

Transitioning a Private Business to a Worker Cooperative –Select Machine

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ACE Institute Winnipeg, MB, Canada

Presented by

Ohio Employee Ownership Center

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Select Machine's Conversion to a Worker Cooperative

- To date the Ohio Employee Ownership Center had assisted over 80 private businesses to ESOPs
- Cooperative Option for Employee Ownership
- Co-op option a better fit for smaller businesses and
Less costly when compared to an ESOP

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Why Select Machine Transitioned to Worker Co-op

- No other logical successors within the business
- Employees were part of "the family"
- Outside offers would close the facility
- Employees could appreciate & benefit from ownership
- Impact on the community

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Ohio Cooperative Law

1998 and 2005 changes to the Ohio Cooperative Law:

- Expanded focus beyond agriculture
- Allowed labor to be a contributed source
- Provisions allowed for balancing of interests
- Retained Patronage as Sweat Equity, not treated as debt

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Select Machine Conversion Overview

Willingness...

Existing Situation...

New Structure...

Completing the Deal

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Can Select Machine become a co-op?

(is there a willing seller & buyer?)

1. Determined the desire of Select Machine Owners

- Seller met with advisors - including co-op knowledgeable resources
- Overview of co-op structure and issues
- Owners interested in selling, but willing to remain for a period of time
- Discuss financing options

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Can Select Machine become a co-op?

(is there a willing seller & buyer?)

2. Determined desire of Buyer(s) - the employees

- Worker participation can improve performance
- Involved early
- Seller and advisors met with employees
- Explained Co-ops - determined interest to proceed
- Employee representatives selected to join management in a co-op buyout committee

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Review the Existing Situation

3. Conducted a Feasibility Study

High level assessment of financials and key factors that can make the transaction feasible

4. Conducted a Valuation

(necessary for "1042 Rollover" & set "fair value")

5. Completed a Business Plan

- Use input from feasibility and valuation

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The New Co-op

6. Reviewed new co-op structure w/ buyout committee
 - Key Documents addressed
 - ❖ Bylaws and Articles of Incorporation (Restated)
 - ❖ Stock Redemption Agreement
 - ❖ Membership Agreement
 - ❖ Offering Statement

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The New Co-op

- Key issues addressed, 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!**

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The New Co-op

7. The financing process
 - Financing issues for Transition to Worker Cooperatives
 - Sale of a portion of the stock (staged sale)
 - Financeable Assets (real property separate)
 - Funding Side of Stock Transfers
 - Employee Loans
 - Employee Notes vs. Bank Notes

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The New Co-op

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

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The New Co-op

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

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The New Co-op

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

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Do The Deal

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

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Doing The Deal

(Prepare and execute final documents cont'd)

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

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Advantages - Select Machine

Private Owners

- 1042 Rollover Qualification
- Staged Sale
- Financeable Transaction
- Retained some control during transition
- Real property kept in use
- Positive Legacy in the Community

Employee Owners

- Retained job
- Gained Control of Career
- Received Equity Position - via payroll deduction plan
- Expanded Capabilities
- Maintained Community
- Job Flexibility

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Subsequent Notes - Select Machine

Select Machine transaction completed in 2005 with initial terms of final purchase by Late 2010.

Sales dropped below 50% of expectations with the economic recession.

Those who could afford layoffs took them so the company could weather the "storm"

Select Machine deferred the final purchase date

Select Machine just announced their pursuit of the final purchase of stock to be completed by the end of 2011

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Conversion Costs & Timing

Estimated Costs

- | | | |
|-----------------------|-------------|--------|
| • Co-op Attorney | \$10,000 to | 30,000 |
| • Valuation | \$ 5,000 to | 8,000 |
| • Other Professionals | \$10,000 to | 20,000 |
| • TOTAL | \$25,000 to | 58,000 |

Timing of Conversion

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

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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% for most tax brackets
 - Slated to increase to 23.8% on 1/1/13 for top two tax brackets
 - 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

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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

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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!

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