Business ownership succession and employee ownership: Why & how

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Ownership succession in family businesses

The US Small Business Administration reports that

- **More than 50% of family business owners expect to pass the business on to the next generation**
- **Only 30% actually make it to 2nd generation family ownership**
- **Only 15% pass to the 3rd generation**

The 2007 Massachusetts Mutual family business study found that 46% of business owners who expect to retire within 5 years had no successor. "Almost a third (30.5%) have no plans to retire, ever…. Many people plan to die in office, which is not beneficial to the family, the firm, its employees or its clients."

Failure to plan for business success is the #1 preventable cause of job loss in America

In rural areas the situation is compounded by…

- Outmigration of business owners' children
- Difficulty in finding buyers from outside who will move to the area to run the business
- Loss of critical mass of economic activity in small towns
- Cost of infrastructure – schools, roads, utilities, etc – is spread over a smaller economic base, so costs go up

Choices when the business doesn't continue in the family

- Sell to manager or outsider who runs it as a stand alone firm
- Sell to a competitor who will often shut the operation
- Liquidate for value of assets
- Sell to employees

Advantages of selling to your employees

- Sale to employees helps to maintain the business, the jobs & the community
- Successful sale for market value is highly probable
- Tax advantages for the seller – the IRS § "1042 rollover"

Sale to employees helps to maintain vibrant businesses & communities

- Business continues as stand alone firm in the community
- Maintains business & payroll in community – anchors capital & jobs
- Stabilizes property values and tax base
- Broader ownership builds assets for more working people
- And there's a tax benefit for the seller!!

Basics of the IRS §1042 tax rollover for the selling owner

- Tax break on capital gain (full capital gains tax deferral) for seller if he/she sells 30% or more of stock to employees
- Must be a "C corporation" for the seller to get the tax-free rollover
- Seller has to roll over proceeds of sale within 3 months prior to or 12 months subsequent to the transaction into other qualified securities and declare to the IRS what the replacement securities are
- If the replacement securities are sold, there is a taxable event; the tax basis in the securities is the basis in the original stock
- If the replacement securities pass into the seller's estate, they do so at the stepped up basis
- Have your cake and eat it to strategy: Put replacement securities in margin account with a brokerage firm, borrow against them, and trade

How do you sell to the employees?

To get the §1042 tax advantage, you have two choices:

- Employee Stock Ownership Plan

Or

- Employee cooperative

Employee ownership in the US is more common than you think….

Type of ownership	Companies	Employee-owners	Employee Equity
ESOPs	9,774	11.2 million	$928 billion
Broad-based stock options	3,000	9 million	“several hundred billion”
401(k) Savings plans primarily invested in company stock	748 plans	1.5 million	$133 billion
Stock purchase plans	4,000	11 million	no estimate on value
Worker cooperatives	Several hundred	perhaps 10,000 employees	no estimate on value

Source: National Center for Employee Ownership, 2008

Comparing ESOPs and Employee Co-ops

Employee Stock Ownership Plans (ESOPs)

- **ESOPs are qualified employee retirement trust plans that invests primarily or exclusively in the securities of the employing company and which can borrow money**
- **Thus ownership is indirect**
- **The ESOP borrows money from the bank to buy stock from selling owner. The company repays loan with pretax income**
- **ESOPs in sub-chapter S corporations are tax free until employees cash out at retirement**
- **Because ESOPs are Federally regulated pension trusts, ESOPs are expensive to set up and maintain**
- **ESOPs aren't cost-effective for ownership succession in businesses with fewer than 20 or 25 employees**

Comparing ESOPs and Employee Co-ops (continued)

