Type II Conversions

TYPE II CONVERSIONS

Type II conversions are when the owner sells to existing employees with the intention of leaving the company, whether to retire or for other reasons. The cooperatives profiled in this section are the Island Employee Cooperative of Stonington, Maine and Select Machine of Kent, Ohio.

→ **Island Employee Cooperative**

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ISLAND EMPLOYEE COOPERATIVE

Three retail stores providing groceries, hardware, prescription drugs, pharmacy items, craft supplies, gas and other goods and services: Burnt Cove Market, The Galley and V&S Variety and Pharmacy Stonington and Deer Isle, Maine (the only 2 communities on the island of Deer Isle)

Date of conversion: June 11, 2014
Number of workers at time of conversion: 60 total: 45 worker-owners; 15 non-owner employees
Number of workers as of summer 2014: 60 total: 45 worker-owners; 15 non-owner employees
Conversion type: Type II

Based on Project Equity's interview with Rob Brown of the Cooperative Development Institute (CDI) and Mark Sprackland of the Independent Retailers Shared Services Cooperative (IRSSC) in the summer of 2014. CDI and IRSSC were advisors to the Island Employee Cooperative throughout its transition to worker ownership and they continue to provide management and governance training.

CDI is the USDA-designated Northeast Center for Cooperative Business Development. Rob Brown is the director of their Business Ownership Solutions (BOS) program, a Maine-based program assisting retiring business owners and their employees to execute conversion to a worker coop as a succession option.

The mission of the IRSSC is to help independent retailers differentiate meaningfully from conventional supermarkets and gain access to the marketing resources, category management and supply chain expertise needed to succeed in today's highly competitive marketplace.

Background

The Island Employee Cooperative is an umbrella cooperative comprised of three businesses in Stonington and Deer Isle, Maine: Burnt Cove Market, The Galley, and V&S Variety and Pharmacy. It is the largest worker cooperative in Maine and the

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second largest in New England. Vern and Sandra Seile owned the stores for 43 years before selling to their employees in 2014.

Why it became a coop

Owners Vern and Sandra Seile wanted to sell their three businesses on the island of Deer Isle and retire, but they and their employees worried that an outside buyer would consolidate operations and cut jobs. Many of the 60 employees of the businesses had been working with the Seiles for several decades—one employee had even been with Burnt Cove Market since it opened in 1973—and the owners and employees had formed a close community. Other employment opportunities on the island are very limited, so if employees were to lose their jobs following the sale of the businesses, finding steady work elsewhere would likely prove very challenging.[55] Additionally, the island communities of Stonington and Deer Isle are dependent upon the businesses of the Island Employee Cooperative; if the businesses were to close, customers would be forced to travel at least 25 miles on backcountry roads to reach comparable stores.

The Seiles found a solution for their tri-fold problem in the worker cooperative model. According to Vern Seile, "We wanted to retire and wanted the stores to continue to serve the Island for many years to come," and selling to his employees would provide "a good incentive to work hard and to make the business more successful."[56] Rob Brown of the Cooperative Development Institute (CDI), which provided technical assistance to the Island Employee Cooperative throughout its transition, notes that selling the businesses to their employees provided the Seiles, the employees, and the community with a "win-win-win."[57] The Seiles gained a succession plan that would allow them to enjoy a comfortable retirement, employees would have the opportunity to build wealth through ownership, and ownership would stay local, keeping operations and profits on the island.

Conversion logistics

Vern and Sandra Seile and their three businesses were members of the Independent Retailers Shared Services Cooperative (IRSSC), a marketing cooperative in New England, when they began to consider selling the businesses and retiring. The IRSSC's Mark Sprackland encouraged them to consider selling the businesses to their employees and brought the Cooperative Development Institute (CDI) into the discussion with the Seiles; CDI's Business Ownership Solutions program specializes in cooperative conversions, and CDI had assisted the IRSSC during its own formation. Rob Brown, Director of CDI's Business Ownership Solutions program, helped the Seiles to better understand the worker cooperative business model, and began a conversation with them about how it might work for their businesses. The Seiles decided they wanted to pursue the option of selling their businesses to their employees as a worker cooperative, and Vern Seile took the idea to key staff at their three stores.

