COOPERATIVE OWNERSHIP TRANSITIONS

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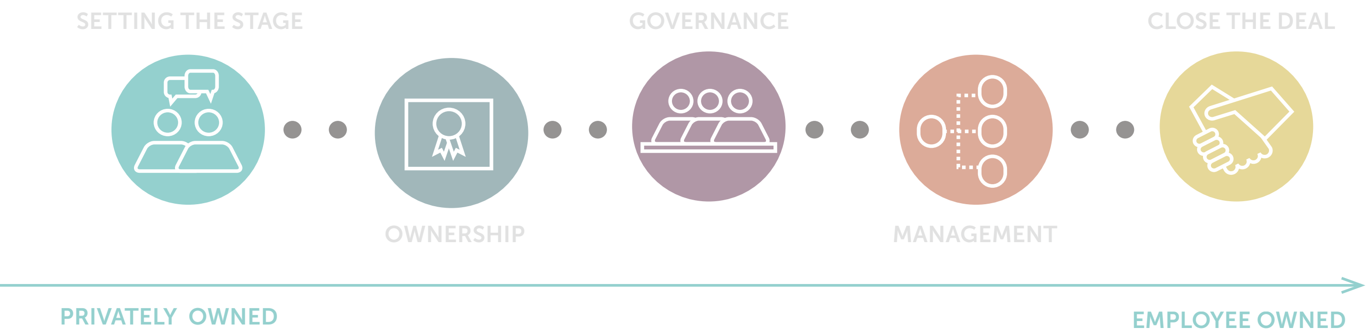
BECOMING EMPLOYEE-OWNED



Options For Business Owners Interested in Engaging Employees Through Ownership

> There are few times in life where you get to make choices that will have multigenerational impact. [Selling the business to employees] is one of those times.
>
> **- Kim Jordon .** CEO of New Belgium Brewing

Regardless of what stage your business is in — from start-up to succession planning — giving employees an ownership stake can have significant benefits for owners, employees, the company, and the community. Decades of research have shown that employee ownership can drive company productivity while rewarding the people who are contributing to the company's success. It also provides a flexible tool for ownership transition that can help preserve the company's mission and values.

There are a number of different ways to share ownership with employees. Which option is right for your business depends on the goals of the business owners, the type of the business, and the company's mission and values. Depending on which structure is used for the transition, there are many potential tax incentives for the selling owner(s) and the business.

This resource provides an overview of the three primary business trasition approaches:

1. **WORKER COOPERATIVES**
2. **EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)**
3. **MANAGEMENT BUY-OUTS**

> The study tracking U.S. public companies from 1983 found that those with substantial employee ownership stakes were 20% more likely than their industry counterparts to survive through 1995.

SELLING TO EMPLOYEES THROUGH A WORKER COOPERATIVE

WHAT IS A WORKER COOPERATIVE?

Worker cooperatives are values-driven businesses that put worker and community benefit at the core of their purpose. Employee-owners at worker co-ops participate in the profits and oversight of the business. At a minimum, this means that employees vote for board members on a one-worker-one-vote basis; sometimes they participate in management as well. Profits in a worker cooperative are distributed to the employees based on hours worked, comparative salary, or another formula that reflects the employees' contribution to the company through their labor.

There is no single way to form a worker cooperative entity. In many states, there is a statute that creates a corporate form specifically for cooperative corporations. However, many worker cooperatives are structured as an LLC or C or S corporation, with the cooperative structure formalized in their operating agreement or bylaws. Worker cooperatives have some tax advantages (see table on the following page).

HOW DOES A CONVERSION TO A WORKER COOPERATIVE TYPICALLY WORK?

Worker cooperatives are not highly regulated, and there is flexibility in how a transition to a worker cooperative can be structured. As with any ownership transition, the process will include establishing a value for the business, finding financing for the deal, and creating a timeline for implementation. There are no federal or state regulatory requirements around how these steps are completed. It is common for employees to provide some financing for the deal through the purchase of member shares. Conversion to a worker co-op can take anywhere from 6 months to several years.

