INTERNATIONAL ECONOMIC DEVELOPMENT COUNCIL

The Power of Knowledge and Leadership

For Retiring Business Owners, Worker-Owners Can Carry the Torch
By Eli Dile

For the busy owners of small businesses, short-term pressures often take precedence over long-term planning. That's why many business owners lack a succession plan to ensure that the enterprise will continue when they're ready to step down. The stakes are especially high when the firm is a community employer and the owner can't find a buyer, or lacks family interested in taking over the business. But there's a third, often overlooked option right under their nose: employee ownership.

Currently, there are at least 300 worker-owned cooperatives in the United States and nearly 7,000 companies with employee stock ownership plans (ESOPs). The Democracy at Work Institute (DAWI) is a national nonprofit that provides research, education, and relationship-building initiatives in support of worker cooperatives, and which also helps businesses navigate the transition to employee ownership. *ED Now* interviewed Joe Marraffino, co-director of DAWI's Cooperative Conversion program, and Dave Hammer, executive director of DAWI technical assistance partner ICA Group, about strategies, best practices, and where EDOs fit in. The following interview has been edited for length and clarity.

ED Now: How do you know if a business is a good candidate for conversion to employee ownership?

Joe Marraffino, DAWI: It's not so much whether the type of business makes it a likely candidate, but whether there's readiness. For businesses that can take the time to become ready, any business is a likely candidate.

The cases that most commonly indicate a lack of readiness are, one, if the books are a mess and it's difficult to untangle the owner's personal and professional finances. Another is if there's been little delegation of managerial responsibility. Third, there's the question of the firm's value, and business owners not really having a grasp of what their company is worth, which usually requires a third-party valuation to come into the conversation with some outside sources.

Dave Hammer, ICA Group: There are really three levels of feasibility for conversion to employee ownership: financial, operational, and cultural.

In terms of financial feasibility, companies generally have to take on debt to finance the transaction, and they have to decide whether it will be seller-financed, worker-financed, or bank-financed. You also need the operational feasibility to be there – that is, the ability to transfer ownership, especially if the owner is leaving, and knowing who is going to take over what roles.

There's also the cultural feasibility, both in terms of the selling owner and the buyers. There are a lot of different cultures in employee-owned companies. And especially for co-ops, workers are going to have to play an active role in the governance of the company, and that requires people to step up.

Is it more difficult for a company to become a co-op vs. an ESOP?

Hammer: I wouldn't say that it's more difficult to do one or the other. I would say depending on the company, one is a more logical choice. There are financial implications and cultural implications to consider. An ESOP, because it's regulated by the IRS and Department of Labor, is a more expensive process. The transaction is more expensive because there's more people involved – there's lawyers, and you need to engage a trustee who obtains a third party to evaluate the company. The flip side of that is the tax benefits of being an ESOP almost always outweigh the cost of the transaction.

For companies that are too small to make an ESOP effective, a worker co-op, which is far less regulated, has a lot more flexibility. There are still significant tax benefits, but just not as much as an ESOP. We often do a side-by-side analysis to show what it would look like to become a co-op vs. what it would look like to become an ESOP. And you have some that are a hybrid of both; one company we worked with in California decided to become an ESOP but with a democratic power structure, like a co-op.

Marraffino: Sometimes it depends on whether a subsidy is available, and that can come in a variety of forms. It could be business classes from the community college, a patient and sympathetic lender, or a nonprofit. It's easier to do if the ecosystem of those support organizations is there and harder without those services because the market usually doesn't provide them.

What sort of assistance do businesses need most when transitioning to employee ownership?

Hammer: Often, what people need assistance with is building a robust assessment of their finances. Something we do is recast the past financials as though it were a co-op, which means pulling out the cost of the owner. Sometimes there are costs in there, like a car, that wouldn't be there in the future. But in other cases, owners will pay themselves significantly below market rate, so in the future that managerial cost will go up. So recasting the finances gives them an understand going forward how things are going to work. But before we can do that, we need to have the books in order so we can do those projections in a way we can feel confident about.

After that, the key thing we do in a conversion is help the company build a governance structure. Often times with small businesses there is no board of directors. There may be a board in name, but they don't act like it or think of themselves as one. The role of owner, management, and the board are often wrapped up in a single person or a small group of people. In a co-op, an ESOP, and any employee-owned firm, you have to disaggregate those three elements.

