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Presented by
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An Exit Planning Strategy

- The OEOC’s Succession Planning Program
- Co-op Option for Employee Ownership
- Advantages:
  - Smaller businesses
  - 1042 Rollover
  - Staged sale
  - Less costly
COOPERATIVE DEVELOPMENT CONVERSION
OVERVIEW

Willingness...

Current Situation...

New Structure...

Do the Deal
COOPERATIVE DEVELOPMENT CONVERSION

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
- Loan covenants
- Co-op redeems stock from seller
- Agreements
- Sell the redeemed stock to employees
- Close

- Management succession
- Offering Statement
- Employee Approval
- Articles, Bylaws, Governance
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
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
CURRENT SITUATION

3. Conduct a Feasibility Study
   - Interview & hire independent 3rd party with co-op experience
   - Does your state have Prefeasibility Grant $ (threat of job loss?)
CURRENT SITUATION

4. Conduct a Valuation
   - Do full valuation, if not part of feasibility
     (especially if “1042 Rollover”)

5. Do a Business Plan
   - Use input from feasibility and valuation
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
- Key issues to address, continued

  ...Control – 1 vote per member vs shares
  ...Surplus distributed based on patronage formula
  ...Patronage allocation
  ...Selling owner rights (on BOD, management, etc.)
  ...Selling owner stock redemption

CULTURE!
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
  - Staged Sale/Other Options
THE NEW CO-OP

(FINANCING PROCESS CONT’D)

- Funding 100% Buyout
  ▶ Bank lending constraints: Collateral, Remaining Equity, Who “guarantees” the note(s)?
  ▶ Seller financing

- Staged Sale & Other Options
  ▶ Staged transactions 30%, 49% and 100%
  ▶ Potential tax benefits for selling owners
  ▶ Other transfer strategies
THE NEW CO-OP

(FINANCING PROCESS CONT’D)

- Funding side of stock transfer
  - Cash
  - 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
  - Houses and spouses
8. Obtain a Co-op Attorney
   - Deal advice
   - Business structure
   - Compliance with state & federal law

9. Management Succession
   - Define key tasks
   - Training/Development
THE NEW CO-OP

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

12. Complete the transaction

- Financing commitment
  (loan documents & covenants)
- Prepare and execute final documents
  …Stock Redemption Agreement
  …Membership/Stock Subscription
  Agreements
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
Capital Gains Tax deferred if, after the transaction, the Co-op owns ≥ 30% of the common stock of the company.
  - Must be the “best” class of voting stock
  - Federal Capital Gains Tax Rate = 15%
    - Slated to increase to 20% on 1/1/11
  - State Capital Gains Tax ≈ 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
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” 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: $10-30,000
- Valuation: $5-8,000
- Trustee: -0-
- Administrator: -0-
- TOTAL: $15-38,000
CONVERSION TIMING

- Start to Finish:
  - 5-9 months, typical
  - 3 months – probable shortest time possible
- GANTT Chart of steps & time required