Because worker cooperatives are participatory democratic organizations, transitioning ownership to employees in this way requires setting up thoughtful structures, as well as a training for employees in democratic decision-making, business and financial literacy, which will help employees think and act like owners. If the business will be democratically managed — where employees participate in major management decisions — additional training is required.

> “Employee owned firms with participation in management grow 8% to 11% per year faster with their ownership plans than they would have without them.”

SELLING TO EMPLOYEES THROUGH AN ESOP

WHAT IS AN ESOP?

An employee stock ownership plan, or ESOP, is a type of employee benefit plan (like a 401(k) or profit sharing plan) that can be used to transfer partial or full ownership of a company to employees. With an ESOP, shares are not held directly by employees, but through an ESOP trust, which is administered on employees' behalf. Federal law governs many aspects of how the plan is administered, including allocation, vesting, distribution, and more. ESOPs have significant tax benefits (see Table).

Under the plan, employees must have voting rights on certain major issues such as dissolution or sale of company assets, but do not necessarily vote for the board or have other governance or management rights. Almost all ESOPs are completely company-funded; employees do not pay to participate in the ownership plan. ESOPs are the most popular form of broad-based employee ownership in the United States, with almost 7,000 ESOPs covering approximately 13.5 million employees.

> "Employee ownership increases sales, employment, and sales/employee by about 2.3% to 2.4% per year."

HOW DOES A TRANSITION TO AN ESOP TYPICALLY WORK?

In an ESOP transition, owners sell some or all of their shares to the ESOP trust, which owns those shares on behalf of employees. A majority of ESOP transitions use a loan or other financing to fund the transaction. Because ESOPs are regulated at a federal level, there are a number of rules around how an ESOP transaction must occur. A third party appraisal is required and the ESOP trust cannot pay more for the shares than fair market value established by the valuation. Transactions can take between six months to over a year depending on the complexity of the deal and the owners' preferences.

SELLING DIRECTLY TO MANAGEMENT

Management buy-outs are a very flexible way to transfer ownership of a company. The price of the business can be determined in any way that sellers and buyers agree on. The structure of the sale is also flexible, and may include cash purchase by managers, seller financing, continuing compensation agreements, outside financing, or other agreements. There are no major tax benefits to this method of ownership transfer.

A COMPARISON OF EMPLOYEE OWNERSHIP MODELS

Type of Transition	Key Benefits	Key Challenges	Tax Benefits	Cost	Minimum Requirements	Timeline
Worker	Best structure for mission preservation Flexible Tax benefits Deepest employee/ community impact	Can be difficult to find financing Considerable employee training requirements Needs employee buy-in	Capital gains tax deferral for transition Ongoing: Deductibility of profits allocated to employees	Initial transaction: $20,000 to $50,000	Early investment in employee training Willingness of owners to give eventual control of board to employees Willingness of employees to buy and run the business	6 months to a year for the initial transition, up to 3 years to transition leadership
ESOP	Good structure for mission preservation Significant tax benefits Easier to find financing	High initial and ongoing costs Less flexible Larger audit risk from DOL	Capital gains tax deferral (Ccorp ESOPs) Exemption from federal corporate income tax (Scorp ESOPs) Ongoing: Deductibility of contributions to the plan	Initial transaction: $60,000 to $250,000 Ongoing: $10,000-$40,000/year	Profitable company At least 20-25 employees At least $500,000 in payroll Currently a C or S corporation (or can convert to one)	6 months to over a year
Management Buy-Out	Most flexible structure	No tax benefits Can be difficult to find financing		Varies. Includes legal fees and cost to find financing.	Must be profitable At least 15-20 employees	Varies. Can take very little time

“Employee ownership is associated with greater employment stability and productivity.”

