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

because of Select Machine's small size. Setting up a coop is generally much less expensive than establishing an ESOP, which made a worker cooperative a more feasible employee-ownership option for the small company.[65]

Conversion logistics

Select Machine's conversion to a worker cooperative began in 2005, when Beavers and Sagaser reached out to the Ohio Employee Ownership Center (OEOC) for guidance about how to sell their company to their employees. The OEOC held educational meetings with Select Machine's employees about worker cooperatives and how the model might be structured to work for Select Machine. After voting to further investigate worker ownership as a possible solution for Select Machine, the employees elected a "buy-out committee" to lead the investigation and to work with advisors.[66] In addition to the Ohio Employee Ownership Center, Select Machine worked with Shumaker, Loop and Kendrick, a Toledo, Ohio law firm, to put together a multi-stage plan for Select Machine's employees to purchase the company.

The conversion process took about six months from when Select Machine first talked with the OEOC. They were able to get a feasibility study and third party financial valuation funded by a state grant program (the Ohio Department of Job & Family Services' Prefeasibility Study Grant Program), which helped the owners and the employees make an informed decision about the value of the company and what level of debt payments the new worker coop could afford to take on.[67]

The two owners of Select Machine entered into a sales agreement with eight of their 13 employees that same year, and sold an initial 40% of their shares to their workers.[68] The coop board, comprised of the two selling owners and three new worker-owners, voted to accept the agreement.[69]

The initial sale was financed by loans from a local bank and a non-profit loan fund that focuses on employee ownership. Beavers and Sagaser personally guaranteed the $324,000 in loans that the coop took out to complete this first stage of the buy-out. It was decided that when the loans were re-paid, Beavers and Sagaser would sell the remaining shares to the cooperative and retire. Until the buy-out reached completion, Beavers and Sagaser would stay on with the company as worker-owners alongside their former employees.[70]

Coop logistics

According to a case study on coop-law.org,[71] the new worker-owners voted to set the member buy-in amount at $1,000. They also created a formula for allocating profits among worker-owners based on a combination of hours worked, pay level, and seniority, "The formula assigns 50% to W-2 earnings (rewarding current market

65 In her article entitled "Unlikely Pioneers," Joan Raymond paraphrases a description from John Logue about the cost difference between setting up and ESOP and a worker cooperative: "Most small businesses can get going for $10,000, and annual administrative costs are virtually nil, says John Logue, director of the Ohio Employee Ownership Center (OEOC) at Kent State University, the nonprofit that advised Select Machine. That compares to an ESOP's typical setup costs of $50,000, plus at least $10,000 to $15,000 in annual administrative costs."
66 "Converting a business to a cooperative," Co-opLaw.org. 2013. http://www.co-oplaw.org/conversion/#fnref-8602-6
67 Ibid.
68 Messing, Roy. "Transitioning a Private Business to a Worker Cooperative: A Viable Community Development Tool." Grassroots Economic Organizing (GEO) Newsletter, Volume 2, Issue 8. http://geo.co-op/node/637
69 "Converting a business to a cooperative," Co-opLaw.org. 2013. http://www.co-oplaw.org/conversion/#fnref-8602-6
70 Messing.
71 "Converting a business to a cooperative," Co-opLaw.org. 2013. http://www.co-oplaw.org/conversion/#fnref-8602-6

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)." Worker-owners' patronage allocations are earmarked to pay down the loan they took out to purchase the business.

Challenges during conversion

Their original plan to purchase the remaining 60% of the stock by 2010 hit a snag when economic downturn of the 'great recession' negatively impacted their finances. Select Machine went through a voluntary workforce reduction in 2009, and was able to grow their revenue back up to pre-recession levels by 2010. Since then have resumed the process to purchase the remaining stock.[72]

Key lessons / effective practices

The involvement of OEOC and attorney Mark Stewart's legal assistance during Select Machine's conversion points to the critical role that expert advisors so often play in helping worker ownership transitions reach completion.

This case study also demonstrates some of the flexibility that coops have in determining how patronage will be distributed. In Select Machine's case, they wanted to reward a combination of hours worked, current market value of worker's skills and seniority. They were able to create a formula for patronage that takes each of these into account.

Select Machine shows the value of completing a feasibility study and a third party financial valuation, and the potential for grant funding to pay for the work. Select Machine was able to tap a state grant program to fund this effort.

Finally, Select Machine highlights the important role that selling owners can play in creating a successful transition to employee ownership. In personally guaranteeing loans taken out by the cooperative, Beavers and Sasager provided invaluable financial support for the transition into worker ownership. With the economic downturn, this financial support proved critical. Perhaps even more importantly, their decision to remain on as worker-owners for the first years of the cooperative's existence enabled them to pass on to their employees the rich knowledge and expertise they had acquired through their years of ownership—and leadership—at Select Machine.

1042 Rollover

Select Machine's transition to a worker cooperative gained attention in part due to its potential use of the '1042 rollover,' a tax incentive for employee ownership.

The 1042 rollover, named for the section in which it appears in the IRS Code, allows a selling business owner to defer the tax on the capital gain of the sale when he / she sells at least 30 percent of the company to either an Employee Stock Ownership Plan (ESOP) or a worker cooperative. Although the tax incentive was always intended to be a tool for use by worker cooperatives as well as ESOPs, it hasn't been widely used by worker coops.[73] Thousands of ESOPs have made use of the 1042 rollover since it became available in 1984.

72 Messing.
73 Corey Rosen, who helped to draft the original legislation for the 1042 rollover, confirmed in an interview with Project Equity in the summer of 2014 that the 1042 rollover was always intended to be applied to both ESOPs and worker cooperatives.

→ Select Machine

Type II Conversion

The late Mark Stewart, a former coop attorney at Shumaker, Loop & Kendrick in Toledo who created the legal framework for Select Machine's conversion to a cooperative, was instrumental in not only navigating Ohio's legal code but getting some key changes made to the code that helped Select Machine implement their conversion.[74]

The 1042 rollover holds significant and largely untapped potential as a tool for facilitating the transition of businesses into worker cooperatives. It may be more appropriate for larger deals, as the strictures imposed by the rollover in exchange for sheltering the sale from capital gains taxes can be more cumbersome than they are worth for smaller deals.[75] The Island Employee Cooperative is an example of a coop conversion that has utilized the 1042 rollover.

74 Messing.

75 During an interview with Project Equity, Don Jamison of the Vermont Employee Ownership Center noted that while the 1042 rollover functions well for larger companies, it may be "too big an instrument" to use in smaller deals (anything around $1-2 million or less) given the strictures it imposes around property and accessing cash.