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The 1042 roll-over cooperative in practice

A case study of how Select Machine became a co-op

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On September 30, the seven employees of Select Machine, in Brimfield, Ohio, began to purchase their company from the two retiring owners, Doug Beavers and Bill Sagaser, using an employee-owned cooperative. This purchase used a precedent-setting structure that (1) permits the sellers to take advantage of the "1042 rollover" of their capital gains while (2) structuring the sale over a period of several years, making it easy to finance and enabling the owners to transfer their managerial expertise to the other co-op members over time.

In 1984, changes in the tax law concerning Employee Stock Ownership Plans (ESOPs) created the so-called "1042 rollover" which permits owners of closely held businesses who sell 30% or more of the stock in their company to their employees through an Employee Stock Ownership Plan (ESOP) **or a co-operative** to shelter the capital gains from taxes by rolling the proceeds of the sale over into other qualified domestic securities within 12 months of the sale.

Today that is the number one reason for establishing ESOPs, **but not one employee co-op had been established using this provision – prior to Select Machine.**

Why not? The primary reason is that ESOPs' stock structure enables owners to sell part of their companies to employees, while retaining enough equity to make financing easy. The typical 1042 rollover ESOP is done as a 2 or 3 stage transaction over a 5-10 year period. By contrast, co-ops are conventionally structured as 100% employee owned. Financing a 100% leveraged transaction is extraordinarily difficult, especially if the owners are leaving and taking their management skills with them.

Comparing ESOPs and Co-ops

ESOPs have tax advantages that make them the employee ownership structure of preference in companies that are profitable, capital intensive, and employ more than 20-25 employees. Because ESOPs are Federally regulated qualified employee benefit plans, the costs of establishing them -- $50,000 and up -- and maintaining them -- $10-15,000 annually -- makes them unduly expensive in smaller, less profitable companies. Furthermore, small ESOPs have great difficulty staying in compliance with the law because they try to save money on professional advice. That eventually catches up with them in expensive Department of Labor fines and Plan corrections.

By contrast, employee co-ops are membership associations similar to agricultural co-ops and consumer co-ops. Co-ops distribute their profits to members on the basis of labor input measured by W-2 earnings, hours worked, or other measures, not unlike the way ESOP stock is

distributed. Unlike ESOPs, however, members elect a majority of the board on a one-person, one-vote basis. Co-ops have fewer tax advantages than ESOPs, but they are less expensive to set up and even cheaper to maintain. They would seem an ideal employee ownership solution in smaller companies, if a multi-stage transaction model could be established.

Structuring the co-op business succession model

What is needed for a multi-stage co-op purchase? With the financial support of the George and Gladys Dunlap Cooperative Leadership Program of the Nationwide Foundation, the Ohio Employee Ownership Center and the Ohio Council of Cooperatives (now part of the Mid-America Cooperative Council) sought to develop a practical model for ownership succession in small businesses using the employee cooperative as an ownership structure.

We teamed with Mark Stewart, one of the nation's leading co-op attorneys, and ESOP-specialist Eric Britton at the Toledo, Ohio, law firm of Shumaker, Loop and Kendrick, to develop the legal framework for the conversion of the company to a cooperative and for the purchase transaction to take place over time.

The model that Stewart and Britton designed calls for converting the company into a co-op which then redeems the retiring owners' stock in several steps with a valuation at each step. The owners qualify for a tax free rollover of the proceeds provided the co-op redeems at least 30% of the owner's stock. The owners' remaining equity makes the deal easy to finance, and the owners' continuing involvement for several years enables them to transfer their management skills to the other co-op members.

This model has two distinct financial advantages for the selling owners. First, they obtain the control premium on the first stock redemption, because a co-op by definition must be controlled by its members. Second, the retiring owners can be members of the co-op as long as they are working and can also receive internal capital allocations annually.

On the other hand, the selling owners have to be comfortable with a board elected on a one-member, one-vote basis and with the inherently democratic nature of the co-op.

