

# MADISON, WISCONSIN CO-OP WORKSHOP

## *CONVERSIONS – WORKER COOPERATIVES*

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Presented by

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# COOPERATIVE DEVELOPMENT CONVERSION

*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**

- **Management succession**
- **Offering Statement**
- **Employee Approval**
- **Articles, Bylaws, Governance**

## D. The Deal

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

# CAN WE HAVE A CO-OP?

*(IS THERE A WILLING SELLER & BUYER?)*

## I. 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



# 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

# THE NEW CO-OP

- 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!**

# 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
- ▶ 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

# 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

# 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

# 1042 ROLLOVER - I

- ▶ 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 = 15%
    - ▶ Slated to increase to 20% on 1/1/11
  - ▶ 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	\$10-30,000
▶ 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

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