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## **USDA B&I Loan Guarantee Program**

### **The Push for Change**

The USDA Business and Industry (“B&I”) Loan Guarantee Program commenced in 1972, as authorized by the Rural Development Act of 1972.<sup>1</sup> The program is designed to “improve, develop, or finance business, industry, and employment and improve the economic and environmental climate in rural communities.”<sup>2</sup> It achieves this goal by strengthening the credit structure that lends money to rural communities “through the guarantee of quality loans that will provide lasting community benefits.”<sup>3</sup>

In 2007, Dr. John Logue, the founder of the Ohio Employee Ownership Center and professor of political science at Kent State University, spoke with USDA economist Bruce J. Reynolds about the possibility of using USDA loan programs to better support financing of ownership conversions in rural communities. Inspired by Dr. Logue, Bruce J. Reynolds began to push for changes to make the USDA B&I Loan Guarantee Program more supportive of business transfer from retiring, rural business owners to their employees.<sup>4</sup>

The first change came in a rule proposed on December 17, 2008. This rule proposal directly addressed some of the concerns Dr. Logue had expressed to Bruce J. Reynolds. It proposed allowing “distribution or payment to an individual owner, partner, stockholder, or

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<sup>1</sup> Guaranteed Loanmaking and Servicing Regulations, 81 Fed. Reg. 35,984, 35,988 (June 3, 2016) (to be codified at 7 C.F.R. pts. 4279, 4287).

<sup>2</sup> 7 C.F.R. § 4279.101(b) (2016).

<sup>3</sup> *Id.*

<sup>4</sup> Dan Campbell, *Co-op Developments, Coast to Coast*, RURAL COOPERATIVES, Sept./Oct. 2015, at 43.

beneficiary of the borrower or the immediate family of such an individual when...the distribution or payment is part of the transfer of ownership within: (i) the immediate family; or (ii) an employee-owned cooperative.”<sup>5</sup> This was adopted even though comments from lenders were extremely negative.<sup>6</sup>

In 2009, Bruce J. Reynolds began a campaign to further improve the B&I Program’s applicability to employee conversion. He began to build a backstory that revealed the necessity for further changes. The existing rules required a selling owner to immediately exit the business. He pointed out that requiring immediate exit of the owner severely limited the applicability of the USDA B&I program for employee conversion. He noted that immediate transfer of ownership was sometimes viable for conversion into a worker cooperative, but he argued that many owners desire to stay on for a period of time in order to share expertise and have their equity redeemed. Moreover, he made clear that immediate exit was simply unworkable for the gradual transfer of ownership into an Employee Stock Ownership Plan (ESOP) that allows a selling owner to take advantage of a 1042 rollover.<sup>7</sup> In light of these limitations, he argued for a transition period for employee conversion.

He further accentuated the need for change by directing attention to the impending “silver tsunami” and its likely effect on rural communities. Silver tsunami is a term for the purported mass exodus of baby boomers from the workplace as the baby boomer generation reaches retirement age. Every generation reaches retirement age at some point, but the baby boomer generation is not any generation. It is a generation that from the start was far larger than any that

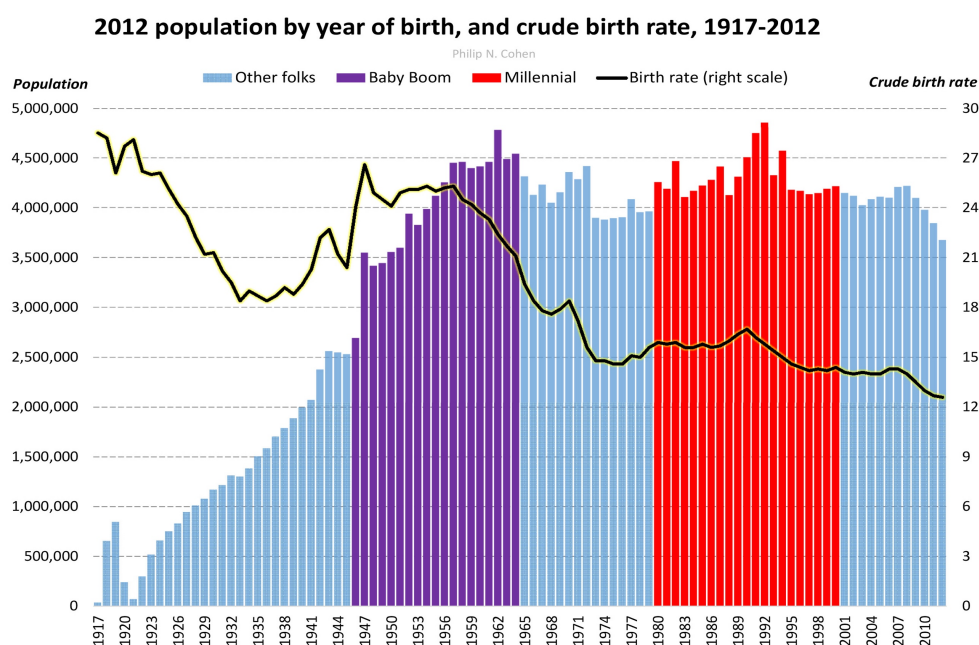
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<sup>5</sup> 73 Fed. Reg. 76,503, 76,788 (Dec. 17, 2008).

