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Here's How It Works

A Guide to Worker Co-Op Conversions

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Introduction

There is a compelling small-business story developing in the US and worldwide. The worker cooperative (worker co-op) has become an important business entity of choice as millions of baby-boomer company founders reach retirement age (the “Silver Tsunami”), contemplate their legacies, and plan for business succession. The phenomenon has begun to spread to younger people who are not yet ready to retire but see the value of early worker co-op conversion.

Emerging new concepts recognize small businesses as living systems for all the right reasons: to make people’s lives more meaningful and satisfying, to spread wealth more equitably, to treat the planet – and each other – better, and to protect mission.

Worker co-ops are businesses that are owned and democratically controlled by their employees. The structure creates an economic alternative to the traditional corporate model and is a way to assure continuity and legacy in small businesses.

Worker co-ops create long-term stable jobs, have a built-in tendency to be more equitable, and are commonly connected and accountable to their communities. In worker co-ops, employees own their jobs and have the power to chart the course of their business in beneficial ways.

Most small businesses do not have a succession plan and only about 30% of family businesses survive into the second generation. Planning to become a worker co-op and proceeding through the conversion process is a way to strengthen businesses and provide continuity.

Business owners consider transitioning to worker ownership for a variety of reasons:

- *To preserve the business that took years to construct*
- *To include employees in reaping the benefits of the business they helped create*
- *To extend mission continuity by not selling to an outside entity*
- *To provide a path to retirement and return on investment for owners*

Transitioning ownership and transitioning leadership are two very different efforts. Sometimes they happen simultaneously, sometimes not. I advocate for early ownership transitions; effecting this succession well before the founder is ready to retire positions a business for a long runway for building leadership capacity.

No two companies are the same. To find the right solutions, it is necessary, in each individual case, to understand the dynamics, the culture, the origin, the finances, and the aspirations of the company and plan accordingly.

This guide is for those who are exploring the possibility of converting to a worker co-op. It is important to digest the following Conversion Steps and Key Decisions prior to a first meeting. This guide also describes, in brief, the model of South Mountain Company, the company I founded in 1973, converted to a worker co-op in 1987, and retired from at the end of 2022. This model offers additional detail for those who want to dive a bit deeper.

Conversion Steps

[Cooperative Development Institute](#), which is responsible for a multitude of worker co-op conversions in the Northeast, suggests the following basic steps which I paraphrase here:

- **Step 1: Business owner or leadership team meets with consultant to conduct an initial feasibility analysis.** Discuss purpose, anticipated approach, current financial & cultural condition of the company, degree of readiness, and fears and concerns.
- **Step 2: Business owner decides to move forward.** Obtain accountant's company valuation, and consider price & financing, ownership, and management.
- **Step 3: Organize an employee meeting to introduce the idea.** Explain worker cooperatives basics & conversion process, answer questions, gauge interest.
- **Step 4: Organize a Worker Cooperative Steering Committee.** Create a steering committee made up of some subset of employees and advisors to conduct the work of the cooperative conversion.
- **Step 5: Come to an agreement with the current owner.** Build consensus on key elements of a Purchase and Sale (P&S) agreement, including price, terms, financing, management and governance. Conduct a vote on whether to proceed.
- **Step 6: Finalize the conversion.** Incorporate the cooperative, sign the P&S, execute the financing and transaction agreements. Finalize a Cooperative Business and Management Plan.
- **Step 7: Participate in ongoing worker co-op training and education.** All owners, board members, and managers of the new, cooperatively owned business work with technical-assistance providers to develop an ongoing training program to build ownership culture and ensure future success.

Key Decisions

At the heart of the process is a set of key decisions:

Purchase Price

- How will the company be valued?
- What will the sale price be and how will the seller be paid?

Ownership Share Price

- What is an affordable but meaningful share price?
- What is the process for purchasing a share?

Vesting Period

- How long must an employee work before they become eligible for ownership?