Why sell Select Machine to the employees?

Select Machine was founded in 1994 by Doug Beavers and Bill Sagaser and today employs 9 people full-time, including the two owners. The company manufactures, sells and distributes machined products and equipment for installation on construction and demolition equipment.

"Bill and I set up this company to be the kind of company that we would like to work for if we were working for someone else," is the way Beavers describes the owners' philosophy. Symptomatic of the workplace practices at Select Machine is that Bill and Doug serve everyone

lunch on Friday at 2 and send everyone home to have Friday afternoon with their kids. "Best place I have ever worked!" was the opinion freely offered by several of the machinists when we started talking about an employee buyout.

"What impressed me most about this group is their spirit of community within the business," says Attorney Mark Stewart who did the legal work on the buyout. "In a co-op, you need a concern for each other's welfare, just like partners have. That attitude is infectious. That's the kind of attitude they have at Select Machine."

Beavers and Sagaser had sought to sell their profitable business for months before offering it to the employees. Several interested potential buyers surfaced, but all of them wanted to buy the business for its customer list, cherry-pick the equipment, and consolidate production into underutilized facilities elsewhere. Shutting the plant and leaving their employees out of work was not why Beavers and Sagaser had built the business. Why not sell to their employees instead? They turned to the Ohio Employee Ownership Center (OEOC) for advice.

From the initial telephone discussion on 3/22/05 to completion, the deal took 6 months. See the time line attached as Appendix 1.

The OEOC staff conducted several meetings with the owners, reviewed the financials, and toured the facility to get an understanding of the business and what the transaction would entail. The owners broached the idea of ownership to the employees, and got a favorable response. We then met with the employees to explain the basics of employee ownership, what an employee cooperative is, and how the deal could be done. (Our roadmap, prepared for a meeting with the owners on 3/25/05 and then expanded for the initial meeting with the employees on 4/8/05 in provided as Appendix 2.) The employees voted to investigate the possibility of setting up a co-op, and elected a buyout committee to undertake that task.

Given the threat to the jobs if the employees didn't buy the plant, a preliminary feasibility assessment of an employee purchase was funded by a grant from the Ohio Department of Job & Family Services' Prefeasibility Study Grant Program administered by the OEOC. The study was performed by Brott Mardis, a local accounting firm, and included a valuation.

Funds for preliminary feasibility assessments of employee purchases to avert job loss are available in every state through the Federally funded Workforce Investment Act, but are only regularly used in half a dozen states.

Doing the deal

With a favorable feasibility study in hand and expressed willingness from a local bank and from a revolving loan fund to finance the redemption of 40% of the owners' stock, Attorney Mark Stewart prepared an offering statement for the employees.

Unlike ESOPs, which are trusteed pension plans and whose trustee acts on behalf of the employees to buy the stock, in co-ops the members act on their own behalf. Thus members buy the company much as individuals buy used cars: it's buyer beware. ESOP participants have recourse against a trustee who pays too much. In a similar situation, co-op members' recourse is against the seller for fraudulent conveyance. So it is in the interest of both the buyer and the seller that the co-op members are fully informed in writing about the risks of the transaction.

The tool to do that is the **offering statement.** It describes the company, the proposed transaction, the intent of the owners to sell their remaining stock to the co-op, how the co-op will redeem the owners' stock, how the company will be managed, the various legal documents necessary to establish the co-op and complete the transaction, and the risks involved. It is not a Securities and Exchange Commission disclosure statement, but it performs the same role in informing the potential co-op members about what they may buy and the risks involved in doing so.

After reviewing the offering statement, the feasibility study and valuation, and the financial statements of the company, Select Machine employees voted to set up an employee-owned cooperative. They discussed and made key decisions about the structure of the cooperative including qualifications for membership, membership fees, and how to allocate patronage.

They set the co-op membership fee at $1000. Patronage allocations are distributed on the basis of a formula that assigns 50% to W-2 earnings (rewarding current market value of their skills), 25% to hours worked (rewarding diligence and equality), and 25% to seniority capped at 120 months (long-term contribution to the business).