WORKERS TO **OWNERS**

EMPLOYEE OWNERSHIP CONVERSION OVERVIEW

Converting a business to employee ownership is a practical solution for ownership succession, job stabilization, and employee retention. The process takes an investment of resources and professional assistance to ensure long-term benefits. The conversion process is unique for each business, but generally has five stages.

Stage	Summary	Estimated time	Estimated cost
EXPLORE	Key stakeholders learn the conversion process	Varies	$0
ASSESS	Professionals assess financial and legal feasibility	12 months	$5,000
STRUCTURE	Seller structures the deal Buyers structure any changes	6 months	$10,000
COMPLETE	The business legally changes hands and loans are drawn	3 months	$10,000
SUPPORT	Employees build ownership culture with outside support	Ongoing	$25,000

Many steps in the process require specialized technical assistance. Local conversion guides should join the Workers to Owners collaborative to learn and partner with an experienced pool of professionals.

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Once you figure out the transactional nuts and bolts side of things, it's really about building that governance structure, and one that has built-in systems of accountability. Sometimes they need help learning how to run meetings, write job descriptions, or do financial training. It will vary between companies, as will the type of culture they want to develop.

What challenges come up in the conversion process, and how do you work through them?

Hammer: The most common issue is around the price of the business. Often there is a big gap between what the owner feels the company is worth versus what the independent evaluation finds. In those cases, we try to show the business owner their company *could* be worth that much if they do the following things. For example, if you shorten your collection period, if you had greater diversity of customers, or if your finances were tighter. And that challenge then becomes an opportunity to teach people what are the value drivers of their business.

The other challenge is deciding what role the workers are going to take. Workers may have one expectation while the owner has another – he or she might trust some workers but not others. It happens very often, and that process is getting people to understand what those roles are and understanding why those roles are the way they're set up.

With co-ops, you really have to learn to start solving problems as a group. One of the ways we address those things is embodying into the business early on best practices of democratic management systems around transparency and education. They also have to learn to proactively share information, and make sure that information flows freely through the organization and doesn't become a traded commodity.

There are actually a lot of lenders that focus on co-ops. So if the business is good, you can find a lender. But sometimes, the business has to dip into collateral, and so finding a lender is difficult. And sometimes you have to go with seller financing, and a lot of businesses don't want to do that.

In every case, businesses need to work with their vendors and their customers; any time there's a transition, there's the risk their buyers and sellers will get worried. We always say you really have to get your bank, suppliers, customers, really your whole supply chain to understand what you're doing, and why you're doing it.

Marraffino: Another challenge is that of tempo. The owner may want to go very fast or very slow. Sometimes that tempo can be difficult for a professional advisor to endure. The owner will often be more interested in making the transition when profits are high, but if they have a bad year they may get cold feet, which sometimes puts a freeze on the professional relationship.

The solution I see is making sure we have enough patient organizations in different places that can endure that cycle. We don't need to rush the business owners, they should make the decision for themselves. But we need professional groups that can endure that tempo.

What role can economic development organizations play to assist a transition?

Marraffino: Something we always look for is some sort of evangelist who can articulate the benefits, and who knows where to refer people. I feel like that's where economic development organizations can be really terrific. It's better when there's a long-lasting, trustful relationship that's been built up with the business owner, rather than a national actor coming in.

Something we've been trying to coin at DAWI is a "conversion guide," someone who can play that trust-building role with an owner, but who isn't interested necessarily in doing the whole job. The preparation stage can take many years, and it's very hard for many organizations to sustain that level of relationship over a prolonged period of time. I feel like that's a place where economic development organizations can really play a strong role because they're often already serving those people.

Hammer: We've worked with various EDOs across the country, and they've been valuable partners. One thing I would say is missing in general is succession planning for small businesses. As we look at the landscape of businesses that are closing, you see these very small businesses that employ really critical middle-skill jobs; these businesses are closing and they're not being replaced. We look at this and say this is a crisis we have as an economy, and we're not providing the right kind of support for these businesses. Getting people to understand that employee ownership is a viable option, and sometimes the best option for the workers and the owner, is important from an education and outreach standpoint.

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Democracy at Work Institute
US FEDERATION OF WORKER COOPERATIVES

The Democracy at Work Institute offers many resources and data on worker cooperatives and employee ownership, including publications, information on conversions, case studies (PDF), and a conversion guide toolkit.

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