"Of course we jumped at the chance," said Deanna Oliver, long-time bookkeeper for Burnt Cove Market, V&S Variety and the Galley, in an interview with The Free Press

55 O'Brien, Andy. "The Worker Co-op Movement Expands into Maine." The Free Press. February 20, 2014. http://freepressonline.com/main.asp?SectionID=52&SubSectionID=78&ArticleID=30860

56 Brophy, Jessica. "Employees of Burnt Cove Market, V&S Variety and Pharmacy and The Galley form cooperative, plan to purchase businesses." Island Ad-Vantages. January 23, 2014. http://islandadvantages.com/news/2014/jan/23/employees-of-burnt-cove-market-vs-variety-and-phar/#.U6NyCo1dU_4

57 Ibid.

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of Maine in February 2014. "It's a huge opportunity because we would be guaranteed job security. We've pretty much helped him run the stores for many, many years, and we knew this way that it wouldn't be changed."[58]

With the interest of the owners and the employees piqued, the Island Employee Cooperative conversion began to take shape. CDI organized a meeting with all 60 of the employees and the Seiles, and gave a presentation about the basics of worker cooperatives, along with presentations on cooperative business planning by IRSSC and potential financing options by CEI (Coastal Enterprises, Inc.), an expert in rural business funding, development and financing. After learning about worker cooperatives and how they operate, 80% of the employees decided to sign a written Commitment of Interest document drawn up by Rob Brown of CDI. The Commitment of Interest did not represent a binding financial commitment of any kind, but was rather a written expression of employee support for an exploration of the idea of transitioning the businesses to worker ownership. Additionally, the document authorized the formation of a steering committee comprised of employees. The steering committee was charged with leading the processes of developing an ownership structure, incorporating the cooperative corporation, drafting bylaws, researching financing options, and doing other initial nuts-and-bolts work of forming the worker cooperative.

The Seiles recommended a dozen experienced employees as candidates for membership on the steering committee. Many of these recommended employees had some general idea of how a cooperative works, as the Stonington Lobster Coop (a producer cooperative) has been a mainstay of the local economy since 1948, and as the stores were members of Associated Grocers of New England (a grocery purchasing cooperative). Ten of these twelve employees then self selected into the committee, which the majority of the rest of the employees had previously agreed to support by signing the Commitment of Interest document. According to Brown, although the members of the steering committee had a better than average understanding of cooperatives at the beginning of the conversion, there was at that point little understanding of how a *worker* cooperative operates.

Over the course of the following three months, the steering committee met with Brown and Sprackland for 2-3 hour sessions most weeks to learn about worker-owned businesses, as well as the basics of finances, taxation, accounting, valuation and other issues important to the transaction. Together, the steering committee members and Brown read through the bylaws and articles of incorporation of half a dozen other worker cooperatives to better understand different options for structuring their own cooperative. CDI also connected the steering committee with members of other worker cooperatives, including Equal Exchange, to learn about varying experiences with worker ownership.

Working with the steering committee, Mark Sprackland of the IRSSC led development of a comprehensive business plan, negotiations with suppliers, due diligence on the operational evaluation, organizing documentation needed by lenders, and trainings for the employees in which they learned essential business skills like how to read financial statements. Although the education processes led by the IRSSC and CDI focused on the members of the steering committee, the steering committee and the advisors also held several all-employee meetings to check in about the conversion's progress and to keep the process transparent.

58 O'Brien, Andy. "The Worker Co-op Movement Expands into Maine."

At the same time the educational sessions for the steering committee were being held, the financing side of the conversion was moving forward as well. CDI, IRSSC and the employee steering committee negotiated with the selling owners about how much they would be willing to put into the transaction, and reached out to potential lenders. The Maine-based CEI and the Cooperative Fund of New England (CFNE), two New England area Community Development Financial Institutions (also known as CDFIs; financial institutions that provide technical and financial assistance to underserved areas), committed to organizing the financing for the conversion. Both of these lending institutions have significant experience in rural business development (CEI) and cooperative financing (CFNE), so linking these two lenders in the process made the most sense.

In an interview with Rob Brown, he noted that the Island Employee Cooperative was able to secure loans in large part because of CDI's and the IRSSC's close involvement in the conversion. CDI and the IRSSC both signed a contract with the new cooperative in which they pledged to provide assistance to the businesses for a minimum of five years, and negotiated with lenders on behalf of the cooperative. The CDFIs saw the contracts as a loan guarantee of sorts, shoring up the gaps in governance and financial management that the new worker-owners possessed. The contracts were required as loan covenants, and without this and the negotiation expertise of CDI and the IRSSC, the cooperative would have found it much more difficult to secure sufficient loans.

