U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

January 8, 2014

The Honorable Eric Swalwell
U.S. House of Representatives
Washington, DC 20515

Dear Representative Swalwell:

Acting Administrator Hulit has asked me to respond to your recent correspondence regarding the U. S. Small Business Administration's (SBA) regarding rules governing the 8(a) Business Development (BD) Program as they relate to Employee Stock Ownership Plans (ESOP).

The Small Business Act, as amended, (the Act), authorizes the SBA to assist eligible small disadvantaged business concerns to compete in the American economy through business development services. These services include technical and management assistance; financial assistance and assistance in performing prime contracts with the Federal Government.

As you correctly noted, SBA's current regulations mark companies owned by ESOPs to be ineligible for the benefits of the 8(a) BD Program. Under the Act, and 8(a) BD Program regulations, 13 CFR § 124.105, the 8(a) Participant must be at least 51% unconditionally and directly owned by one or more disadvantaged individuals. Additionally, the Participant must be controlled by disadvantaged individuals; a disadvantaged individual must be the highest ranking individual and must be the highest compensated; and, one or more disadvantaged individuals must be entitled to receive at least 51% of the annual distribution of dividends paid on the stock of a corporate applicant concern; 100% of the value of each share of stock owned by them in the event that the stock is sold; and, at least 51% of the retained earnings of the concern and 100% of the unencumbered value of each share of stock owned in the event of dissolution of the corporation.

A Participant owned principally by another business entity or by a trust (including ESOPs) that is in turn owned and controlled by one or more disadvantaged individuals does not meet the direct ownership criterion. However, ownership by a trust, such as a living trust, may be treated as the functional equivalent of ownership by a disadvantaged individual where the trust is revocable, and the disadvantaged individual is the grantor, a trustee and the sole current beneficiary of the trust.

An employee stock ownership plan (ESOP) is a retirement plan in which the company contributes its stock (or money to buy its stock) to the plan for the benefit of the company's employees. The plan maintains an account for each employee participating in the plan. Shares of stock vested over time before an employee is entitled to them. With an ESOP, employees never buy or hold the stock directly while still employed with the company. Any time new shares are issued, the stock of existing owners is diluted. If an employee is terminated, retires, becomes disabled or dies, the plan will distribute the shares of stock in the employee's account.

Although there are some exceptions, generally all full-time employees over the age of 21 participate in the plan. Allocations are made either on the basis of relative pay or some more equal formula. As employees accumulate seniority with the company, they acquire an increasing right to the shares in their account, a process known as vesting. Employees must be 100% vested within 3 to 6 years, depending on whether vesting is all at once (cliff vesting) or gradual.

When employees leave the company, they receive their stock, which the company must buy back from them at its fair market value (unless there is a public market for the shares). Private companies must have an annual outside valuation to determine the price of their shares. In private companies, employees must be able to vote their allocated shares on major issues, such as closing, selling, or relocating, but the company can choose whether to pass through voting rights (such as for the board of directors) on other issues. In public companies, employees must be able to vote all issues.

Based on the above, SBA could not conclusively determine, at the time of its review of an application submitted by a company owned by an ESOP to participate in the 8(a) BD program, that disadvantaged individuals unconditionally and directly owned and controlled the applicant concern and that the majority of the benefits of program participation would flow to the intended individuals. However, and ESOP can own up to a 49% of a firm that is determined to be eligible to participate in the 8(a) BD Program. In such an instance, a disadvantaged individual(s) must unconditionally and directly own at least 51% of the concern; control the concern; is the highest ranking and highest compensated individual; and, one or more disadvantaged individuals are entitled to receive at least 51% of the annual distribution of dividends paid on the stock of a corporate applicant concern; 100% of the value of each share of stock owned by them in the event that the stock is sold; and, at least 51% of the retained earnings of the concern and 100% of the unencumbered value of each share of stock owned in the event of dissolution of the corporation.

We appreciate your continued support of SBA and the small business community. If you and your staff have any questions, please contact the SBA Office of Congressional and Legislative Affairs at (202) 205-6700.

Sincerely,

Darryl K. Hairston
Associate Administrator
Office of Business Development