Employee Co-ops

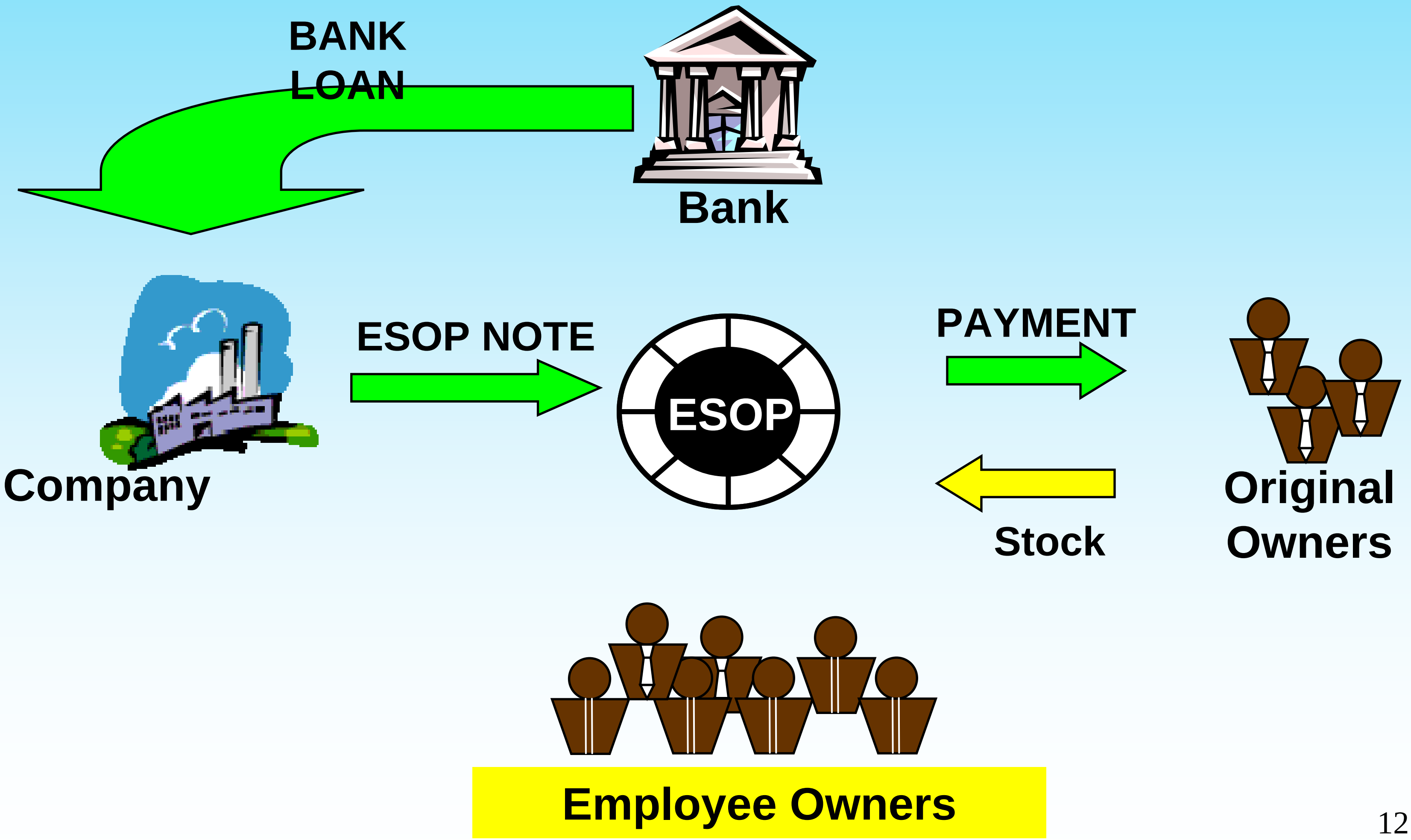
- **Employee co-ops (or worker co-ops) are like other co-ops: they are owned directly by employee members who pay a membership fee and who receive patronage allocations**
- **Patronage dividends are allocated on the basis of their labor input into the co-op**
- **Patronage dividends are taxable to the members, not to the co-op**
- **The co-op can borrow money from the bank to buy stock from selling owner**
- **Because employee co-ops are inexpensive to set up and maintain, they are highly cost-effective in ownership succession in small businesses**

