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Subject: **A State or City Holding Company to Block the Leveraged Buyout of the U.S. Real Economy – A Local Economy Preservation Fund – using the Federal Reserve's Municipal Liquidity Facility**

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Summary: To preserve local businesses at risk of failure or being sold at fire sale prices to private equity and absentee corporations, states and cities could create holding companies – Local Economy Preservation Funds (LEPFs) – to purchase small and medium-size enterprises, hold them during the crisis, and refloat in the recovery. Financing might come from the Federal Reserve's Municipal Liquidity Facility, or from private or philanthropic capital. To ensure firms remain locally owned and in the public interest, the funds could support existing owners through the crisis, or mandate or preference exit of firms to local owners, to ESOPs and cooperatives, to state and local governments, or to people of color. Policymakers should put in place incentives to support employee buyouts. Some firms might remain in municipal or state ownership over the long run, generating public income. Some funds might be organized explicitly to serve businesses owned by or employing high numbers of people of color.

After The Democracy Collaborative (TDC) published the concept of LEPFs, and spoke at the National League of Cities about it, a variety of communities reached out. Two have already formed to pursue creation of LEPFs, one in Broward County, FL, the other in Asheville, NC, both of whom are working with TDC. TDC is also in dialogue with European leaders in Wales and Amsterdam on the same concept. A white paper on the concept will be released in July by TDC. Also TDC is at work on a four-part series of short videos on LEPFs and the Municipal Liquidity Facility, in partnership with the National League of Cities.

As the COVID-19 pandemic-related shutdown of the economy extends into the future and becomes protracted, large numbers of U.S. businesses are increasingly at risk of bankruptcy and dissolution. In a terrifying number of cases, these businesses will simply disappear, taking with them tens of millions of jobs and causing the further decimation of local economies and economic equality. In other instances, waiting in the wings are private equity funds looking to acquire valuable but distressed assets for pennies on the dollar. Blackstone already has a $1.5 trillion war chest ready for the "unique opportunities to invest" of what could turn out to be a company buying spree at fire sale prices. Not far behind will be the corporate acquirers. Both buyers would primarily strip companies for assets and would destroy most of the jobs the companies had. If all this proceeds, it would represent a massive shift in ownership upwards, a funneling of wealth to already wealthy top elites, resulting in levels of inequality never before seen in this country, and the massive loss of local enterprises. What can be done about this potential fire sale of struggling small- and medium-size enterprises (SMEs)?

Given the extraordinary amount of public spending on the economy, there is a tremendous opportunity for businesses to be preserved for the public benefit. One avenue of exploration for state and city governments is the establishment of public holding companies that would acquire distressed business during the COVID crisis. These businesses could be maintained at some minimal level until recovery begins and, more importantly, rebuilt once economic recovery begins. One historical model for such an approach is the Reconstruction Finance Corporation (RFC) of the 1930s, a large-scale public company set up to provide financial support to banks and other businesses during the Great Depression and World War II. During the New Deal, the RFC became not only the biggest bank in America but also the single largest investor, owning shares (and often actively exercising voting rights) in thousands of U.S. companies. Another example is the Resolution Trust Company (RTC), which in the late 1980s took over 747 failed Savings and Loan banks with assets of more than $400 billion.

There have already been calls in the U.S. to establish a Coronavirus Finance Corporation. The IMF research arm has also speculated such a step may become necessary. While this might be done at the federal level, more rapid success could be at the state level. One or more states, or large cities, could implement such a holding company soon, which might inspire replication or scaling up at the federal level, further into the recovery. This would build on the already existing capacities and capabilities of state and local governments, many of which already regularly engage in business investing and lending, often through development finance corporations.

Given the dire straits of state and municipal finances due to the crisis, perhaps the most practical way to capitalize such a public holding company is through the Municipal Liquidity Facility created by the Federal Reserve in April, through which the Fed will purchase up to $500 billion of municipal notes from states, counties of at least 500,000 population, and cities of at least 250,000 population. (See term sheet here.) States could issue revenue or bond anticipation notes, purchased by the Federal Reserve through this facility, or use other methods of capitalization.

