

Private Business Conversions to an Employee-Owned Cooperative

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1

Private Business Conversion

An Exit Planning Strategy

- The OEOC's Succession Planning Program
- Co-op Option for Employee Ownership
- Advantages:
 - Smaller businesses
 - 1042 Rollover
 - Staged sale
 - May be less costly than an outside buyer or forming an ESOP

2

Conversion Overview

Willingness...

Current Situation...

New Structure...

Do the Deal

3

A Private Business Conversion To an Employee-Owned Cooperative

- A. Can we have a Co-op?
 - Willing Seller
 - Willing Buyer
- B. Current Situation
 - Feasibility
 - Valuation
 - Business Plan
- C. New Structure
 - Key decisions
 - Funding
 - Legal
- D. The Deal
 - Management succession
 - Offering Statement
 - Employee Approval
 - Articles, Bylaws, Governance
 - Loan covenants
 - Co-op redeems stock from seller
 - Agreements
 - Sell the redeemed stock to employees
 - Close

4

Can we have a co-op?

(is there a willing seller & buyer?)

1. Determine desire of Seller

- Seller meets with advisors – include a co-op knowledgeable resource
- Overview of co-op structure and issues
- High level assessment of financials and key factors that can make the transaction doable

5

Can we have a co-op?

(is there a willing seller & buyer?)

2. Determine desire of Buyer(s)

- Worker participation can improve performance
- Involvement early
- Seller and advisors meet with employees
- Explain Co-op's - determine interest to proceed
- If so, select employee representatives to join management in a co-op buyout committee

6

Current Situation

3. Conduct a Feasibility Study

- Interview & hire independent 3rd party with co-op experience
- Assess the financial feasibility of a conversion
- Assess the "employee readiness and acceptance"

7

Current Situation

4. Conduct a Valuation

- Do full valuation, if not part of feasibility (especially if "1042 Rollover")

5. Develop a Business Plan

- Use input from feasibility and valuation

8

The New Co-op

6. Review new co-op structure w/ buyout committee
 - Key Documents to address
 - ❖ Bylaws and Articles of Incorporation
 - ❖ Stock Redemption Agreement
 - ❖ Membership Agreement
 - ❖ Offering Statement

9

The New Co-op

- Key issues to address, *continued*
 - ... Control – 1 vote per member vs. shares
 - ... Establishing share price
 - ... Surplus distributed based on patronage formula
 - ... Patronage allocation
 - ... Selling owner rights (on BOD, management, etc.)
 - ... Selling owner stock redemption
- CULTURE!

10

The New Co-op

7. Begin financing process
 - Financing issues for Transition to Worker Cooperatives
 - Underlying transaction transfers ownership to employees
 - Typically requires new debt to fund “payout” of owner’s equity
 - Increased leverage increases company’s operating risk
 - Funding options for “buyout of previous owners”
 - Outside funding
 - Seller financing
 - Preferred shares
 - Staged Sale/Other Options

11

The New Co-op

(financing process cont’ d)

- Funding 100% Buyout
 - Bank lending constraints: Collateral, Remaining Equity, Who “guarantees” the note(s)?
 - Seller financing – notes or preferred shares
- Staged Sale & Other Options (varies by state law)
 - Staged transactions 30%, 49% and 100%
 - Potential tax benefits for selling owners
 - Other transfer strategies

12

The New Co-op

(financing process cont' d)

- Funding side of stock transfer
 - Cash from employees
 - Company loans to employee for equity portion
- Employee Loans
 - Limited liability notes
 - Disclosure of financials and accompanying risks
- Employee Notes vs. Bank Notes
 - Limited liability vs. unlimited guarantee
 - Future equity from "earnings" vs. unlimited exposure
 - No pledges of houses or spousal guarantees

13

The New Co-op

8. Obtain a Co-op Attorney
 - Deal advice
 - Business structure
 - Compliance with state & federal law
9. Management Succession
 - Define key tasks
 - Training/Development

14

The New Co-op

10. Employee approval
 - Offering Statement
(deal description, benefits, risks)
 - Thorough review:
feasibility, offering statement, financials

15

The New Co-op

11. Design the new business structure
 - Restate Articles of Incorporation as a co-op
 - Write Bylaws
 - Determine governance, select BOD
 - Authorize stock redemption & borrowing

16

Do The Deal

12. Complete the transaction

- Financing commitment
(loan documents & covenants)
- Prepare and execute final documents
 - ...Stock Redemption Agreement
 - ...Membership/Stock Subscription Agreements

17

Do The Deal

(Prepare and execute final documents cont' d)

- ...Business Plan
- ...Employment Agreements
- ...Limited Recourse Note (sell redeemed stock)
- ...Exchange cash for stock redeemed

18

1042 Rollover - 1

- Capital Gains Tax deferred if, after the transaction, the Co-op owns $\geq 30\%$ of the common stock of the company.
 - Must be the "best" class of voting stock
 - Federal Capital Gains Tax Rate = 20%
 - Other impacts from other federal legislation
 - State Capital Gains Tax $\approx 6\%$ -- additional savings
- Proceeds from sale must be invested by selling owner in Qualified Replacement Property (QRP)
- Reinvestment must occur within the period 3 months prior to the transaction to 12 months after the transaction

1042 Rollover - 2

- QRP is stocks/bonds of U.S. operating companies:
- QRP is NOT:
 - Mutual Funds
 - Non-U.S. company stock
 - Financial institutions' stock
 - Partnerships
- Any future sale of QRP triggers the capital gains tax
 - Includes sale to switch from one investment to another; e.g. selling IBM to buy Apple stock triggers the tax
 - Brokers have products that get around this issue
- Sellers should consult QRP specialists

1042 Rollover -3

- “1042” refers to the IRS section
- The 1042 Rollover is an election – it is not required
- These co-op conversions are “1042 Rollover Eligible”
- At death of selling owner, any capital gains tax deferred is eliminated – heirs inherit the QRP at a “step-up basis” – this is the goal!

Co-op Conversion Costs

• Co-op Attorney	\$10- 20,000
• Valuation	\$5- 10,000 *
• Other Attorney	\$0 – 10,000 *
• Co-op Developer	\$5 - 20,000
• Loan & Other Fees	\$0 - 10,000 *
• TOTAL	\$15- 60,000
• Vs. Broker fee	8 -12%

Conversion Timing

- Start to Finish:
 - 5-12 months, typical
 - 3 months – probable shortest time possible
- GANTT Chart of steps & time required

OEOC Resources

- Seminars & Webinars
- Conferences
- Technical Assistance
- Transaction Management
- Training Programs
- Referrals for Service Providers
- Training Programs
- Website – www.oecockent.org

OEOC Contact Information

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25