<sup>6</sup> Bruce J. Reynolds, *Applying USDA Programs to Assist Worker Ownership*, DOCSLIDE (Feb. 8, 2017, 5:32 PM), <http://documentslide.com/documents/applying-usda-programs-to-assist-worker-ownership-bruce-j-reynolds-usdarural.html>.

<sup>7</sup> *Id.*

came before it. It is a generation that has carried its mass through into old age due to increasing life expectancy. The situation created by this great number of baby boomers coming of retirement age has been referred to as a tsunami due to fear of a sudden mass exodus from the workplace with catastrophic effects. For example, the US Bureau of Labor Statistics predicts that one out of ten workers will retire in 2017 or 2018.<sup>8</sup> Bruce J. Reynolds specifically expressed worry that baby boomers retiring in rural areas will not have children willing to take over the business and will have few local investors willing to take over and continue running the business. This, he explained, would likely funnel the coming sales of rural businesses toward non-local competitors who, instead of continuing to operate those rural businesses, will scrap them for parts, equipment, or inventory.<sup>9</sup> This would gut rural America.



Some have theorized that there will be several small waves rather than one tsunami; the changes proposed by Bruce J. Reynolds would account for the reasons for those waves too.

<sup>8</sup> Meghan M. Biro, *Preparing for the Retirement Boom*, HUFFINGTON POST (July 27, 2016), [http://www.huffingtonpost.com/meghan-m-biro/-preparing-for-the-retirem\\_b\\_11208530.html](http://www.huffingtonpost.com/meghan-m-biro/-preparing-for-the-retirem_b_11208530.html).

<sup>9</sup> Bruce J. Reynolds, *Building a Bridge for Ownership Succession*, RURAL COOPERATIVES, Jan./Feb. 2009, at 10.

Economists have been predicting a mass exodus for many years. It simply has not happened. There are many reasons for this, not least of which are the financial instability of those nearing retirement age and that demographic's desire to remain professionally active.<sup>10</sup> By allowing owners to stay on for a certain period of time after employee conversion, the changes proposed by Bruce J. Reynolds would allow continued wage-earning for a period of years, thereby mitigating some of the concern about financial instability, and would allow continued professional involvement, thereby meeting the demographics' desire for continued professional community.

On September 15, 2014, the USDA published a proposed change to the B&I program that implemented many of the changes Bruce J. Reynolds had been arguing for 2007. This proposed change was submitted for a 60-day period of public comment.<sup>11</sup> On October 23, 2014, Brenda Griffin and Bruce J. Reynolds of the USDA participated in a webinar sponsored by the National Cooperative Business Association. Parties interested in the rule attended and were given the background information necessary to make meaningful comments on the rule proposal's employee conversion provisions.<sup>12</sup> Shortly thereafter, national organizations that support employee ownership began to urge their followers to comment on the proposed rule. The National Cooperative Business Association published a call-to-comment on its webpage shortly after the webinar.<sup>13</sup> It included a drafted potential comment that highlighting the benefits of

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<sup>10</sup> Meghan M. Biro, *Preparing for the Retirement Boom*, HUFFINGTON POST (July 27, 2016), [http://www.huffingtonpost.com/meghan-m-biro-/preparing-for-the-retirem\\_b\\_11208530.html](http://www.huffingtonpost.com/meghan-m-biro-/preparing-for-the-retirem_b_11208530.html).

<sup>11</sup> Guaranteed Loanmaking and Servicing Regulations, 79 Fed. Reg. 55,316 (proposed Sept. 15, 2014) (to be codified at 7 C.F.R. pts. 4279, 4287).

<sup>12</sup> *Take Action by Nov. 14!: NCBA CLUSA Requesting Comments to USDA on the Business & Industry Guaranteed Loan Program*, NBCA CLUSA (Feb. 8, 2017, 5:51 PM), <http://www.ncba.coop/press-releases/788-take-action-by-nov-14-ncba-clusa-requesting-comments-to-usda-on-the-business-industry-guaranteed-loan-program>.