CDI, IRSSC, and the rest of the advisory group educated the selling owners and the Island Employee Cooperative about a taxation benefit known as the "1042 rollover," which allows owners who sell their business to an Employee Stock Ownership Plan (ESOP) or a worker cooperative to avoid a capital gains tax on the transaction. The added incentive of the 1042 rollover allowed the IRSSC, CDI, and the cooperative's steering committee to convince the selling owners to reduce the selling price by "a substantial amount," according to CDI and the IRSSC. In order to take advantage of the 1042 rollover, which requires that the sponsor company be a C Corporation, the Seiles transferred their two LLCs (V&S Variety & Pharmacy and Burnt Cove Market) into The Galley (a C Corporation) at the closing table.[59] At this point, 80% of the employees voted in favor of incorporating the Island Employee Cooperative under Maine's worker cooperative statute, pledged an initial investment to purchase shares in the coop, and, in January of 2014, the new worker-owners and the Seiles signed the Purchase & Sale agreement.

In June of 2014, the Seiles and the new cooperative closed the deal, transferring the C Corporation into a worker cooperative in a $5.6 million transaction. The entire transition process took a little over a year to complete from the origination of the idea to the formal closing of the deal. The Seiles agreed to stay on part-time for 1-2 years to help the cooperative through the transition period.

Coop logistics

CDI designed a share structure for the Island Employee Cooperative that rewarded the founding worker-owners for their initial risk in launching the cooperative. The cooperative has two different kinds of shares: Class A and Class B shares. Only worker-owners can own Class A shares, and each worker-owner can only own one. A Class A share entitles the member to a patronage dividend (a share of the profits

59 "The 1042 Rollover," Mercer Capital. http://mercercapital.com/article/the-1042-rollover

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from the businesses), and gives members the rights and responsibilities detailed in the bylaws, including the right to vote on cooperative decisions and to elect members to the board of directors. Class B shares are non-voting equity shares and earn a set dividend.

For the founding worker-owners, Class A shares and Class B shares both cost $1,000 per share, and each founding worker-owner was required to purchase one Class A share and six Class B shares (a total initial investment of $7,000). After the completion of the conversion, the cost of one Class A voting share increased from $1,000 to $7,000, thereby incentivizing worker-owners to join as founding members rather than waiting to see if the cooperative was successful before committing to worker ownership.

Each worker-owner could pay their initial investment up front or over time through payroll deductions and with accumulated patronage dividends. The Island Employee Cooperative transitioned into cooperative ownership with 45 worker-owners, and with roughly 15 more non-owner employees. Eventually, the cooperative hopes for all employees to become worker-owners.

The Island Employee Cooperative's board of directors is elected from the worker population, and oversees operations for the businesses.[60] After the completion of the formal conversion process, the board of directors continued to meet with CDI and IRSSC on a near-weekly basis for training in effective worker ownership. Trainings, which covered the roles and responsibilities of a board of directors and how to read financial statements, also introduced board members to the Four Pillars of Cooperative Governance (teaming, accountable empowerment, strategic leadership, and democracy) and to the strategies used by other employee-owned businesses to build a culture supportive of shared ownership.[61] Small groups of non-board member employees have also been self-selecting into additional worker ownership training sessions held by the cooperative's advisors, and CDI and IRSSC will begin more formalized trainings for all Island Employee Cooperative workers in winter 2015. By securing a state workforce training grant, CDI has been able to work with instructors from Eastern Maine Community College to design a training curriculum for all cooperative members in the basics of high performance retail operations, business ownership, reading and understanding financials, and developing an ownership culture. Another more intensive financial and operational management training will be offered for managers.

Challenges during conversion

As Rob Brown noted in an interview with Project Equity, conversions to worker ownership never go "textbook-smoothly," and the Island Employee Cooperative had its fair share of challenges during its transition process. Closing the sale by the agreed-upon timeline was one of the primary difficulties encountered by the cooperative. While the Purchase & Sale agreement was signed in January 2014, the deal did not close until June 2014. Mark Sprackland points to underestimation of the amount of work required to secure financing and prepare for the transaction as the main reason for the delayed purchase. Fortunately, the selling owners were willing to allow extra time for the deal to close; this illustrates how advantageous an involved, patient selling

60 Brophy, "Employees of Burnt Cove Market."
61 "Four Pillars of Cooperative Governance." Website of the CDS Consulting Co-op. http://www.cdsconsulting.coop/cooperative_governance/4pcg

owner can be to a worker ownership conversion.

The fact that the businesses of the Island Employee Cooperative continued to conduct business as usual throughout the conversion process presented an additional hurdle for the worker-owners and their advisors to overcome. Gathering all employees for meetings and trainings proved nearly impossible, given that the full-time work schedule meant many employees could not meet until after 8:30 pm, when they were too tired for the meetings to be effective. CDI and IRSSC both expressed regret that they were unable to conduct more preparatory trainings for all the employees during the conversion process, but still can see no easy solution to the problem. Due to the highly seasonal nature of retail business on the coast of Maine, there will be time for more intensive training and engagement during winter 2015.

