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The 1042 rollover co-op: An affordable ESOP alternative

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On September 30, 2005, the 9 employees of Select Machine, in Brimfield, Ohio, began to purchase their company from the retiring owners using an employee-owned cooperative. Their purchase uses a precedent-setting structure that (1) permits the sellers to take advantage of the "1042 rollover" of their capital gains while (2) structuring the sale over a period of several years, making it easy to finance and enabling the owners to transfer their managerial expertise to the other co-op members over time.

In 1984, changes in the tax law concerning Employee Stock Ownership Plans (ESOPs) created the so-called "1042 rollover" which permits owners of closely held businesses who sell 30% or more of the stock in their company to their employees through an Employee stock Ownership Plan (ESOP) or a co-operative to shelter the capital gains from taxes by rolling the proceeds of the sale over into other qualified domestic securities within 12 months of the sale.

Today that is the number one reason for establishing ESOPs, but not one employee co-op has been established using this provision – prior to Select Machine.

Why not? The primary reason is that ESOPs' stock structure enables owners to sell part of their companies to employees, while retaining enough equity to make financing easy. The typical 1042 rollover ESOP is done as a 2 or 3 stage transaction over a 5-10 year period. By contrast, co-ops are conventionally structured as 100% employee owned. Financing a 100% leveraged transaction is extraordinarily difficult, especially if the owners are leaving and taking their management skills with them.

Comparing ESOPs and Co-ops

ESOPs have tax advantages that make them the employee ownership structure of preference in companies that are profitable, capital intensive, and employ more than 20-25 employees. Because they are Federally regulated qualified employee benefit plans, the costs of establishing them -- $50,000 and up -- and maintaining them -- $10-15,000 annually -- makes them unduly expensive in smaller, less profitable companies. Furthermore, small ESOPs have grave difficulty staying in compliance with the law because they try to save money on professional advice. That eventually catches up with them in expensive Department of Labor fines.

By contrast, employee co-ops are membership associations similar to agricultural co-ops and consumer co-ops. Co-ops distribute their profits to members on the basis of labor input measured by W-2 earnings, hours worked, or other measures, not unlike the way ESOP stock is distributed; unlike ESOPs, however, members elect a majority of the board on a one-person, one-vote basis. Co-ops have fewer tax advantages than ESOPs, but they are inexpensive to set up and even cheaper to maintain. They would seem an ideal employee ownership solution in smaller companies, if a multi-stage transaction model could be established.

Structuring the co-op business succession model

What was needed for a multi-stage co-op purchase? With the financial support of the George and Gladys Dunlap Cooperative Leadership Program of the Nationwide Foundation, the Ohio Employee Ownership Center and the Ohio Council of Cooperatives (now part of the Mid-America Cooperative Council) sought to develop a practical model for ownership succession in small businesses using the employee cooperative as an ownership structure.

We teamed with Mark Stewart, one of the nation’s leading co-op attorneys, and ESOP-specialist Eric Britton at the Toledo, Ohio, law firm of Shumaker, Loop and Kendrick, to develop the legal framework for the conversion of the company to a cooperative and for the purchase transaction to take place over time.

The model that Stewart and Britton designed calls for converting the company into a co-op which then redeems the retiring owners' stock in several steps with a valuation at each step. The owners qualify for a tax free rollover of the proceeds provided the co-op redeems at least 30% of the stock. The owners' remaining equity makes the deal easy to finance, and the owners' continuing involvement for several years enables them to transfer their management skills to the other co-op members.

This model has two distinct financial advantages for the selling owners. First, they obtain the control premium on the first stock redemption, because a co-op by definition must be controlled by its members. Second, the retiring owners can be members of the co-op as long as they are working and can also receive internal capital allocations annually.

On the other hand, the selling owners have to be comfortable with a board elected on a one-member, one-vote basis.