Selling to employees through an ESOP

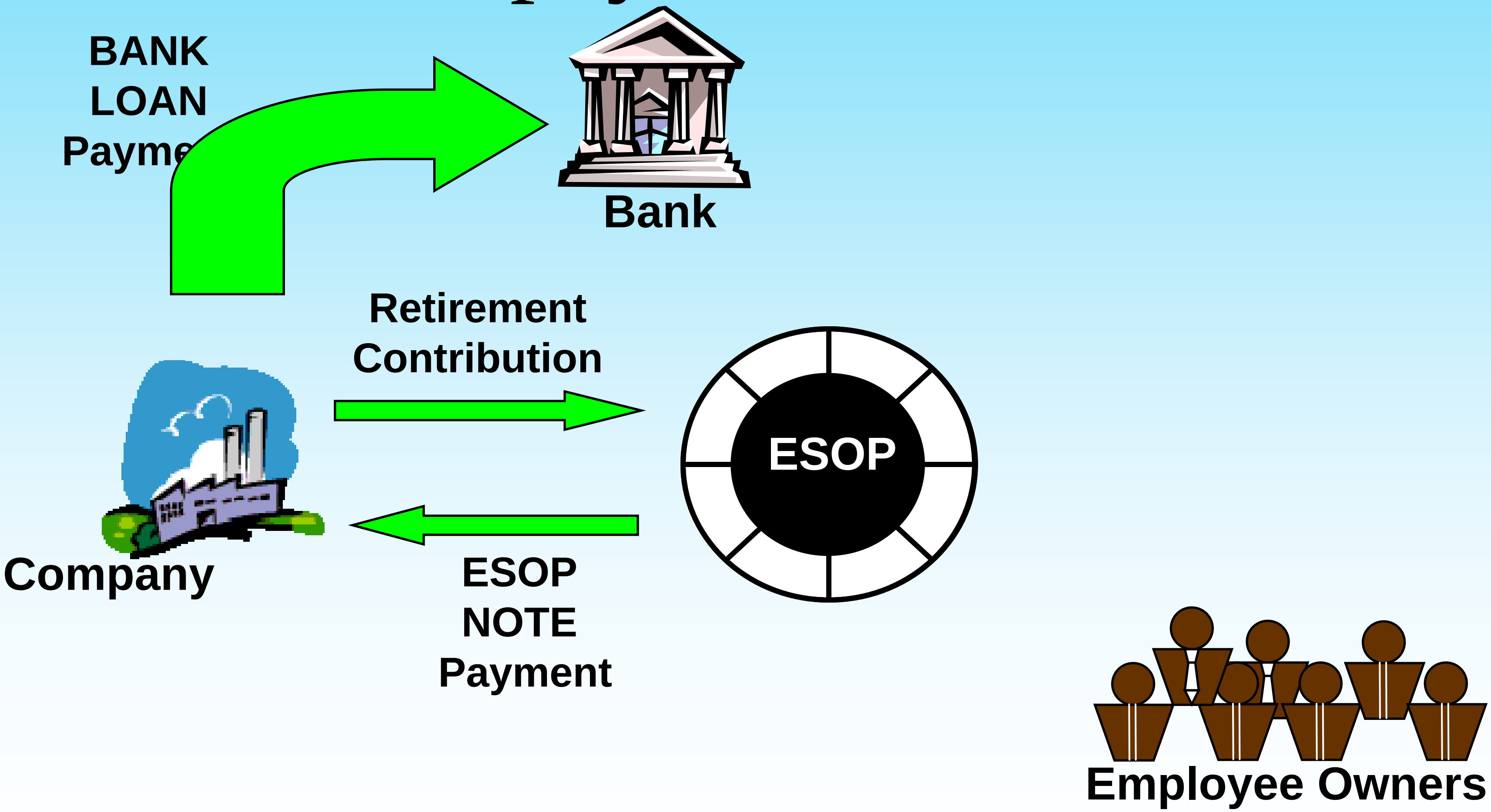
- **ESOPs are stock-based plans. Conceptually it's easy to sell PART of the stock of the company to an ESOP.**
- **In doing ownership succession, the old owner typically sells 30% or more of the company stock to the ESOP in step 1. (30% is the minimum to get the capital gains tax break.) After the loan for the initial sale is paid back, the owner then sells the remainder of stock to the ESOP in several additional steps.**
- **The old owner stays involved in the business until the last sale, transferring management skills to the new management.**