<sup>13</sup> *Id.*

cooperative worker ownership both for sustaining wealth and for developing community infrastructure in rural areas. It pitched employee conversion as a solution to the silver tsunami. It argued that owners possess a wealth of managerial and operational knowledge and as such should be allowed to stay involved in the business for a period of time to impart that wisdom to employees.<sup>14</sup> On November 7, 2014, the Democracy at Work Institute of the United States Federation of Worker Cooperatives released its own call-to-comment. It provided a list of talking points echoing those from the National Cooperative Business Association.<sup>15</sup>

At the end of the 60-day comment period, 233 comments had been made on the rule proposal and 175 of those comments were in support of allowing an owner to stay involved in a phased ownership transition into an ESOP or cooperative.<sup>16</sup> Most of the comments paraphrased the call-to-comment released by the Democracy at Work Institute. The majority of these comments came from individuals without any listed affiliation to cooperative organizations or ESOPs. However, several comments did come from individuals affiliated with such businesses.

A sampling of these is as follows:

- ALT Banking Group, New York, NY
- The Bailey Group LLC, Annandale, VA
- Common Enterprise Development Corporation, Mandan, ND
- CooperationWorks!, Lindstrom, MN
- Democracy Collaborative, Cleveland, OH
- Equal Exchange, Boston, MA
- Great Sky Solar, Brookline, MA
- Human Agenda, San Jose, CA
- Lowcountry Local First, Charleston, SC
- National Association of Housing Cooperatives, Washington, D.C.
- National Center for Employee Ownership, Oakland, CA

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<sup>14</sup> *Id.*

<sup>15</sup> *ACTION ALERT: USDA Rule Change Affecting Worker Coops – Comment by 11/14*, DEMOCRACY AT WORK INSTITUTE (Feb. 8, 2017, 5:56 PM), [http://institute.coop/action\\_alert\\_USDA\\_rule\\_change](http://institute.coop/action_alert_USDA_rule_change).

<sup>16</sup> Guaranteed Loanmaking and Servicing Regulations, 81 Fed. Reg. 35,984, 35,988, 35,991 (June 3, 2016) (to be codified at 7 C.F.R. pts. 4279, 4287).

- National Cooperative Business Association, Washington, DC
- New York City Network of Worker Cooperatives, New York, NY
- Ownership Associates, Inc., Cambridge, MA
- People’s Food Co-Op, Portland, OR
- Rainbow Grocery Cooperative, San Francisco, CA
- Stanford Graduate School of Business, Stanford, CA
- Sustainable Economies Law Center, Oakland, CA
- UCLA Luskin School of Public Affairs, Los Angeles, CA
- Vermont Employee Ownership Center, Burlington, VT
- Webskillet Cooperative, Burlington, VT
- Whispering Winds Bamboo Cooperative, Inc., Hana, HI
- Worker’s Justice Project, Brooklyn, NY<sup>17</sup>

On June 3, 2016, the rule proposal from November 2014 went into effect. It was revised on August 2, 2016 to correct for three technical errors.<sup>18</sup>

### **The New Rule: General Requirements for Borrowers**

#### *The Rural Requirement*

USDA B&I Loan Guarantees are administered by USDA Rural Development and as such are available, with a few exceptions, only in rural areas. For eligibility purposes, rural areas are defined as “[a]ny area of a State other than a city or town that has a population of greater than 50,000 inhabitants and any urbanized area contiguous and adjacent to such a city or town.”<sup>19</sup> The USDA uses the latest decennial census to determine which areas have under 50,000 residents.<sup>20</sup> As it turns out, most of the geographic area of the United States is composed of localities with less than 50,000 residents. For example, on the map below, only the areas colored purple are not rural. Thankfully, the USDA spares interested parties the chore of looking through the last

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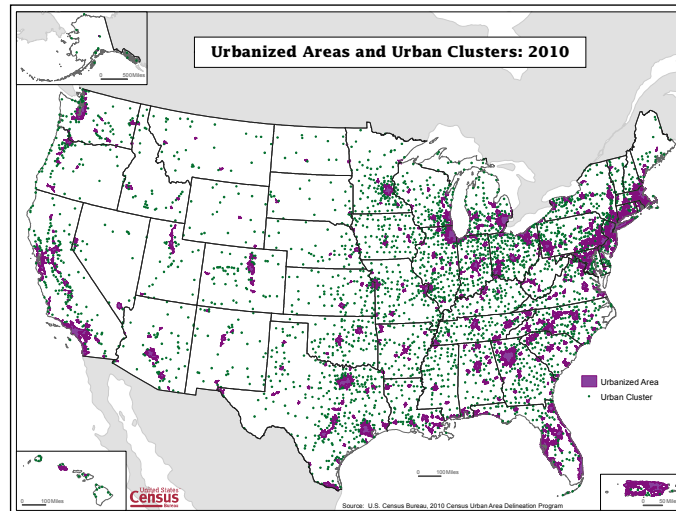
<sup>17</sup> Comments on 2014 FR Doc # 2014-21351, REGULATIONS.GOV, <https://www.regulations.gov/searchResults?rpp=25&po=0&s=comment%2Bon%2BFR%2BDoc%2B%23%2B2014-21351&dct=PS>.

<sup>18</sup> Guaranteed Loanmaking and Servicing Regulations, 81 Fed. Reg. 54,477 (Aug. 16, 2016) (to be codified at 7 C.F.R. pts. 4279, 4287).