Key lessons / effective practices

The Island Employee Cooperative's exceptionally hands-on advisory committee, led by CDI and IRSSC, played an essential role in helping the cooperative successfully navigate the conversion process. In addition to securing financing for the buy-out, the cooperative's advisors mediated negotiations between the selling owners and the employees, guided the steering committee through the nuts-and-bolts work of forming a worker cooperative, connected the cooperative with existing worker cooperatives, and prepared employees to become worker-owners through educational sessions and trainings. The commitment that CDI and IRSSC have made to the Island Employee Cooperative to continue serving as their advisors for a minimum of five years after the businesses incorporated as a cooperative—a commitment required by the lenders as a binding loan covenant—means that this support will also help to carry the new cooperative through its early years.

Several other key factors facilitated the Island Employee Cooperative's transition into worker ownership. The island community of Stonington is close-knit in general, but the community of Island Employee Cooperative workers is especially so because many of the employees have been with the business for many years. Many of the workers already had a long history with the businesses by the time the Seiles introduced the idea of converting to a worker cooperative, priming them to transition smoothly into worker ownership.

Another factor that helped to ease the transition process somewhat was the presence of other cooperatives in the community. The unfamiliarity of most Americans with worker-owned business models often results in misperceptions and distrust of worker ownership. Although the employees of the Island Employee Cooperative were not familiar with worker cooperatives, familiarity with the Stonington Lobster Co-op, Associated Grocers of New England, and the IRSSC made them more comfortable with the concept of cooperatives in general and more understanding of the wide variety of cooperatives that exist.

In an interview with Project Equity, Rob Brown reflected that one of the most important lessons to be learned from the Island Employee Cooperative's transition story is the importance of managing shared expectations. Worker ownership conversions are never cut-and-dried processes; uneven progress and the appearance of unexpected obstacles are almost a guaranteed part of a cooperative conversion. For this reason, Brown advises that expectations about the speed and smoothness of the conversion process be consciously held in check. Willingness to adapt as unforeseen challenges arise is often a key component of a successful conversion. Mark Sprackland reflected that succession planning 3-5 years in advance can help build the equity needed for pre-development funding and the buyer's down payment. This can happen through employee contributions in advance of selling the business, which will also help to expedite and streamline the lending process. Additionally, if the seller has already engaged or intends to engage a commercial broker, the broker can play a productive role preparing the seller to transition the business and in ensuring a smooth transition.

→ **Select Machine**

Type II Conversion

SELECT MACHINE

Manufacturing of custom machine equipment
Kent, OH

Date of conversion: September 30, 2006
Number of workers at time of conversion: 13 total; 8 founding worker-owners
Number of workers as of summer 2014: 10
Conversion Type: Type II

Background

Founded in 1994 by Doug Beavers and Bill Sagaser, Select Machine is a Kent, Ohio-based company that manufactures, sells, and distributes machined products and equipment for installation on construction and demolition equipment.

Select Machine has been the focus of a number of case studies and news coverage, in part because of its potential use of the "1042 rollover,"[62] a tax incentive for converting to employee-ownership. Select Machine ultimately chose not to utilize the 1042 rollover, but we have included some background about it below.

Why it became a coop

When owners Doug Beavers and Bill Sagaser decided that the time had come to retire, they were confronted with a difficult choice. Their children weren't interested in taking over the company, and prospective buyers planned to dismantle the company and lay off its workers, preserving only the company's client list. "These are our guys, our family, and we wanted them to keep on working," Sagaser said of his former employees in a 2006 interview with Bloomberg BusinessWeek.[63]

Beavers and Sagaser began to consider employee ownership as an option for keeping their employees in their jobs, keeping their company healthy and profitable, and allowing them to retire with peace of mind. They decided to discuss worker ownership with their employees, who welcomed the idea enthusiastically. According to Beavers, "We 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."[64]

The company considered the Employee Stock Ownership Plan (ESOP) model as well as the worker cooperative model, but settled on transitioning to a worker cooperative

62 Information shared with Project Equity by Sushil Jacob of the East Bay Community Law Center from a phone conversation between Sushil Jacob and Todd Brewster from Select Machine in October, 2014.
63 Joan Raymond, "Unlikely Pioneers," Bloomberg BusinessWeek, March 19, 2006, http://www.businessweek.com/stories/2006-03-19/unlikely-pioneers.
64 Clem, Steve and Bill McIntyre. "Worker Cooperatives: A New Twist. First Use of Little Known Tax Incentive Helps Employees Buy Their Company." Ohio Employee Ownership Center. http://www2.kent.edu/CAS/oeoc/first1042.cfm