ENSURING YOUR LEGACY

Succession Planning & Democratic Employee Ownership

ICA GROUP

WHAT WILL YOUR LEGACY BE?

Whether you're a business owner thinking about retirement, or an entrepreneur looking for a new and different opportunity, you've poured your life into your small business.

While it's daunting to think about, coming up with a succession plan for when you leave is critical, and careful planning is essential. Otherwise, you may wind up like the 75% of business owners who regret selling their business a year after the transfer occurs, or worse, one of the millions of businesses that close up shop when the owner retires.

You've probably thought about selling to your children, key managers, or a competitor. You've likely wondered if a strategic buyer is out there, or about simply liquidating your assets. How about your employees?

You've created jobs and want to ensure they are around when you leave; you've built a business you want to see survive for the next generation; you want to convert some of the equity you've built into cash; but aren't quite ready to leave the company. You want the legacy you've built to mean something to the people who helped build it – If this is the case, a democratic corporation or a worker co-op is the solution.

Many people are put off by the notion of a co-op – they think of consensus decision-making or flat management structures with no accountability. The reality is that a co-op is simply a business that applies the principle of democracy to the legal structure of the workplace – a co-op can be what you make it. Studies have shown that when ownership is paired with a meaningful degree of employee participation, performance, productivity and firm longevity is enhanced. A democratic workplace is more than just a way to make jobs better, it's a way to make companies better.

4 REASONS SELLING YOUR BUSINESS TO YOUR EMPLOYEES IS GOOD FOR YOU, YOUR STAFF, AND YOUR COMMUNITY.

1 **You can realize a higher gain in selling to your employees.**

The capital gains from the sale to a co-op or an Employee Stock Ownership Plan (ESOP) can be deferred indefinitely. Furthermore, the money used by your company to pay off any loan can be fully tax deductible – including the principal. Repaying this loan with pre-tax dollars greatly improves the company's cash flow and the willingness of lenders to finance the deal. Finally, profits paid to employees either in cash or paper, can be a deductible expense.

2 **The sale can happen gradually, at a pace that suits your needs and that you can control.**

You do not have to sell all at once with a co-op or an ESOP. And you do not have to give up control of the company until you are ready to do so. In addition, if you wish, your partners or family can retain an interest in the company indefinitely. These features make a sale to a co-op or ESOP an extremely flexible way to sell a business.

3 **Employee owned firms are more profitable and grow faster than traditional companies.**

Research has shown that profits, productivity, job satisfaction and growth are higher in employee-owned firms. This is particularly true in companies that combine communication and participation with ownership.

4 **It rewards employees for years of dedicated service and strengthens the community in which you operate.**

Selling to an outsider can often result in the facility being closed, or existing management being replaced. Selling to employees leaves control to those who have helped you build your business for years – those who know it best. This rewards them, and ensures that the people you have depended on are in control of your company and their futures. It also makes it more likely that your company will continue to thrive.

IS EMPLOYEE OWNERSHIP RIGHT FOR YOUR COMPANY?

How do you know if employee ownership is a good fit for your company? There are some basic measures that need to be met – the most successful transactions are ones where the company is something worth owning and both the owner and the employees want to complete the transaction. When thinking about selling your business to your employees consider the following:

What are your relationships with your employees like?

The basic idea of democratic employee ownership is that the people who helped you build your company are in the best position to take it to the next level. You need to have decent relationships with your staff in order to make the transaction successful. How do you feel about letting employees elect the Board of Directors? How do you feel about sharing financial information and other participatory management practices? Do you think your employees have the skills and excitement to take a leadership role? You don't need to have all these cultural elements in place before you transfer your business, but when it comes to employee ownership, it's important that you trust your employees to be owners.

How strong is your management team?

Every business needs strong leadership, regardless of its ownership structure. Even if you plan on staying on after the transaction is complete, you need to identify whether the existing staff have the skills, technical expertise and relationships to make the business succeed. The best approach is to outline your current business operating procedures. This ensures that both you and key leadership understand how the business really works, who does what, and what skills are required to ensure the firm can succeed in the long term.

Are you willing to spend the time necessary to make it succeed?

While ICA's business transfer approach is designed to streamline the process, before the transaction can be completed, we must determine whether it is feasible. This requires compiling financial information and ensuring the new structure meets your objectives, which take some time. Once the transaction is complete, you'll also need to train the board and the new owners to ensure that your governance and management systems are effective. The process usually takes from 6 to 12 months.

Is the company profitable, with consistent positive net cash flow?

It's not the case that an employee owned company has to make huge profits to work – many firms with thin margins are very successful co-ops or ESOPs. The reality, however, is that employee ownership often isn't the best way to turn around a struggling company. If you're using a leveraged buyout that pays off the selling owner with the firm's cash flows, you need to ensure that the funds are there to build up workers equity. Furthermore, building an ownership culture takes time and energy – if the firm doesn't have any room to breathe, it's unlikely that you'll have the resources necessary to build a thriving business.

Are you only interested in maximizing your financial return?