For more information, see Appendix 1 ("Required Documents").

How Do ESOPs Buy Stock?



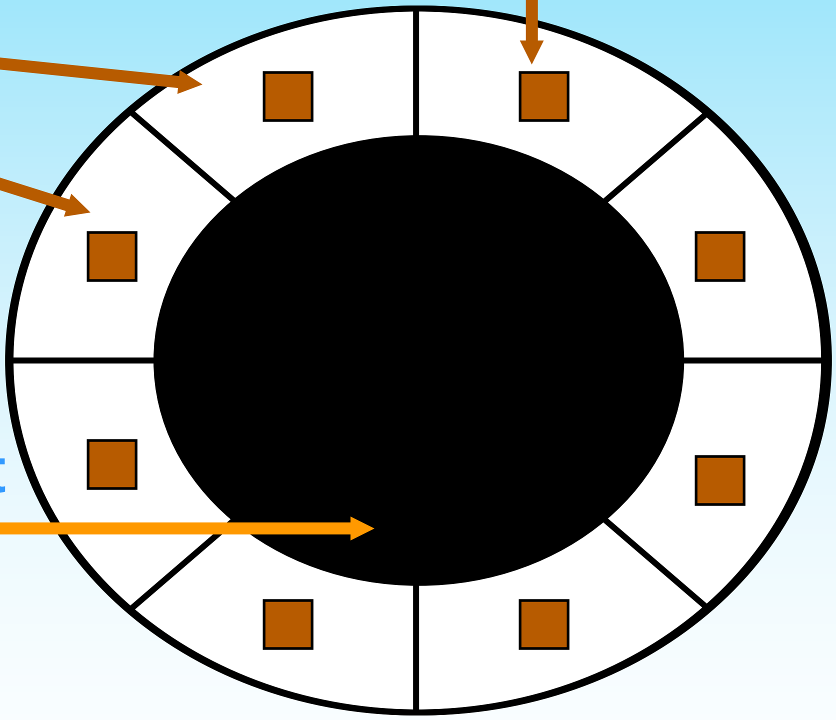
How Do ESOPs Repay the Loan?



How Do Employees Get Stock in their Accounts?

Allocation to Individual Accounts

(Paid-for shares are allocated to ESOP participants)



Suspense Account

(Unpaid-for Shares held as Collateral on ESOP Loan)

Selling to employees through a co-op

The basic problem in selling a business to employees through a co-op is that we generally think of co-ops at 100% member-owned. It is hard to finance a 100% leveraged sale of a small business to employees at the retirement of the owner.

Why:

- **No equity**
- **No continuing management**

We handle this problem in ESOPs with dividing the sale into several steps:

For example:

Step 1. The owners sell first 30% to employees

Step 2. After the debt is paid, the owners sell next 19%

Step 3. Again after paying the debt, the owners sell the remaining 51%

Over the years of the sale, the owner transfers management skills.