<sup>19</sup> 4279.108(c)(1)-(7).

<sup>20</sup> 4279.108(c)(1).

decennial census to determine if their business is in a rural area. The USDA includes a tool on its website that allows users to find out if a particular address is in a rural area.<sup>21</sup>



The USDA will make certain exceptions to the rural requirement. For example, the Under Secretary of USDA Rural Development can determine that an area designated as urban according to the definition of rural area in 4279.108(c)(1) is in fact “rural in character.”<sup>22</sup> Areas determined to be rural in character must be within “[a]n urbanized area that has two points on its boundary that are at least 40 miles apart, which is not contiguous or adjacent to a city or town that has a population of greater than 150,000 inhabitants or the urbanized area of such city or town; or an area within an urbanized area contiguous and adjacent to a city or town of greater than 50,000 inhabitants that is within ¼ mile of a rural area.”<sup>23</sup> This definition must be assigned to a locality before USDA B&I Loan Guarantees are available in that locality. In order to have

<sup>21</sup> USDA.Gov (Feb. 8, 2017, 6:10 PM), <https://eligibility.sc.egov.usda.gov/eligibility/welcomeAction.do?pageAction=rbs>.

<sup>22</sup> 7 C.F.R. § 4279.108(c)(7) (2016).

<sup>23</sup> *Id.*

this definition applied to a locality, a local government or Rural Development State Director must petition the Under Secretary of USDA Rural Development.<sup>24</sup>

### The Citizenship Requirement

In order to be eligible for receipt of a USDA B&I Loan Guarantee, individuals must meet certain citizenship requirements and private entities must demonstrate certain commitments to keeping profits within the United States. An individual borrower must be either a citizen of the United States or a legally admitted permanent resident in possession of a permanent green card. In past iterations of the B&I rules, private entities had to demonstrate that they were owned mainly by American citizens. Now, they need only demonstrate that “loan funds will remain in the United States” and that the financing covered by the loan guarantee will “create new or save existing jobs for U.S. rural residents.”<sup>25</sup>

### The Entity-Type Requirement

The entity requirements for USDA B&I loans are fairly expansive. Eligible entities include cooperative organizations, corporations, partnerships, and other legal entities that are operated either on a profit or nonprofit basis.<sup>26</sup> A cooperative organization is defined as “[a]n entity that is legally chartered as a cooperative or an entity that is not legally chartered as a cooperative but is owned and operated for the benefit of its members, with returns of residual earnings paid to such members on the basis of patronage.”<sup>27</sup>

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<sup>24</sup> 7 C.F.R. 4279.108(c)(7)(i)-(ii) (2016).

<sup>25</sup> *Id.* at § 4279.108(b).

<sup>26</sup> *Id.* at § 4279.108(a).

<sup>27</sup> *Id.* at § 4279.2(a).



## **The New Rules: General Requirements for Lenders**

### **Regulated and Non-regulated Lenders**

USDA B&I Loan Guarantees may be offered on top of loans from either regulated or non-regulated lenders. Regulated lenders include federal chartered banks, state chartered banks, farm credit banks, other Farm Credit System institutions with direct lending authority, banks for cooperatives under the Federal Farm Credit System, savings and loan associations, savings banks, the National Rural Utilities Cooperative Finance Corporation, and mortgage companies that are part of a bank-holding company.<sup>28</sup> In addition, credit unions may qualify as regulated lenders if they are “subject to credit examination and supervision by either the National Credit Union Administration or a State agency.”<sup>29</sup>

Non-regulated lenders may also issue loans covered by USDA B&I Loan Guarantees. Non-regulated lenders are lenders that do not fit within any category of regulated lender per 4279.29(a) but do meet extensive requirements detailed within 4279.29(b).

### **The New Rules: Applicability to Ownership Conversion**

The June 3, 2016 edition of the rule includes employee ownership succession as an eligible loan purpose. It provides that B&I loans can be issued to finance ownership conversion to either a worker cooperative or an ESOP. It requires that transitions be completed within five years of the initial transfer of stock.<sup>30</sup> With respect to ESOPs, this means that the selling owners must no longer be owners when five years have passed since the initial transfer of stock.<sup>31</sup> With respect to cooperatives, this means that the selling owners can stay on with the cooperative after the fifth year as members so long as they have control rights equal to that of other members.

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<sup>28</sup> 7 C.F.R. § 4279.29(a) (2016).

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at § 4279.115(c) (2016).

<sup>31</sup> *Id.* at § 4279.115(c)(6).