There are numerous tax incentives for selling to your employees, and if you have a successful business it may be the case that you can realize a higher gain converting to a co-op than you would from selling to an outsider. If you're mostly concerned with maximizing your financial return, however, democratic ownership may not be for you. Determining an appropriate sales price for the business you've poured so much of yourself into can be a delicate process and can cause strife if not handled properly. The best approach is to adhere to the principles that drive the top democratic management practices – honesty, transparency, and communication.

THE CONVERSION PROCESS: WHAT TO EXPECT WHEN YOU SELL YOUR BUSINESS TO YOUR EMPLOYEES

Selling your business to your employees can be an intimidating process. Every business is unique, and so are the objectives of the owners who wish to sell their business. ICA's approach is to provide simple straightforward tools designed to minimize costs, yet ensure that the interests of all parties are adressed.

There are five basic steps to transferring your business to your employees:

1 **Outline Objectives**

2 **Test the Feasability**

3 **Structure the Transaction**

4 **Complete the Transfer**

5 **Operate as a Democratic Firm**

ICA is the foremost firm designing employee ownership for small businesses. We have been instrumental in transactions in a variety of industries and for companies ranging in value from less than $1 million to more than $20 million in value.

The first step in exploring the employee ownership option is to email or call ICA. We will arrange an initial consultation at no charge. We can then perform a more detailed review of your situation and determine whether employee ownership may help you achieve your goals. Contact us at (617) 232-8765 or by email at ica@icagroup.org.

PHASE 1: OUTLINE OBJECTIVES

The first step in any conversion process is to identify the objectives of selling your company. Questions such as how much control you're interested in transferring to employees, what proportion of the firm you want to sell, and how quickly the process should take, all influence how the project will unfold. Once we have outlined the objectives and reached an agreement, the conversion process begins.

Questions addressed in the initial consultation

- Why are you interested in selling the company to your employees?
- What is the current capital structure of the firm?
- How much do you think the business is worth?
- How strong is your management team?
- Are there are other owners?
- What is their interest in employee ownership?
- What do you view a democratic workplace to be?
- How quickly are you looking to sell the business?
- Will you remain working or are you looking to exit?

PHASE 2: TEST THE FEASIBILITY

Having established a set of objectives and identified a range of alternatives to be evaluated, the process turns to developing a financial model to test the feasibility of each option. This involves reworking the historical and projected financials, estimating the market value of the firm, and initiating preliminary discussions with financing sources. Each option is evaluated in terms of its impact on the sellers, the employees, and the long term viability of the company. Based on this analysis, you and your team decide which option is best.

PHASE 3: STRUCTURE THE TRANSACTION

Once you have determined that employee ownership is right for your company, we work with you to structure the deal to meet the needs of both the owners and employees. This involves determining the purchase price, exploring the financing possibilities, adapting ICA Model By-Laws to fit your business, and making sure all the key stakeholders understand the process. While ICA's conversion approach is designed to minimize or even eliminate the need for outside counsel or tax advice, it is during this process that your outside advisers are brought up to speed so they understand what's happening.

PHASE 4: EXECUTE THE DEAL

With a deal that everyone involved is happy with, you can now complete the transaction. The new company will have to hold its first annual meeting to elect the officers (who are usually chosen during the structuring process), approve the by-laws, and sign the sales document to buy the company, obtain assets, and assume certain liabilities. If you're staying on, it's often the case you remain the President and Chair of the Board. The new company will legally exist at this point and can open a bank account, and the employees can become owners. The final step in the transaction is signing and swapping all the paperwork. When that is complete the new firm is in business.

PHASE 5: START OPERATING AS A DEMORATIC FIRM

With the transaction complete, you are now a democratically owned firm. While ownership is integral, the transaction is just the beginning of the process. ICA works with its clients to develop an effective and efficient governance system, train key staff and your accountant on any accounting issues, and works with your board to understand the financial issues that ensure all the owners own and can articulate your business strategy.

FREQUENTLY ASKED QUESTIONS ABOUT CONVERSIONS

What is a Worker Cooperative?

A worker cooperative is a firm where the employees own all or at least a majority of the company. Workers are entitled to own only one voting share and when owners vote on issues, they do so on a one person, one vote basis. Membership in a worker co-op also entitles you to a share of the profits in proportion to the labor contribution each member made.

What is an ESOP (Employee Stock Ownership Plan)?

An ESOP is a specialized stock bonus plan that is allowed to invest primarily in employer stock. ESOPs are governed by both the Internal Revenue Service and the Employment Retirement Income Security Act (ERISA). In an ESOP, workers do not own the stock of the company directly, but rather through a trust.

What is the difference between a co-op & an ESOP?

The key distinctions between co-ops and ESOPs is whether the shares are held directly or indirectly (through a trust). The practical distinction between the two are the regulatory burden each carry and the requirement that workers have a real role in the governance of a co-op. ESOPs are regulated as part of ERISA, and as such, they are qualified retirement plans that require engaging a trustee, completion of an annual audit, an independent valuation, and other filings with the Department of Labor.

Do the employees have to raise the funds to buy the company?