Our answer to the co-op sale problem: Mimic ESOP multi-step sale through stock redemption over time

- Maintains necessary equity in business
- Doesn’t over-leverage the business by borrowing too much money
- Transfers management skills over time

Here's how the co-op stock redemption model works:

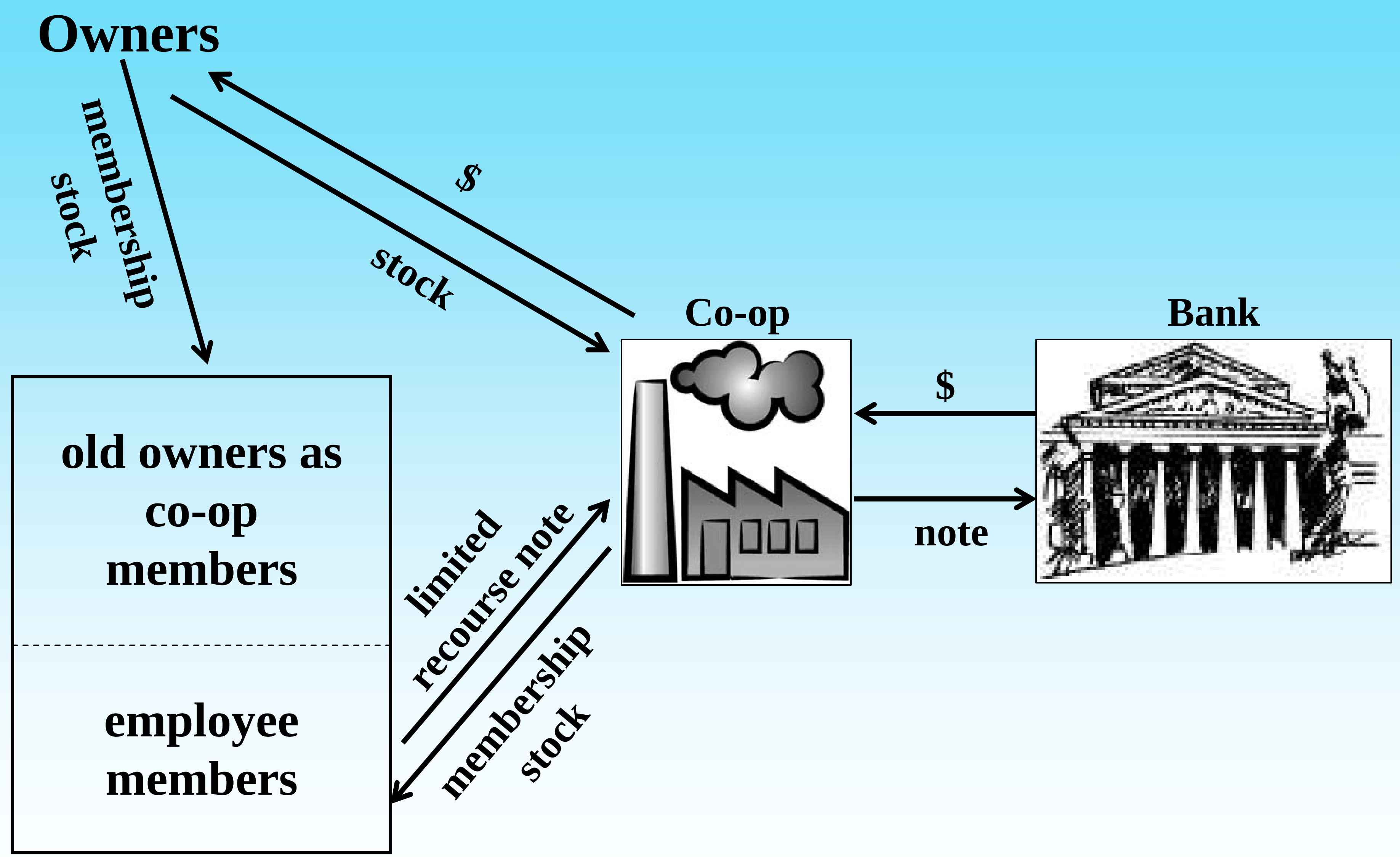
1. **Convert company into co-op with 100% of equity still owned by old owner(s)**
2. **Co-op borrows funds to redeem at least 30% of stock from owners -- this threshold triggers the tax break for the seller**
3. **Employee members pay for shares through patronage allocations which pay down bank debt**
4. **After bank debt is paid off, co-op borrows additional funds and redeems additional stock from owners**