However, in the period between the initial sale of stock and the five-year mark, the selling owners are members with “special rights to protect their stake in the business while a succession plan is implemented.”<sup>32</sup>

Other provisions of the new rule clarify that funds for conversion of the business to either a worker cooperative or an ESOP can be distributed to immediate family of the selling owner. Immediate family is defined as “individuals who live in the same household or who are closely related by blood, marriage, or adoption, such as a spouse, domestic partner, parent, child, sibling, aunt, uncle, grandparent, grandchild, niece, nephew, or cousin.”<sup>33</sup> Immediate family of a selling owner can have funds distributed to them so long as the selling owner does not retain an ownership interest.<sup>34</sup> Therefore, immediate family can be a part of the group of employees borrowing funds to form an ESOP or a worker cooperative.

### **Substance of Loan Guarantees for Employee Conversion**

The maximum loan amount for purchase of stock by employees forming either a worker cooperative or Employee Stock Ownership Plan is \$600,000.<sup>35</sup> Loans of less than \$5 million dollars can be guaranteed up to eighty percent.<sup>36</sup> Therefore, a loan of \$600,000 from a lender in order to purchase stock in a cooperative or ESOP can be guaranteed by the USDA for up to 80% of the value of the loan, or \$480,000. This maximum is not guaranteed. The actual percentage of

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<sup>32</sup> *Id.* at § 4279.115(c)(5).

<sup>33</sup> 7 C.F.R. § 4279.2(a) (2016).

<sup>34</sup> *Id.* at § 4279.117(a).

<sup>35</sup> *See* Guaranteed Loanmaking and Servicing Regulations, 81 Fed. Reg. 35,984, 35,985 (June 3, 2016) (to be codified at 7 C.F.R. pts. 4279, 4287); 7 C.F.R. § 4279.113(k) (2016); 7 C.F.R. § 4279.115(c) (2016); 7 C.F.R. § 4279.61(c) (2016).

<sup>36</sup> 7 C.F.R. § 4279.119(b) (2016).

the guarantee depends on negotiations between the lender and the USDA.<sup>37</sup> Generally, the guarantee is between 60% and 80% of the loan value.<sup>38</sup>

Although 80% is generally the maximum amount of the guarantee, there are two situations that may merit a maximum guarantee of up to 90% of the value of the loan. This first situation obtains if the lender provides sufficient documentation to demonstrate that the loan will not be made “due to the bank’s legal or regulatory lending limit” unless a higher percentage of the loan is guaranteed.<sup>39</sup> This is relevant mainly for midsize and community banks which have lower lending limits than larger banks. The portion of the loan guaranteed by the USDA does not count against a bank’s legal lending limit, and because the USDA supports rural communities, they may be willing to adjust the guaranteed amount upward to support rural banks and thereby support rural communities.<sup>40</sup> The second situation obtains if the project is a high-priority project, meaning a project that scores more than “50 percent of the priority points available under §4279.166(b)(1) through (5).”<sup>41</sup> This would mean scoring over 75 of the 150 points available in that section. The priority point system is described in the tables below.

#### *Likelihood of Guarantees Being Given for Employee Conversion*

The same priority points that determine whether a loan may be guaranteed for 90% determine the order in which loan guarantees will be awarded. In the past, all applications were held until a certain date and then reviewed together. This is no longer the case. Now, applications and pre-applications are considered in the order received. However, applications are still

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<sup>37</sup> *Id.*

<sup>38</sup> FREQUENTLY ASKED QUESTIONS, USDA.GOV, [https://www.rd.usda.gov/files/BCP\\_BI\\_LEAP\\_LEAPfaqs.pdf](https://www.rd.usda.gov/files/BCP_BI_LEAP_LEAPfaqs.pdf).

<sup>39</sup> *Id.* at § 4279.119(b)(2).

<sup>40</sup> FREQUENTLY ASKED QUESTIONS, USDA.GOV, [https://www.rd.usda.gov/files/BCP\\_BI\\_LEAP\\_LEAPfaqs.pdf](https://www.rd.usda.gov/files/BCP_BI_LEAP_LEAPfaqs.pdf).

<sup>41</sup> *See* 7 C.F.R. § 4279.119(b)(1) (2016); 7 C.F.R. § 4279.2(a) (2016).

weighed against other pending applications to determine which loans will be awarded funding.<sup>42</sup>

Priority points are awarded according to the total points earned in the following categories:

<b>Occupation Priority</b>	
Business that creates or saves jobs with an average wage exceeding 125 percent of the Federal minimum wage.	5 points
Business that creates or saves jobs with an average wage exceeding 150 percent of the Federal minimum wage.	5 points
Business that offers a healthcare benefits package to all employees, with at least 50 percent of the premium paid by the employer.	5 points

<b>Population Priority</b>	
Projects located in an unincorporated area or in a city with a population under 25,000.	10 points

<b>Demographics Priority</b>	
Located in an eligible area of long-term population decline according to the last three decennial censuses.	5 points
Located in a rural county that has had 20 percent or more of its population living in poverty based on the last three decennial censuses.	10 points
Located in a rural community that is experiencing trauma as a result of natural disaster.	5 points
Located in a city or county with an unemployment rate 125 percent of the Statewide rate or greater.	5 points
Located within the boundaries of a Federally recognized Indian tribe's reservation, within tribal trust lands, or within land owned by an Alaska Native Regional or Village Corporation as defined by the Alaska Native Claims Settlement Act.	5 points
Business is owned by a qualified veteran as defined by § 4279.2.	5 points

<sup>42</sup> 7 C.F.R. § 4279.166 (2016).

