Employee Ownership Conversions

by Carrie Green, Esq.

Your client sells or produces food. Selling and producing food requires labor. As this is Maine, the business's workforce is small, and the owner knows each employee well. Of Maine's 32,000 employers, 80% have under 100 employees, and 50 % of these have fewer than 20.

The owner wants to retire…. someday.

In an outside sale, the owner will need to value the business, and shop it around. Small food businesses aren't operated from a distance; prospective buyers are either in Maine or willing to move here. Some of those buyers only want the business's assets. Others want a going concern, but will not commit to employee retention.

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In contrast, the business's employees are nearby and motivated to stay employed. The Cooperative Development Institute's Rob Brown says, "the largest single source of avoidable job loss is owner retirement." Inside sales have lower transaction costs. There may be significant tax advantages to transferring ownership to employees. Are the employees interested?

Rock City Café and Rock City Roaster's long-standing employees are. As a result they keep their jobs, Rockland keeps a 25-year-strong community center, and the business owner, Susanne Ward, can plan for retirement. The conversion received national coverage. *See:* https://shelterforce.org/2016/05/03/the-next-boom-for-worker-co-ops/

Tax Incentives and Transaction Costs

IRC Section 1042 allows sellers to defer capital gains on ownership transfers to employees by rolling sale proceeds into qualified replacement property. If the replacement property passes to the owner's estate, gains may be avoided altogether.

Section 1042 rollovers drive the creation of employee stock ownership plans (ESOPs). However, professional fees to establish an ESOP can be upward of $50,000. Annual regulatory compliance is expensive when contracted to professionals, and perilous in-house.

Worker cooperatives are an ESOP alternative, particularly for small businesses with 25 or fewer employees. They are less costly to create, and have lower administrative costs. Conversions can be structured to take advantage of §1042. In contrast to an ESOP, however, an owner selling to a worker cooperative must accept loss of control, and an employee-elected governing board. If the owner plans to use the conversion to retire or move on, this may not matter.

Maine businesses may soon have another reason to consider conversion to employee ownership. Maine bill LD 1338, An Act to Create and Sustain Jobs through Development of Cooperatives and Employee-Owned Businesses, would create state tax incentives for employee ownership conversions.

See: https://legislature.maine.gov/bills/display_ps.asp?paper=HP0932&snum=128&PID=0.

Sponsored by Martin Grohman (I-Biddeford), the bill would allow an exiting owner to subtract gains from the conversion in calculating state taxable income. Interest earned on qualifying business acquisition loans financing conversions could also be subtracted.

Maine Employee Cooperative Statute

The "Employee Cooperative Corporations Act," 13 M.R.S. §§ 1971-1984, governs Maine worker cooperatives. All cooperatives are governed democratically. A worker cooperative extends the one-member, one-vote concept yet further: only employees can be members. § 1978 (3). The co-op's (affordably low) membership fee is set by its board. § 1978 (2).

Worker cooperatives may declare "patronage allocations," similar to dividends in business corporations. Unlike dividends, patronage allocations are distributed based on the value of work performed and not capital contributed. This work is called the member's "patronage." §1980 (4). The co-op's bylaws or articles of incorporation define how patronage is measured. §1972 (4).

Separating economic interest from governance interest creates a unique dynamic. A business corporation's board acts in the interests of

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the majority of capital. A worker co-op board acts in the interests of the majority of employees. Workers have a direct, personal interest in the co-op's profitability. If the board declares a patronage allocation, the allocation is distributed to the workers. Conversely, a board may retain net earnings to allow the cooperative to continue as an employer.

Conversion

Conversion to a worker cooperative involves transfers of 1) ownership; 2) governance; and 3) management. As with any successful succession strategies, transitions to worker ownership take time. They take time to ensure that the business's viability under worker management, time to recruit members and elect qualified board members, and time for governance and management education.

Consequently, an owner should think of conversion as a long-term goal, measured in years, and not in months. Susanne Ward recommends five years. New businesses, particularly those started by the increasing number of entrepreneurs over fifty, may want to consider an employee ownership conversion as an exit strategy in their original business plans.

Ownership transfer begins with a letter of intent between the owner and employee representatives. The parties then negotiate a conversion or sale agreement, establishing price, assets to be transferred, non-compete obligations, etc. Homework is critical: no transfer should occur without business planning demonstrating that future cash flow under employee management will cover operating expenses and the owner's buy-out, and allow the business to operate at a profit.

Governance transfers when the newly-formed co-op and owner sign the agreement. A co-op is formed by filing or amending existing articles of incorporation and adopting or amending bylaws. The co-op's bylaws establish membership rights, allocation rules and board size, composition and authority. The bylaws may also define management positions. In a successful transfer, worker-members assess their collective skill set realistically. Do they have the financial and operational expertise needed to run the business? Can they fill gaps by appointing outside board members or hiring managers?

Management transfer assigns responsibility for day-to-day management decisions, defining individual managers' responsibilities, and ensuring that those responsible have adequate training and expertise. This can include an ongoing arrangement with the exiting owner to provide expertise and ensure continuity. Rock City's owner plans to stay on another two years as an employee-member and manager to facilitate the transition.

Resources

Maine has free programs to assist small businesses with business planning:

- Coastal Enterprises, Inc., www.ceimaine.org
- Maine Small Business Development Centers, www.mainesbdc.org
- Venturing Forth, a Maine New Ventures entrepreneurship program affiliated with the University of Maine. www.newventuresmaine.org/programs/start-a-business/

Each of these organizations has offices throughout the state.

The Cooperative Development Institute's Business Ownership Solutions program advises on worker cooperative management and governance, provides design, implementation, finance, and education services to owners and employees in conversions to employee ownership . For more information, contact Rob Brown, rbrown@cdi.coop.

The Cooperative Development Fund of New England's website has an extensive list of cooperative technical advisors: www.cooperativefund.org/content/technical-assistance-providers.