Here’s how the co-op stock redemption model works (continued):

5. During this 3-7 year transition period, owner transfers management expertise, customer and supplier relationships, banking relationship, etc., to co-op members
6. Owner rolls proceeds of sale into other “qualified replacement securities” (stocks and bonds of domestic companies which produce goods and services)
7. Employee co-op pays down debt and remains rooted in the community

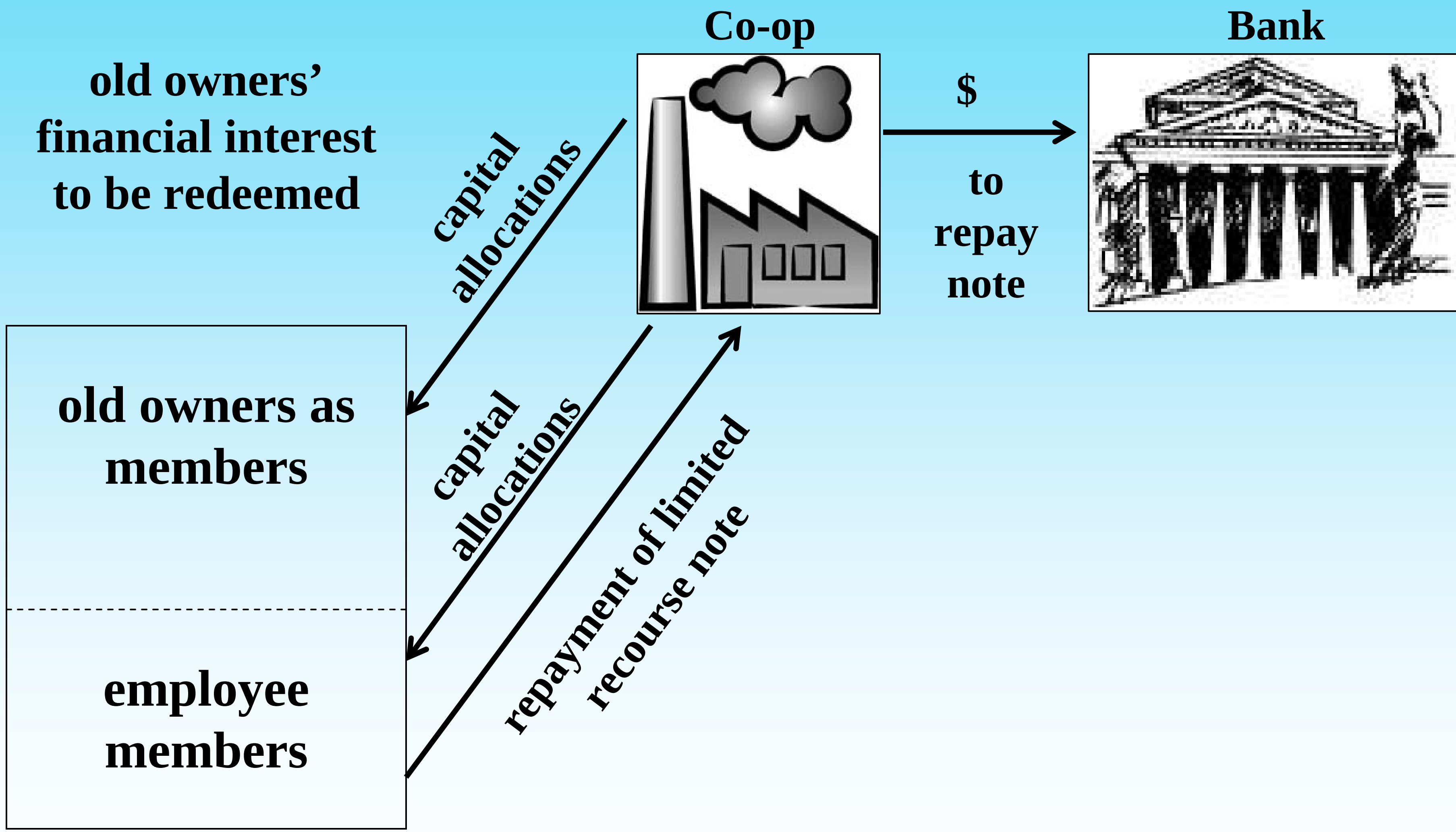
For more information on this model, see Appendices 2 (“Required documents”) and 3 (“The Select Machine case”).