With the decision to proceed, preparing the documents swung into high gear because essentially everything else has to happen virtually simultaneously: converting the company into a co-op; selecting a board and holding an initial board meeting to authorize the redemption and borrowing to fund it; executing the various legal documents related to co-op membership, members' stock subscription and the stock redemption; formalizing employment agreements; and borrowing the money to redeem the first 40% of the owners' stock.

So what exactly happened?

- The articles of incorporation of Select Machine were amended and restated to establish the firm as a cooperative under Ohio Cooperative Law. New bylaws appropriate for the cooperative were written to replace existing bylaws of the company.
- Select Machine cooperative members elected a board of five including the two selling owners – who joined the co-op as members – and three employee members.

$ The board voted to authorize the stock redemption and borrowing the money to fund it.

$ The documents for the transaction were prepared: the stock redemption agreement which establishes the terms and conditions for redeeming the stock from the original owners; membership and stock subscription agreements for the new co-op members; the business plan; employment agreements for the co-op members; and the owners' employment agreement which provides them certain reserved rights as "protected shareholders" until their stock is redeemed.

Because of the fact that the 1042 rollover assumes the conveyance of the seller's stock to the employees, the stock redeemed from the owners is distributed to the other members of the co-op as membership stock in return for limited recourse notes by which the members pledge to pay for the stock with their patronage allocations and stock pledge agreements that put up the stock as collateral against the loan. Consequently, the redeemed stock is allocated among the members just as initial patronage allocations will be made.

Over time, as newer employees acquire more seniority, the weighting of the allocation formula will give them larger patronage allocations, and the stock accounts will ultimately have to be rebalanced.

Beavers and Sagaser sold 40% of their shares in this transaction and became themselves members of the co-op. To do so, they put up a portion of their unredeemed stock holdings as membership stock, equivalent to the average membership stock the other members hold.

While the patronage capital allocations for all members except the owners will go to pay down the note used to acquire their stock, the owners will simply receive their patronage allocations. After all, they already own their membership stock. So they will build their capital accounts within the co-op, but will not acquire additional stock in the process.

Beavers and Sagaser intend to sell the remaining 60% of their shares as soon as the debt to purchase the 40% has been repaid. They then intend to retire from the business. In the intervening period, they need to train other co-op members to run the business successfully. A first step in this process was writing a business plan for the transition period that spells out what functions the owners have performed for the firm and who will be trained to take over which tasks. This document, which was drafted by the OEOC's Bill McIntyre on the basis of the owners' input, creates a formal transition plan that specifies the skills and knowledge which Beavers and Sagaser will need to transfer to the other co-op members over the next few years.

National implications

"The structure of an employee co-op and its tax advantages under Section 1042 of the tax code are relatively obscure for business owners," says Stewart, "but once we have viable models of how this can be achieved, we will have a lot more co-ops set up for business succession."

The model pioneered at Select Machine should be transferable to many other small companies with under 25 employees. The employee-owned cooperative offers an attractive alternative to those owners of companies that are too small for the ESOP option and do not have family members available, willing and capable of taking over the business. The stock redemption model permits selling owners to shelter their capital gains, get a better price than they otherwise would, and see their business legacy continue.

How has it worked so far?

I called Dave Baird, a machinist who has been with the company for 6 years and is the co-op vice-chairman, a month after the co-op was established to get an update on where things stand.

"It's all good, John. Everyone is real excited to make this thing happen. You know that we felt good about working here before, but everyone is more enthusiastic now. I was talking to one of the younger guys yesterday on this. 'I just see the company differently now,' is what he told me."

"This co-op's an honor," Baird continued. "It's a challenge that I look forward to every day."

"We did not set out to establish a precedent or develop a model," said seller and new co-op member Beavers. "We just wanted to do what was best for the employees of our company and for ourselves. We chose the employee-owned cooperative because it made sense."