Local Economy Preservation Funds could acquire businesses with a view to refloating them when the crisis passes and the economic recovery begins. In some cases, a fund might take a partial ownership interest to support local owners through the crisis, allowing them to continue operating or reopen later. In other cases, full ownership might be obtained, if, for example, owners are nearing retirement and not interested in starting over in a recovery. To ensure such firms remain locally owned and in the public interest, the funds could preference or mandate exit of some or all ownership shares to shared ownership models: ESOPs and cooperatives, state and local governments, or community-based non-profits (where they could be run as social enterprises). Exit preference might be added for local owners who are people of color, women, and returning veterans. In some cases, firms might be rolled up or networked upon exit, to enhance viability. Some firms might remain in municipal or state ownership over the long run, generating public income. Or government might retain a percent of Golden Shares, conferring the ability to keep firms locally rooted.

Policymakers should be wary of simply re-privatizing these companies in ways that further exacerbate wealth inequality, or of selling firms to corporate acquirers, which means loss of significant local wealth and likely dramatic shrinkage in jobs. Once a state or city has ownership and control, there is an opportunity to create a next generation of enterprises, locally rooted, that create quality jobs over the long term.

Policymakers should put in place special financial incentives and educational and technical resources to support employee buyouts from these holding companies. For many small businesses, the only viable buyers may be their employees, whether this is an entrepreneurial apprentice, a senior management buyout, or a broad-based form such as a cooperative or ESOP. As the ICA Group has noted, close-to-retirement owners are not in a position to take on additional debt to breathe life back into their businesses, but employee-owners might afford to do so over a longer time horizon and with the right financing and supports. Employee owners of course include managers, who could provide the leadership necessary for relaunching firms. Large cities or states might consider funds targeted exclusively to employee ownership.

Locally owned small business is the lifeblood of our economy, providing nearly half of all jobs, and circulating three times more money back into local economies. Yet according to a recent survey, a third of small-business owners said they could not withstand this crisis if it lasts a month, and two-thirds would have to close if it lasts for four months. Cities could lose their engines of prosperity. Millions of workers could lose their jobs, and increasing automation by large firms could mean those jobs are gone forever. We face an inevitable and massive ownership transition. We have the opportunity to make it a transition for the good, preserving firms for local and broad-based ownership.

Appendix – Holding Company Design

There are various options on how a holding company could be structured and operated. One way this could work is for cities, counties, or states to keep management in-house, drawing on the existing business lending and investment capacities of governments or their development finance arms. For instance, the New York City Economic Development Corporation, a non-profit governed by a board appointed or approved by public officials, routinely makes the kinds of investments suggested here, through a variety of loan and investment funds totaling around $180 million. If such expertise does not already exist in the public or quasi-public sector, another approach would be to delegate management to experienced fund managers, with strict guidelines on firms to support as well as metrics for social impact. There is more to design, including how a fund should be governed, through methods such as enhanced transparency, accountability, and democratic oversight.

The Potential Role of CDFIs

CDFIs – as experts in local lending, particularly to small and disadvantaged businesses – have a potentially important role to play in LEPFs. There are several ways this could be structured. Some localities might choose to act quickly, not waiting for a bond issuance, but instead forming a local pilot fund; this might be funded by impact investors, and could be located within a CDFI or credit union, with equity investments managed by CDFI enterprise lending experts. This could offer proof of concept for a larger statewide or multi-county fund to follow.

If city, county, or state bonds were issued to capitalize a LEPF, such a fund could be located within a governmental or quasi-governmental entity, with equity investment management outsourced to a local CDFI loan fund. CDFI investment managers would bring expertise in blending social impact criteria with financial criteria, which is crucial to the successful implementation of LEPFs. Potentially, a publicly housed funding pool could direct management/oversight to a series of on-the-ground, smaller partners such as CDFIs, CDCs, etc. This combination might feature initial purchase of/investment in local firms by the public holding company, with quick movement of oversight of enterprises to the smaller partners who would incubate the firms for exit to final stakeholders.