CASE STUDIES IN EMPLOYEE OWNERSHIP

NAMASTE SOLAR

www.namastesolar.com

Based in Boulder, Colorado, Namasté Solar was founded in 2005 to provide residential and commercial solar services. The company chose to restructure as a worker cooperative in 2011 to better align the company's capital structure with its governance structure. Prior to the transition, the company operated on a one person, one vote basis for most operational decisions, but when it came to shareholder votes, decisions were made on a one share, one vote basis.

The cooperative model more closely matched the democratic ideals and more equitably distributes the risk/reward equation of the company's employee-owners. In addition, this enabled the company to accept external investors without sacrificing internal control.

Today, Namaste Solar has more than 60 members and employees, and is a nationally recognized leader in innovative solar instillation.

SELECT MACHINE, INC.

Founded in 1994 by Doug Beavers and Bill Sagaser, Select Machine manufactures, sells, and distributes machined products and equipment for installation on construction and demolition equipment. When the founders started looking to sell the business, several interested potential buyers surfaced, but all of them wanted to buy the business for its customer list and equipment, and consolidate production into underutilized facilities elsewhere. Shutting the plant and leaving their employees out of work was not an acceptable outcome for the founders, who then started exploring alternatives to a traditional sale. After research, they determined that a worker cooperative was the best option for their company, and transitioned in 2011.

SOUTH MOUNTAIN COMPANY

www.southmountain.com

South Mountain Company is a 37 year old design and build company located on Martha's Vineyard. The business began as a partnership in 1975 and then became a sole proprietorship owned by the company's co-founder, president and CEO John Abrams in 1984. After a period of unexpected growth, the company experienced a cultural shift and began to considering restructuring. The leadership team determined they wanted a structure that distributed both ownership and control to committed employees, and decided that a worker cooperative was the best fit. The company, which converted to a worker cooperative in 1987, currently employs over 30 people, 18 of whom are currently worker-owners, and is a leader in green design, renewable energy instillation, and affordable housing development on Martha's Vineyard.

NEW BELGIUM BREWING

www.newbelgium.com

In December of 2012, New Belgium Brewing, one of the largest craft breweries in the country, became 100% employee-owned through an ESOP. The transition to employee ownership started in 1996 as a way for co -founders Kim Jordan and Jeff Lebesch to access some of the value of the company without bringing in outside investors. Since starting its ESOP, the company has continued to grow at an exceptional rate. The decision to transition to 100% employee ownership was driven by a desire to keep ownership in the hands of employees, as well as to achieve full liquidity for the current owners. Kim Jordan plans to remain CEO for the long-term and the executive team remained the same through the transition.

“Initially I became an owner because it seemed like the right thing to do – kind of like voting. A requirement of ownership includes serving a stint on the management committee to learn the nuts and bolts of keeping this ship afloat. It was through this experience that I gained a deep appreciation for "ownership". During my term on management the changing economic environment required the company to evaluate the situation and make difficult decisions.

As owners we all profit during the good times; similarly, during hard times we each share responsibility for those hard decisions that affect the welfare of co-workers and their families. As an owner it is a privilege to be part of a process that looks to each other for the solutions that will keep the whole organization strong and healthy.”

– Ken Leuchtenmacher
(Employee to Owner from South Mountain Company)

NEXT STEP

EMAIL TO SCHEDULE A FREE INITIAL FEASIBILITY CONSULTATION
conversions@institute.usworker.coop

The Democracy at Work institute expands the promise of worker ownership to new communities of worker-owners, ensuring that this growth is adequately supported, effective, and strategically directed. The Institute brings both a birds-eye view of the national stage and an experiential on-the-ground understanding of cooperative business.

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Drawing on our ongoing research and direct knowledge of worker cooperative enterprises, we work with a variety of clients and partners:

- With worker cooperatives to help them develop, grow and replicate.
- With non-profit organizations to support the implementation of new cooperative programs, and to increase the impacts of existing programs.
- With conventional businesses to support them in succession planning & transition to cooperative ownership.
- With governments and economic developers to design and implement policies and programs that use worker cooperatives as a tool for local economic development.