Selling Select Machine to the employee co-op

Select Machine was founded in 1994 by Doug Beavers and Bill Sagaser and today employs 9 people full-time. The company manufactures, sells and distributes machined products and equipment for installation on construction and demolition equipment.

“Bill and I set up this company to be the kind of company that we would like to work for if we were working for someone else,” is the way Beavers describes the owners’ philosophy. Symptomatic of the workplace practices at Select Machine is that Bill and Doug serve everyone lunch on Friday at 2 and send everyone home to have Friday afternoon with their kids. “Best place I have ever worked!” was the opinion freely offered by several of the machinists when we started taking about an employee buyout.

“What impressed me most about this group is their spirit of community within the business,” says Attorney Mark Stewart who did the legal work on the buyout. “In a co-op, you need a concern for each other’s welfare, just like partners have. That attitude is infectious. That’s the kind of attitude they have at Select Machine.”

Beavers and Sagaser had sought to sell their profitable business for months before offering it to the employees. Several interested potential buyers surfaced, but all of them wanted to buy the business for its customer list, cherry-pick the equipment, and consolidate production into underutilized facilities elsewhere. Shutting the plant and leaving their employees out of work was not why Beavers and Sagaser had built the business. Why not sell to their employees instead? They turned to the Ohio Employee Ownership Center (OEOC) for advice.

Given the threat to the jobs, a preliminary feasibility assessment of an employee purchase was funded by a grant from the Ohio Prefeasibility Study Grant Fund administered by the OEOC and performed by a local accounting firm. (Funds for preliminary feasibility assessments of employee purchases to avert job loss are available in every state through the Federally funded Workforce Investment Act, but are only regularly used in half a dozen states.)

After reviewing the feasibility study, Select Machine employees voted to set up an employee-owned cooperative. They set the co-op membership fee at $1000. Those electing to join purchased the shares of the selling owners via notes payable from future profits of the cooperative. Those profits are distributed on the basis of a formula that includes W-2 earnings (rewarding skill), hours worked (equality), and seniority capped at 10 years (building the business over the years).

Beavers and Sagaser sold 40% of their shares in this transaction and will themselves be members of the co-op. They intend to sell the remaining 60% of their shares as soon as the debt to purchase the 40% has been repaid.

I called Dave Baird, a machinist who has been with the company for 6 years and is the co-op vice-chairman, a month after the co-op was established to get an update on where things stand.

“It’s all good, John. Everyone is real excited to make this thing happen. You know that we felt good about working here before, but everyone is more enthusiastic now. I was talking to one of the younger guys yesterday on this. ‘I just see the company differently now,’ is what he told me.”

“This co-op’s an honor,” Baird continued. “It’s a challenge that I look forward to every day.”

National implications

“The provisions of 1042 are relatively obscure for business owners,” says Stewart, “but once we have viable models of how this can be achieved, we will have a lot more co-ops set up for business succession.”

The model pioneered at Select Machine should be transferable to many other small companies with under 25 employees. The employee-owned cooperative offers an attractive alternative to those owners of companies that are too small for the ESOP option and do not have family members available, willing and capable of taking over the business. The stock redemption model permits selling owners to shelter their capital gains, get a better price than they otherwise would, and see their business legacy continue.

“We did not set out to establish a precedent or develop a model,” says Beavers. “We just wanted to do what was best for the employees of our company and for ourselves. We chose the employee-owned cooperative because it made sense.”

The OEOC is a non-profit program based at Kent State University providing information and technical assistance to people interested in exploring employee ownership as well as developing and delivering training material and sponsoring conferences and programs for employee-owned companies. Its website: www.kent.edu/oeoc/ Since it was established in 1987, the OEOC has assisted 80 companies employing over 14,500 employee-owners to become employee owned; these firms have created over $350,000,000 in equity for their employee-owners. For more information on the 1042 rollover co-operative, read Mark Stewart and Eric Britton’s articles on the subject at www.kent.edu/oeoc/OEOCLibrary/

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