Below are some potential suggested guidelines from Brendan Martin, executive director of The Working World, a NYC cooperative lender.

Holding Company Suggested Details		
Business Purchasing	*Criteria*	• Only acquire businesses that were cash-flow positive before March 22nd, 2020. • Create strategic criteria specific to location, for example, targeting essential industries, large job creators, culturally significant companies, geographically clustered businesses, etc.
	Deal Terms	• Purchased companies to be owned entirely by holding company at outset. • Workers or final stakeholders would not bear the risk of debt burden from initial, COVID-era purchase. • Valuations based only on actual cash flows and • Purchase discounted in price or via low down payment due to high degree of uncertainty and cost of rebuilding.
Exit	• Flexible exit within from 1 - 10 years with most between 3 -5 years. • Exits to local ownership that could include multiple stakeholders. • Primary targeted stakeholders would be workers and local governments, but the model is open to broader stakeholders. • Holding company investments would be repaid by achieved free cash flow before or possibly continuing after exit. • Trigger to exit: financial solvency and ability to repay initial investment. • Trigger to exit: Capacity of the new ownership and stakeholdership to run and direct the company ("ownership culture" among the stakeholders).	
Holding Company Structure Options	• Direct and full governmental ownership. • Publicly directed funding to pool of on-the-ground, smaller partners such as CDFIs, CDCs, etc. • Combination: initial purchase by public holding company, quick movement to smaller partners, incubation for exit to final stakeholders.	
Portfolio expectations	• Even with careful criteria, expectation is of investment losses, not fixed income, and a portfolio tolerance for up to one-third of acquisitions failing to recover to positive cashflow.	

	• Portfolio solvency would be maintained by public debt guarantees and forgiveness that would cover those acquisitions that close before exit. • Additional forgiveness for businesses that reach positive cashflow but would require more than a seven-year repayment period. • Losses for the fund balanced by returns from successful acquisition, though it is suggested profits be left with companies for reinvestment rather than being used to make the portfolio whole. • Some loan forgiveness to successful acquisitions could be considered for reinvested earnings.

Information on potential use of the Municipal Liquidity Facility (MLF)

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According to the term sheet (which can be accessed here), the Federal Reserve specifies that funds from the MLF must be used to manage cash flow implications or lack of tax revenue, or to make principal and interest payments on debts. Cornell law professor and Federal Reserve expert Robert Hockett suggests the scope of eligible use will likely be determined by how states and cities try to use the MLF. He recommends that cities and states structure and couch new issuance, to the extent plausible, as revenue-producing; make the case that planned measures will boost commercial activity to the extent that traditional revenues will be restored; and work with the Federal Reserve to help it understand that local needs mean liquidity is not enough and that longer-term investment is needed beyond two years. Based on this analysis, we believe that Local Economy Preservation Funds could, and would, meet the Fed's criteria for eligible use of MLF funds. Open Society Foundations is supporting advocacy in extending the Fed's terms beyond two years.

A state or large municipality could issue a revenue or bond anticipation note with a two-year maturity (as per the Federal Reserve's requirements) based on either A) the anticipation that the Local Economy Preservation Fund would generate revenue by selling its assets once the economy has recovered or receive dividends from companies in which it retains an ownership interest; or B) that the state or locality would issue a general obligation or revenue bond once the economy has recovered, and use those funds to pay back the note the Federal Reserve had purchased. The advantage of the latter option, and in particular a revenue bond, would be that the short-term (2 year) note could be essentially swapped for a bond with a longer-term maturity, which would allow the Local Economy Preservation Fund a longer window to responsibly and profitably divest its assets.

Cornell professor Hockett wrote about the new MLF facility in Forbes, emphasizing that the Fed "stands ready to 'dollarize' state and local issuances," which means "states and cities are now in effect being 'deputized' as something very like de facto federal agencies with much of the authority *and financing* they need." He added that the FOMC "hinted strongly" it would interpret restrictions on municipal use of the facility "*flexibly* until the present crisis is contained." Hockett is circulating a sign-on letter, outlining suggested changes to the MLF, to state treasurers.