Distribution of Profits

- How will profits be distributed? (See South Mountain Company Model below.)

Board of Directors

- What are the responsibilities of the board of directors?
- Who will serve as directors (specific individuals, roles, term lengths)?
- How will directors be elected?

Management System Design

- Will management change? In what ways?
- What are the current company operating policies? Do they need work?
- Will an employment agreement be needed for the current owner(s)?

Mission and Guiding Principles

- Does the company have a mission and guiding principles, or need to develop?
- If existing, do they need to be adapted?
- Is a strategic plan necessary (three, five, or ten year)?

Bylaws

- What models will be used for drafting bylaws and other documents?

Decision-Making

- What decisions will be made by Owners, by Board, by Management, by outside Shareholders (if any)? Create a decision-making matrix.

The South Mountain Model

South Mountain Company (SMCo) moved from upstate New York to Martha's Vineyard in 1973. In 1984 my partner left and I became the sole proprietor. When two of the original employees came to me in 1986 saying they wanted to stay and make their careers at SMCo but needed a greater stake, we decided to investigate structures that would distribute both ownership and control. This was a major hinge point in our history.

At that time, there were few worker co-op models in the US. We hired attorney Peter Pitegoff at the Industrial Cooperatives Association (now [The ICA Group](#)) to help. He suggested we adopt and adapt the democratic structure of the Mondragon Cooperatives, a group of worker-owned industries and businesses in the Basque region of Spain with a long and successful history. With Pitegoff's help, we adjusted the Mondragon principles and model to fit our own idiosyncratic needs.

On January 1, 1987, I assigned ownership of SMCo to a new worker cooperative corporation. I remained as president and general manager of the company, which then had ten employees and three owners (myself and the two original employees).

This structure has held up well for 36 years. It has been adjusted as needed. Our recent transition to the next generation, in December of 2022, was driven by a strong, well-aligned, younger leadership team. After four long-time owners retired at the end of 2022, there are now 38 employees, 18 of whom are owners. The rest are on the path to ownership.

The board of directors is elected by the owners to make policy decisions and guide the company. The functions of owners and board are delineated in the company bylaws. The SMCo board is composed of twelve owners and three non-owners. All owners are expected to serve on the board at some point. Owners, board, and leadership team have defined responsibilities.

SMCo is a democracy with clear divisions of responsibility. The board delegates much of its authority to the leadership team. SMCo makes decisions by consensus with a backup supermajority voting mechanism in case of a stalemate. Since 1987, only three votes have been necessary.

Ownership Criteria

Ownership is not a requirement nor is it a right. It is a privilege to be enjoyed by those for whom it is appropriate and desirable. New owners must be accepted by current owners. SMCo has an unusually long five-year waiting and training period prior to ownership eligibility to provide education, training, and acculturation.

There are three principal criteria that prospective SMCo owners are expected to meet:

- Intent that employment at SMCo will be their primary work for the foreseeable future
- A demonstrated ability to work and collaborate effectively
- A commitment to understand and honor the company's mission and guiding principles (to be good representatives of the company's purpose and culture)

Ownership eligibility begins once an individual has completed five years of employment and worked a minimum of 6,000 hours.

Ownership Responsibilities & Benefits

Owner Responsibilities

- Pay the ownership fee (see below)
- Serve on the Board of Directors at some point in their career
- Understand SMCo governance, financials, bylaws, and operating policies
- Represent SMCo as a community ambassador

Owner Benefits

- One voice (or vote) on policy matters – an opportunity to impact the decisions which chart the direction and destiny of SMCo
- Equity sharing – all owners share annual equity distributions, partly in cash and partly in accumulation of individual capital accounts (see below)
- Ownership position – this is an intangible that may mean more to some than others; for many it is a source of pride to be an owner rather than just an employee

The Mechanics of Ownership

Ownership Fee

This payment, sometimes called the “membership fee” in worker co-op terminology, is for the purchase of a share of SMCo ownership. It is intended to be significant but affordable. If it was too steep, it would discourage participation, so it was originally set at the price of a good used car, an expense workers seem to be able to manage when necessary. At the

initial 1987 restructuring, the SMCo ownership fee was set at \$3,500. It now escalates each year by \$500; in 2023 it is \$18,000.