Day 1



Owners
membership stock
$
stock
Co-op
Bank
$
note
old owners as co-op members
employee members
limited recourse note
membership stock

End of year


Co-op
Bank
old owners' financial interest to be redeemed
capital allocations
$
to repay note
old owners as members
capital allocations
repayment of limited recourse note
employee members

Alternative §1042 co-op models

1) The one-step, 100% transaction

- Credit enhancement through the Business & Industry Loan Guarantee Program is vital here – otherwise the deal won’t be financed
- Primary worry: management transition

Alternative §1042 co-op models

2) The owner prefers seller financing

- For the owner to take the 1042 rollover, employees have to hold at least 30% ownership
- Owner doing seller financing has to have cash to invest in replacement securities within 12 months
- Grape & Grain, Aspen CO: owner is selling 100% in one 30% and seven annual 10% seller-financed transactions.

Comparing the results: Co-ops and ESOPs

1. The sales price for the initial co-op redemption has no minority discount because co-op members control the board – in an ESOP there is a minority discount
2. Selling owners can become co-op members and receive capital allocations as members (but no additional stock) as long as they work in the co-op – in an ESOP they cannot participate in the ESOP if they take the 1042 rollover
3. At subsequent redemption events, the value of the stock is determined by valuing the whole company, subtracting the value of the capital accounts held by the members, and then dividing the remaining value by the shares outstanding including member shares – in an ESOP there are no capital accounts so all the value is assigned to the shares

Comparing Co-op and ESOP transactions (continued)

4. **Co-ops are democratic membership organization with direct ownership and a majority of the board elected by the employee members – ESOPs are trusteed pension plans which provide indirect beneficial share ownership for participants and which generally don't permit employee owners to elect the board**

For more information

Steve Clifford et al., ***An Owner's Guide to Business Succession Planning*****, 2nd ed., OEOC (2008) available for $19.95 with DVD at http://dept.kent.edu/oeoc/publicationsresearch/publicationresearch.htm**

John Logue et al., ***Selling to Your Employees through an ESOP or a Co-op*** **– available in draft from jlogue@kent.edu**

There are a number of articles on employee co-ops and the Select Machine case in the OEOC library at www.kent.edu/oeoc/library

See also: Joan Raymond, "Unlikely Pioneers," ***Business Week Small Biz*****, Spring 2006, pp. 57-59; and**

Bruce Reynolds, "Worker-owned/ESOPs can help preserve business in rural America," ***Rural Cooperatives*****, July-August 2006, pp. 28-31.**

Contacts on §1042 rollover cooperatives:

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Minnesota/Dakotas: Bill Patrie, Northcountry Co-op Development Fund, 612-331-9103; e-mail: bill@ncdf.coop

Pacific Northwest: Diane Gasaway, NW Co-op Development Center, 360-943-4241; email: diane@nwcdc.coop

For legal advice on §1042 rollover cooperatives, call Mark Stewart, Shumaker, Loop & Kendrick, 419-241-9000; e-mail: mstewart@slk-law.com