<b>Loan Features Priority</b>	
Lender will price the guaranteed loan at an interest rate equal to or less than the equivalent of the Wall Street Journal published Prime Rate plus 1.5 percent.	5 points
Lender will price the guaranteed loan at an interest rate equal to or less than the equivalent of the Wall Street Journal published Prime Rate plus 1 percent.	5 points
The Agency guaranteed loan is less than 60 percent of project cost.	5 points
The Agency guaranteed loan is less than 50 percent of project cost.	5 points
The Agency guaranteed loan is less than 40 percent of project cost.	5 points
For loans not requesting an exception under § 4279.119(b), the percentage of guarantee is 10 or more percentage points less than the maximum allowable for a loan of its size.	5 points

<b>Business / Industry Priority</b>	
Industry that is not already present in the community.	5 points
Business that has 20 percent or more of its sales in international markets.	5 points
Business that offers high value, specialized products and/or services that command high prices.	5 points
Business that provides an additional market for existing local businesses.	5 points
Business that is locally owned and managed.	5 points
Business that will produce a natural resource value-added product.	5 points
Business that processes, distributes, aggregates, stores, and/or markets locally or regionally produced agricultural food products to underserved communities in accordance with § 4279.113(y)(5).	10 points

An additional ten points can be awarded by both the State Director and the National Director according to certain economic and community criteria.<sup>43</sup>

<sup>43</sup> 7 C.F.R. § 4279.166(b)(5) (2016).

Applications for loans to fund employee conversion seem slightly disadvantaged compared to applications for other purposes. This is because some of the priority points categories seem facially inapplicable to employee conversion while others do not clearly apply to employee conversion.

One of the demographics' categories is not clear as applied to employee conversion. That category is business ownership by a veteran.<sup>44</sup> By definition, both worker cooperatives and ESOPs have multiple owners. In light of that, it is unclear whether the five priority points for this category can be awarded to a cooperative or an ESOP that has veterans among the owners but not a veteran as its sole owner. Moreover, those employees borrowing money to convert a business to either an ESOP or a worker cooperative are not owners until the transition is complete. Therefore, they likely do not qualify as owners at the time of borrowing, and therefore cannot be veteran owners. Nevertheless, it is not clear that this significantly disadvantages applications for employee conversion, because there is no data on how many veteran owners apply for USDA B&I loans.

Two of the occupation categories are not clearly applicable to employee conversion. Each of these categories awards five priority points to businesses that create or save jobs paying average wages either above 125% or 150% of the Federal minimum wage.<sup>45</sup> Loans for employee conversion are unlikely to create jobs because they are intended to transfer ownership to existing, not new, employees. Furthermore, although loans for employee conversion may save jobs, it is unclear if the relation between employee conversion and saving of jobs is direct enough to qualify employee conversion for these priority points. In some cases, it seems that evidence could be produced showing that the business owner was contemplating closing the business

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<sup>44</sup> *Id.* at § 4279.166(b)(2)(vi) (2016).

<sup>45</sup> *Id.* at § 4279.166(b)(4)(ii)(A)-(B).

before he or she decided sale to employees was a possibility. This position finds support in reasons Bruce J. Reynolds articulated for adopting the transitional period. He explicitly stated that “gradual succession of ownership to employees will . . . save businesses, and hence jobs.”<sup>46</sup>

Two of the business or industry categories seem facially inapplicable to employee conversion. These categories award five points, respectively, for industries not already present within a community and businesses that provide an additional market for existing local businesses.<sup>47</sup> Given that employee conversion is conversion of an existing business, employee conversion does not provide a new market or to create an industry not already present in a community.

These inapplicable categories limit the competitiveness of applications for employee conversion. Should all of these questionable categories be inapplicable, 25 of the 150 available points, or 17% of the available points, would be unavailable for employee conversion applications. Should the two categories regarding retention of well-paying jobs be applicable, as seems fairly likely, only 15 of the possible 150 points would be inapplicable to employee conversion. This would still be 10% of the available points. Neither of these deficits are insurmountable. However, they merit some caution in recommending the USDA B&I Loan Guarantee Program to those interested in employee conversion.