Not necessarily. There are many ways to structure a conversion to a democratic firm. The most common practice is for the seller to finance the transaction, or for both parties to secure financing based on the future earnings of the firm. In both these cases, the workers do not have to raise the funds independently. When choosing a co-op conversion, employees will have to buy a membership share, although the price of this share varies widely. The employees can buy the company outright, either by raising the funds themselves or through selling preferred shares.

Don't abandon the system in time of crisis:

The membership fee can be set at virtually any level, although it's important to find the right balance for your particular business. It needs to be low enough to ensure that it is reasonable for potential worker-owners to pay the fee, yet high enough so that people realize they are making a real contribution to the business. Generally, firms set their membership fee in the range from $1,000 to $20,000. A rule of thumb that some co-ops use is the price of a decent used car: a significant investment, but within reach for most workers. With an ESOP, workers do not make cash contributions.

Is conversion a sale?

Yes, when you convert to a co-op, ESOP, or a hybrid form of worker ownership, you generally are selling your business to your employees. It is possible to simply issue new shares that employees buy, but even in that case, it constitutes a sale of stock.

Does every employee have to join the co-op?

Membership in a co-op must be open to everyone who works at the firm, however, eligibility criteria can be tailored to meet your particular company's needs. Many co- ops limit membership to full time staff, or require that members work a certain number of hours before they are eligible. While generally, the minimum requirement is 2,000 hours or one year of service, some co-ops require significantly more time. Generally, the co-op Board of Directors or the membership also have to approve membership and considerations such as participation, enthusiasm, or the ability to buy a membership share can be considered. Whether your firm will allow non- members to work at the firm is an important decision.

Will my bank, lawyer, or accountant understand the co-op structure?

It's true that the cooperatives are not well understood by most banks and other financial consultants. However, ICA can work with your trusted aides to help them understand the ways co-ops are different and the ways that they are no different than other businesses. To address this, we engage your lenders early in the process to ensure they are comfortable with the transaction. There are also numerous financial institutions that focus on lending to co-ops (including ICA's affiliated loan fund, LEAF) that can be of assistance.

Will my employees be able to take on the task of becoming owners?

Absolutely! Becoming an owner takes training and work, but ICA and other training organizations (such as the Democracy at Work Institute, Ownership Associates, Praxis Consulting, and CDI) can help you build an ownership culture at your firm. The experience of thousands of employee owned companies have demonstrated that, with the right kinds of support, not only can workers become effective owners, but employee owned firms can outperform conventionally structured businesses.

Who manages an employee owned company?

In all likelihood, the same people who manage it today. There are as many ways to manage a company as there are companies and managers. The key distinction is that in a democratically managed firm, the workers have control over the culture that is created. Generally, however, the general manager is selected by the Board of Directors. The general manager is responsible for implementing policies established by the Board and coordinating day-to-day operations, just as in a traditional corporation.

Managers in an employee owned company usually develop a participatory style, encouraging input and ideas from all people in the company.

Will employee ownership work in my industry?

The experience of the more than 7,000 ESOPs and co-ops in the US demonstrate that shared ownership can work across multiple sectors. It's important to determine whether you have the right workplace culture to make employee ownership work.

RESOURCES TO HELP YOU SUCCEED

ICA has developed a series of materials designed to help business owners interested in establishing a democratic firm work through the process and build a structure and culture designed to help you succeed.

To download these resources and learn more about ICA's work, visit our website: www.icagroup.org.

1 A Comparison of Employee Ownership Models:

This publication provides a basic overview of the key differences between worker cooperatives, ESOPs, and hybrid models. It walks through the details of the various forms to help business owners weigh the financial and tax impact of a sale.

2 Business Valuation Basics:

Determining the value of a closely held company is a difficult and imprecise science. This publication walks you through the basics of how a firm's value is determined and provides a checklist of what information is necessary to complete the process.

3 Model By-Laws for a Worker Co-op:

This publication provides a comprehensive introduction to worker cooperatives and includes a compendium of model by-laws for stock corporations, LLCs, or non-profits. Also included are annotations to the by- laws, as well as multitude of model & sample legal forms.

4 Governance Systems for Worker Co-ops:

Worker co-ops are built on a framework of democracy, but without an effective means to put this into place, it does workers very little good. This how-to guide walks you through establishing an effective mechanism to ensure you are creating a democratic culture that works with your business.

5 The Internal Capital Account System:

Value in a worker co-op is tracked using a system of internal capital accounts. This guide covers the basics of co-op finances, including the difference between capital shares and capital accounts, tax treatment for worker co-ops and how to deal with financial losses.

About the ICA Group

The ICA Group is the country's oldest organization dedicated to the development of worker cooperatives. Since 1977, The ICA Group has applied expert analysis, results-based planning, and a collaborative management approach to helping start and grow worker cooperatives, democratic ESOPs and other social purpose ventures. We believe that all people should enjoy economic self-determination as a means to foster an environment where workers' livelihoods and the communities where they live are stable and secure.
We strive to facilitate such a society by acting as a catalyst for groups working to ensure workers have a meaningful say in their own economic future and through the development of firms that put these ideals into practice. *www.icagroup.org.*

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