority share of a company’s stock must be held by the employees. The purchase of a sufficient amount of stock shares by employees to establish ownership and control of a business, whether organized as an ESOP or a worker cooperative, almost always depends on receiving a bank loan.

Lending to an ongoing concern for transferring ownership is usually less risky than a loan for a business start-up. Yet, a bank will consider the amount of debt the business is currently carrying and the effect of adding more with a new loan for the employee stock purchase. Another risk factor for the bank in making such a loan is how well the business will
function under employee ownership and control.

**Business & Industry Loan Guarantees**

USDA Rural Development is authorized to provide loan guarantees for lenders who finance infrastructure and business development under its Business and Industry (B&I) Guaranteed Loan Program (for more information, visit: www.rurdev.usda.gov/rbs/bus/b&i_gar.htm).

The general objective of this program is to improve the economy and quality of rural life. A B&I loan guarantee from USDA reduces a bank’s risk to only 20 percent in the event of default on loans of $5 million or less. When used for employee ownership of businesses with a solid track-record and sound plan for the future, this program saves jobs and improves commercial and retail services in rural America. Assisting a business that operates profitably in a given location to continue to operate after its owners put it up for sale fully meets the mission area objective.

Applying for a USDA B&I loan guarantee to support employee ownership can make many businesses more sustainable than they would be under a narrow ownership by a single entrepreneur. A more widely distributed ownership held by employees removes periodic discontinuity each time a major or single owner seeks an exit strategy for retirement.

A wide range in age distribution of employee-owners can stabilize a business from the standpoint of continuity in leadership, experience and critical skills as retirements periodically occur. Employees are highly motivated to keep a business going because their jobs are at stake.

As of early 2008, only two B&I loan guarantees had been made for employee ownership of a business. Both of these guarantees were made to transition two family-owned businesses into ESOPs. Both were provided by USDA Rural Development’s Pennsylvania office. One was an electrician service company. The other is described in more detail below.

**Doucette Industries Inc.**

The term “small business” is defined as a business with less than 500 employees, which comprises a wide range of companies in terms of employment, but also in the volume of sales, assets and management complexity. Two examples of small businesses in rural communities with modest holdings of physical assets — one operating as an ESOP and the other as a worker cooperative — are profiled in *Rural Cooperatives* magazine, July/August 2007, pages 28-31 (past issues are online at: www.rurdev.usda.gov/rbs/pub/openmag.htm).

Employee-owned companies are also represented in industries with relatively complex manufacturing. Doucette Industries, Inc. is one example. It produces a range of standard and specialized heat exchangers for refrigeration and air conditioning applications. It was owned by one family until a program of employee stock purchase was started in 1993. In 2003, a complete ownership transfer to employees was made as an ESOP company.

Headquartered in York, Pa., Doucette Industries has added a production location in Clearwater, Fla. It has 40 employees with annual sales that average between $6 million and $7 million. It provides customized heat exchanger development to meet very specific customer needs. In fact, Doucette serves customers throughout the world. Its website provides details on its capabilities and services (www.doucetteindustries.com).

**Employee ownership in stages**

Doucette Industries began succession planning in 1993 when it started a program for employee stock ownership. At that time, a father and two sons were sole owners. When it incorporated, company stock was divided into two classes, with voting shares of about 25 percent and 75 percent as non-voting stock.

The father held slightly more than 50 percent of the voting shares. As part of their compensation, in 1993 employees began to annually receive shares of non-voting stock.

By 2003, most of the non-voting stock, or about $2.25 million worth, had been transferred to employees. To complete the ownership conversion to a 100-percent ESOP, $750,000 in voting shares and an additional $250,000 in non-voting stock needed to be purchased. Two separate bank loans to Doucette Industries were necessary to transfer that amount of stock. But banks usually require some type of personal guarantee on loans for the purchase of equity.

The USDA Rural Development office in Pennsylvania was contacted by Doucette Industries about financing the ownership transfer to avoid personal guarantees. After examining the company’s financial condition and its earnings prospects for the future, USDA approved the B&I loan guarantee for the larger loan.

**A bridge to new generations of ownership**

The employees of Doucette Industries today have more control over their economic destiny because they have a voice in such decisions as job reductions or plant closure, as well as in more positive directions such as hiring and business expansion. Creating an ESOP at Doucette Industries was not only good for employees, but also made it feasible for the owners to defer taxes on capital gains from the sale of their business.

The transition of family-owned businesses to non-family members is often a far more financially difficult process than is the sale of firms with publicly traded stock. Rural communities also have fewer buyers for their businesses than those located in urban areas. In turn, a closure of a business in rural areas often results in population losses as unemployed workers may need to seek jobs elsewhere.

The Rural Development B&I loan guarantee program has potential to be an effective “bridge” for making it possible for workers to keep many family-founded businesses in operation for the future.