The need for caution can be understood by looking at the USDA’s data on B&I loan guarantees in California from 2009 to 2016.<sup>48</sup> As demonstrated in the charts below, USDA B&I

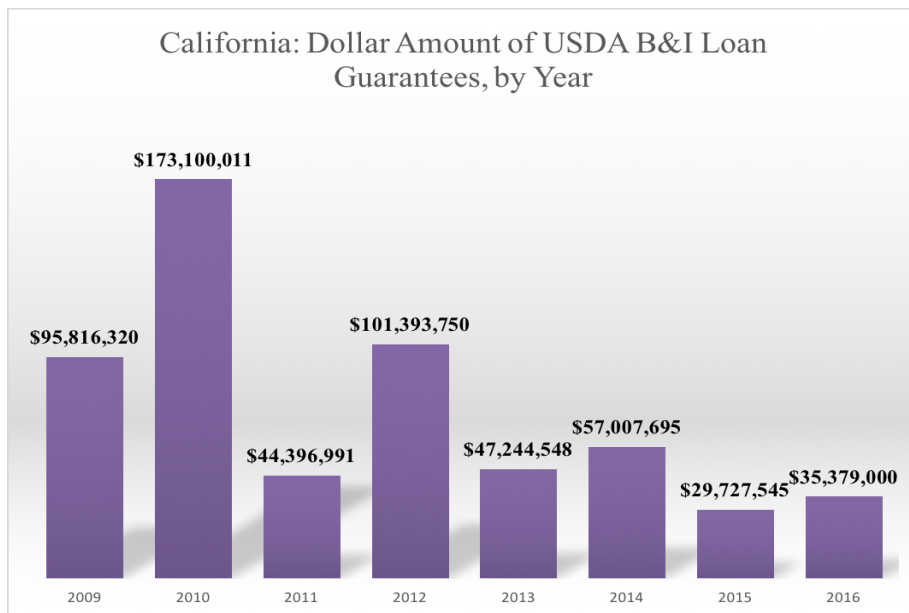
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<sup>46</sup> Bruce J. Reynolds, *Proposed Changes in USDA’s B&I Program Could Aid in Development of New Co-ops*, RURAL COOPERATIVES, Jan./Feb. 2015, at 19.

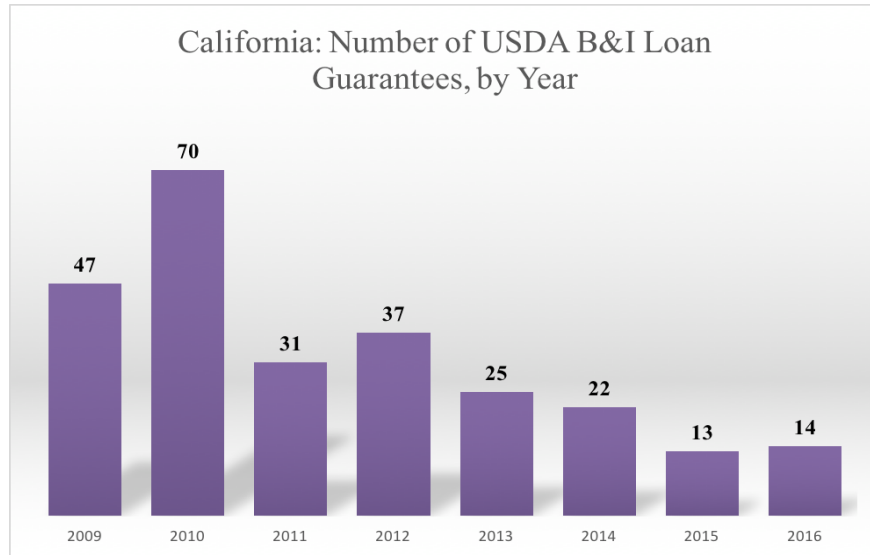
<sup>47</sup> 7 C.F.R. § 4279.166(b)(4)(i)(A), (D).

<sup>48</sup> See USDA RURAL DEVELOPMENT, 2013 PROGRESS REPORT (2013), p. 33, [https://www.rd.usda.gov/files/reports/RD\\_2013ProgressReport.pdf](https://www.rd.usda.gov/files/reports/RD_2013ProgressReport.pdf); USDA RURAL DEVELOPMENT, 2014 PROGRESS REPORT (2014), p. 26, <https://www.rd.usda.gov/files/RD2014ProgressReport.pdf>; USDA RURAL DEVELOPMENT, 2016

Loan Guarantees in California have been decreasing in number relatively consistently and quickly since a high point in 2010. In the past two years, only thirteen and fourteen USDA B&I Loan Guarantees, respectively, have been made in the entire state. This could be a signal that the USDA B&I program is an untapped resource. After all, several years have seen more than thirty loans being made per year. However, even if that is the case, the dollar amount of loans per year divided by the number of loans per year suggests an average loan amount of around \$2.5 million dollars. This may not be the actual average loan amount, but if it is, it is not clear that the USDA would prioritize loans for employee conversion, which are capped at \$600,000 over larger loans which would purportedly support more business in rural communities. In sum, the data could suggest a green light to tap a wealth of untapped USDA B&I Loan Guarantee potential or it could suggest a yellow light, which together with a relative lack of priority points available to employee conversion, urges caution.