The OEOC is a non-profit program based at Kent State University providing information and technical assistance to people interested in exploring employee ownership as well as developing and delivering training material and sponsoring conferences and programs for employee-owned companies. Visit our website at www.kent.edu/oeoc/ Since it was established in 1987, the OEOC has assisted 73 companies employing over 14,100 employee-owners to become employee owned; these firms have created over $300,000,000 in equity for their employee-owners. For more information on the 1042 rollover co-operative, read our coverage of the Select Machine case and Mark Stewart and Eric Britton's articles on the subject at www.kent.edu/oeoc/OEOCLibrary/

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Appendix 1

Timeline on the Select Machine transaction

- X 3-22-2005: Owners contact OEOC; followed by meetings with OEOC staff, discussion of choices, & review of financials
- X Owners like co-op idea & broach it with employees
- X 4-8-2005: OEOC staff meet with employees, explain co-op and how to do the deal
- X 4-8-2005: Employees vote to explore co-op and elect a buyout committee
- X April: Equipment appraisal updated
- X Mid-May: Feasibility study/valuation consultant hired
- X 6-16-2005: Feasibility study and valuation completed
- X Late June: Extensive discussion with OEOC staff of feasibility study and implications
- X July 2005: Owners decide to proceed with sale to employees
- X 7-29-2005: Initial meeting between owners and employees and co-op attorney Mark Stewart
- X 8-9-2005: Attorney retained; offering statement prepared
- X August: Employees review feasibility study, offering statement, and financial statements; they vote to establish co-op and set membership criteria, fee, and allocation formula
- X 8-15-2005: Lenders agree to loan enough for a 40% stock redemption
- X August-September: Documents are drawn up
- X 9-14-2005: Amended incorporation documents and bylaws are filed with state
- X Mid September: Co-op board elected, meets, authorizes stock redemption and borrowing
- X 9-30-2005: New co-op members sign memberships, stock subscription agreements, limited recourse notes, stock pledge agreements, employment agreements, and receive stock certificates
- X 9-30-2005: Owners and co-op officer sign stock redemption agreement and owners' employee agreement
- X 10-3-2005: Loan documents are signed and owners receive cash for stock redeemed
- X Select Machine begins functioning as a cooperative with 40% held as membership shares by the new co-op members and 60% held by the owners
- X Between 2005 and 2010, the owners will transfer their management skills and knowledge to the other co-op members
- X In 2010 or before, the remaining shares held by the owners will be redeemed, and they will retire

During the period between April 8 and September 30, OEOC staff met with the employees and

owners at least biweekly and generally weekly.

Appendix 2
Steps in a 1042 co-op buyout at Select Machine

This memo was originally prepared for the owners and then expanded for the employees.

Date: 3-25-05 and 4-8-05
To: Doug Beavers & Bill Sagaser, Select Machine Inc. & Select Machine employees
From: John Logue, OEOC
Subject: Steps in an employee buyout through an employee cooperative for getting the 1042 rollover in a multistage sale

Employee Stock Ownership Plans (ESOPs) have been the usual tool for selling businesses to employees in the US by retiring owners. However, ESOPs are expensive to put in place, generally costing a minimum of $40-60,000 to put in place and $5-10,000 annually to maintain. Worse, our experience is that small ESOPs in practice are hard to keep in compliance with the law.

Selling to employees through an ESOP or through a co-operative provides the same tax break for the seller. Co-ops are less expensive to set up and essentially free to maintain.

Here's a short road map for how to do a multi-stage sale to the employees through a co-op.

Steps:

1. Discussion with and decision by owner(s) that a sale to the employees is a good idea.

2. Discussion with and decision by employees that purchasing the business from the owners over a period of years is a good idea. Determine procedures by which employees will satisfy themselves that they are knowledgeable buyers. Establish a small committee of employees to represent the employees as buyer.

3. Obtain a current equipment appraisal. We won't be able to borrow the money to buy the first chunk of Bill's and Doug's stock without an appraisal.