Appendix 1.
Required documents for an ESOP

At time of initial transaction

- Initial valuation
- ESOP Plan
- Trustee agreement
- Summary plan description

Ongoing

- Annual valuation
- Annual participant account statement
- Plan amendments

Governance: A major ESOP issue for Co-op developers

As trusteed plans, ESOPs give trustees the right to vote the stock. Key design issues for democratic ESOPS:

- **Full pass through of voting rights to ESOP participants**
- **Non-managerial seats on the board of directors**
- **Non-managerial participation in ESOP administration committee**
- **Employee owner participation in shop floor decisions**
- **Employee owner participation in ESOP design**

Appendix 2.
Required documents for co-op sale:

1. An ESOP-style "fair-market value" valuation of the company before each redemption event (needed for 1042 rollover)
2. Restated and amended incorporation documents and bylaws to convert the company into a co-op; co-op board votes to proceed
3. Offering statement for employee members explaining the business and its risks – Co-ops aren't trusteed plans like ESOPs, so buying the company through a co-op is "buyer beware"
4. Business plan - includes management succession
5. Redemption agreement with owners
6. Co-op membership and subscription agreement for members

Required co-op documents (continued):

7. Limited recourse note for employees' acquisition of stock redeemed by co-op from the owners &repaid through the co-op capital allocations (needed for § 1042 rollover)
8. Management contracts with former owners which provide them certain reserved rights as "protected shareholders" until the remainder of their stock is redeemed
9. Employment contracts with other co-op members
10. Stock certificates for all members

Appendix 3.
An example: Doing the deal at Select Machine
Select Machine is a profitable company with two owners nearing retirement and seven full-time employees

- 3-22-2005: Owners contact OEOC; followed by meetings with OEOC staff, discussion of choices, & review of financials
- Owners like co-op idea & broach it with employees
- 4-8-2005: OEOC staff meet with employees, explain co-op and how to do the deal
- 4-8-2005: Employees vote to explore co-op and elect buyout committee
- April: Equipment appraisal updated
- Mid-May: Feasibility study/valuation consultant hired
- 6-16-2005: Feasibility study and valuation completed
- Late June: Extensive discussion with OEOC staff of feasibility study and implications
- July 2005: Owners decide to sell to employees

Doing the deal at Select Machine (continued)

- **7-29-2005: Initial meeting between owners and employees and co-op attorney Mark Stewart**
- **8-9-2005: Attorney retained; offering statement prepared**
- **August: Employees review feasibility study, offering statement, and financial statements; they vote to establish co-op and set membership criteria, fee, and allocation formula**
- **8-15-2005: Lenders agree to loan enough for a 40% stock redemption**
- **August-September: Documents are drawn up**
- **9-14-2005: Amended incorporation documents and bylaws are filed with state**
- **Mid September: Co-op board elected, meets, authorizes stock redemption and borrowing**
- **9-30-2005: New co-op members sign memberships, stock subscription agreements, limited recourse notes, stock pledge agreements, employment agreements, and receive stock certificates**
- **9-30-2005: Owners and co-op officer sign stock redemption agreement and owners' employee agreement**

Doing the deal at Select Machine (continued)

- 10-3-2005: Loan documents are signed and owners receive cash for stock redeemed
- 10-2005: Select Machine begins functioning as a cooperative with 40% held as membership shares by the new co-op members and 60% held by the owners
- Intention: Between 2005 and 2010, the owners would transfer their management skills and knowledge to the other co-op members
- In practice, one owner exited in 2006 to take another job and thereby ceased to be a working member of the co-op although he retained his financial ownership; management succession was suddenly speeded up
- In late 2006, the owners sold an additional 9% to the co-op, bringing it to 49%
- Intention: In 2010 or before, the remaining shares held by the owners will be redeemed, and they will retire