### The Application Process

Should a party interested in employee conversion choose to go ahead with an application for a USDA B&I Guarantee, they and their lender should be sure to submit a pre-application first.<sup>49</sup> The USDA will provide comments on the pre-application. These comments should inform the subsequent application, making it more likely to succeed. Comments should be provided by the USDA within thirty days of pre-application submission.<sup>50</sup>

When submitting an application, those looking to utilize the USDA B&I Loan Guarantee for employee conversion will always use the short form of the application. The short form is required for all loan requests of less than \$600,000, and the cap for employee conversion loans is \$600,000.<sup>51</sup> This short form requires lenders to submit various items. None of these pose any undue, particular burden on employee conversion.<sup>52</sup>

<sup>49</sup> *Id.* at § 4279.161.

<sup>50</sup> See Guaranteed Loanmaking and Servicing Regulations, 81 Fed. Reg. 35,984, 35,995 (June 3, 2016) (to be codified at 7 C.F.R. pts. 4279, 4287).

<sup>51</sup> See 7 C.F.R. § 4279.161(c) (2016); Guaranteed Loanmaking and Servicing Regulations, 81 Fed. Reg. 35,984, 35,985 (June 3, 2016) (to be codified at 7 C.F.R. pts. 4279, 4287).

<sup>52</sup> 7 C.F.R. § 4279.161(c) (2016).

### **The New Rule: Lack of Clarity with Regard to Employee Conversion**

In one important respect, the new rules about loans for employee conversion are not clear. It is unclear if funds can be applied to fund conversion to a worker cooperative that is not legally incorporated as a cooperative but that nevertheless functions as a cooperative. Under the section specifying eligible loan purposes, loans are allowed for conversion to a “worker cooperative.”<sup>53</sup> However, the definitions section of 7 C.F.R. § 4279 provides a definition of “cooperative organization” but no definition of worker cooperative.<sup>54</sup> A cooperative organization is defined to include both an entity chartered as a cooperative and “an entity that is not legally chartered as a cooperative but that is owned and operated for the benefit of its members, with returns of residual earnings paid to such members on the basis of patronage.”<sup>55</sup> Throughout 7 C.F.R. § 4279, the term cooperative organization is used for all references to loans for cooperatives except for loans for the purposes of employee conversion. When the topic shifts to employee conversion, the term “worker cooperative” is used in place of “cooperative organization.” This seems to suggest that loans are available only for conversion to legally chartered worker cooperatives. However, this is not explicitly stated within the statute so it is nonetheless possible that the broad idea of cooperative from the definition of “cooperative organization” may apply.

### **Secondary Benefits for Selling Owners**

Owners should be aware of the tax benefits of employee conversion. Changes in federal tax laws in 1984 created the 1042 rollover. This 1042 rollover provides an incentive for owners to sell their companies to employees. It does so by allowing deferral of capital gains taxes on

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<sup>53</sup> *Id.* at § 4279.113(k).

<sup>54</sup> *Id.* at § 4279.2(a).

<sup>55</sup> *Id.*

stock sold to employees. This deferral is available if the sale proceeds are used to purchase stock in another company in the United States. The selling owner can then sell this stock when they have dropped to a lower tax bracket after retirement, thereby paying less in capital gains taxes. USDA B&I Loan Guarantees help make possible the purchase of at least 30% of the owner's stock in the first year of the transition to an ESOP. This helps make 1042 rollovers available to selling owners, because 30% of stock must be sold in the first year of transition to qualify for a 1042 rollover.<sup>56</sup>

Generally, 1042 rollovers are not as available to worker cooperatives as they are to ESOPs because many cooperative incorporation statutes require 100-percent ownership by employees within a relatively brief period of transition.<sup>57</sup>

#### **One Example of Conversion to ESOP Financed by a USDA B&I Loan Guarantee**

As of 2008, before the 2016 rule revision providing for a five-year window for succession, B&I Loan Guarantees had been used to finance only two conversions to employee ownership. One of these conversions took place at Doucette Industries in York, Pennsylvania. Doucette had 40 employees and annual sales of around \$6.5 million. It was owned by one family until an employee stock purchase program was started in 1993. At that time, employees began receiving non-voting stock as part of their compensation. By 2003, \$2.25 million of non-voting stock had been transferred to employees but \$750,000 in voting shares and an additional \$250,000 in non-voting stock needed to be purchased to complete the conversion. The employees of Doucette Industries did not want to personally guarantee the bank loan needed to purchase the remaining stock. Therefore, they applied for a guaranteed loan through the USDA

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<sup>56</sup> Bruce J. Reynolds, *Building a Bridge for Ownership Succession*, RURAL COOPERATIVES, Jan./Feb. 2009, at 10.

<sup>57</sup> *Id.*

B&I Loan Program. They were able to obtain two loan guarantees and the employee conversion was completed.<sup>58</sup>

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<sup>58</sup> *Id.*