4. Obtain a valuation for the business to set the value of the shares to be redeemed.

5. Prepare a lease for the building at market rates. (Doug and Bill currently own the real estate separately from Select Machine, a very common way thing in small businesses. Once Select Machine becomes a co-op, there will need to be an arms-length relationship between Doug and Bill as landlords and the co-op, even though the co-op includes Doug and Bill.)

6. Prepare a description of the business that you are buying, of how you are buying it, how you

are going to run it going forward (that is, your plans for the business) and what the risks are. The guys you elect and Doug and Bill will be hiring someone to prepare this with the committee. This is essentially the disclosure document on the sale (so it's similar to an offering prospectus for public company stock – but much shorter and written in English).

You should read this carefully and ask your questions. You are going to become owners of the company, and you should understand what makes the company tick and how you all and Bill and Doug will work together for some years to run the company successfully and how you will run it successfully when Doug and Bill retire.

7. This document becomes the basis for writing a formal business about how you will run the business going forward: markets, customers, suppliers, management, equipment needs, etc. This business plan should pay particular attention to establish procedures and a time line for transferring Bill's and Doug's management knowledge and skills to the other co-op members.

8. Prepare new bylaws of the company (and incorporation papers, as necessary) to reflect that it will be doing business as a co-operative. This requires two things: (a) distribution of future retained earnings annually on the basis of labor input into the company, and (b) election of a majority of the members of the board by co-op members. From the point of view of the seller(s), this also means (c) building in veto power for the selling owners as long as they have a majority financial interest in the company.

9. Establish the co-op as a membership organization. Do membership agreements. Each member gets one voting share.

Note: the sellers can be members of the cooperative and can participate in the annual allocations of retained earnings – provided you use a non-share-based system for allocating retained earnings.

10. Decision by you as a group on whether you want to buy the company from Doug & Bill and by you individually whether you want to be members of the co-op.

11. Elect the board for the co-op.

12. The board will authorize management to redeem at least 30% of the shares of the company (30% is the threshold to get the favorable tax treatment for the sellers). Presumably you will borrow money for this or will lay aside money from current revenues as employee bonuses for investment in the co-op.

Bill and Doug have a banking relationship with Huntington. The OEOC also runs a small revolving loan fund. It looks to me that it should be possible to finance redeeming a third of the stock in the company.

To get the favorable capital tax treatment, the sellers need to reinvest the proceeds in "qualified replacement property" which means stocks and bonds of American companies which produce goods and services.

13. Pay down debt taken on for first stock redemption over several years and then borrow more to redeem some additional stock or all the remainder of the stock. Repeat until all the stock has been redeemed. It is probably necessary to do another valuation at each sale.

14. During the 3-7 years that this process is underway, Doug and Bill need to transfer their management expertise to the other members of the co-op.

You've got to learn how to run all aspects of the business successfully before Doug and Bill really retire. Even when they do, you may want to keep them on the board for a while as senior statesmen so you have their advice and knowledge at your disposal.

15. Before the last portion of Doug's and Bill's stock is redeemed, they should consider rolling the building into the company as a final step in the transaction – assuming they want to sell the building at that time instead of being landlords to a business they no longer own part of. That would let them shelter their capital gain in the building.

That would give them some additional stock (reflecting the market value of the real estate that they contribute to the business) and then that stock would be redeemed and the co-op would own the real estate too.

This doesn't have to happen, though. Plenty of businesses lease the property the occupy.

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It's hard for owners of small businesses to sell them for what they are worth, because part of the value of the business is the skill and knowledge of the owners working there every day. Too often the owners keep hoping that someone will show up to pay them a lot for the business – and then find when they really need to retire that the only real buyers want to buy the customer list, to cherry pick the equipment, and move production to some other place.

The goal of the transactions is that everyone will benefit: Doug and Bill benefit as sellers because they get a tax break (an as co-op members while they continue to work in the co-op) and the employee co-op members benefit from jointly owning and running a successful business right here at Select Machine.

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