The fee may be paid-in-full or payments may be spread out, at no interest, for up to 36 months. A new owner begins to accumulate equity after at least 50% of the fee is paid. The fee is deposited into the Equity Fund; concurrently an individual capital account is established equal to the value of the ownership fee (see below). SMCo ownership is an uncommonly good investment. The value of the ownership fee is generally recouped through dividends in the first several years.

Equity Fund

The internal capital accounts are paper accounts that are backed by the company's net worth, and more specifically by the company's Equity Fund. The Equity Fund provides money to meet commitments to departing owners. The SMCo leadership team and board evaluate the fund annually to assure that it contains sufficient capital to meet short-term and long-term obligations. Except for "Distributions while an Owner" and "Payout upon Ownership Termination" as specified below, equity funds cannot be used for any purpose that does not produce revenue for the fund without the unanimous approval of all owners.

Individual Capital Accounts

These accountings of each owner's equity in SMCo begins with the initial ownership fee. It increases at the end of each profitable year by means of a patronage dividend (and similarly would decrease if there were a loss) and continues to mature until termination of ownership. It is non-interest bearing.

Patronage

A percentage of the company's income is distributed as patronage to owners, in accordance with the recommendation of company accountants and a decision of the board. This patronage is separate and distinct from the cash profit sharing that is extended to all employees each year in the form of wage bonuses. Patronage is based on hours worked during the previous fiscal year and is paid as a combination of paper equity and cash dividends. At least 20% must be paid in a cash dividend (by IRS regulation), and the entire annual patronage (cash and non-cash) is taxable income to each owner. Cash dividend distributions are always at least sufficient to cover the tax burden. In recent years owners have desired more in cash; 50% has been distributed in cash dividends and 50% in equity.

Distributions while an Owner

Individual capital accounts are not accessible until ownership is terminated, but an owner who has passed their 62nd birthday may request payment according to the established redemption schedule. Ownership may continue for the duration of employment.

Payout upon Ownership Termination

After the close of the fiscal year in which ownership is terminated, the value of the owner's individual capital account is calculated and paid out in equal payments spread over a period of eight years. A departing owner who wishes an accelerated payout, or has any other special request regarding payout, must receive board approval. In the case of accelerated payout, the account is de-valued as follows:

- Five-year payout @ 85% of value
- Three-year payout @ 75% of value
- One-year payout @ 65% of value

Additional detail about the SMCo model can be found here in the [SMCo Operating Policies](#).

The Path to Ownership

The [SMCo Path to Ownership](#) begins at hiring and includes 33 experiences designed to give new employees, over seven years, a complete understanding of what South Mountain is, how it works, and how to be an effective owner. Each new employee gets a “passport” and gradually works through the distinct experiences. Experiences are dispersed among six levels. The purpose of the program is twofold: to develop active and engaged SMCo owners and to strengthen relationships within the company.

Conversion Roles

We at [Abrams+Angell](#) act as guide and consultant. In this role, we help you work through your motivations, intentions, solutions, and particulars. We can help with both ownership and leadership transitions, simultaneously or not, and we can help with training, before and/or after conversion. At times we collaborate with the Business Ownership Solutions Group at [Cooperative Development Institute](#).

Other advisors are necessary to complete a conversion, especially compatible valuers, accountants, and attorneys. We bring these to the process and orchestrate the relationships.

And Finally...

... A quote from each of two of my mentors and heroes:

William Greider, in his book *Come Home America*, says, “The democratized workplace is capitalism’s next great advance toward human self-realization for all.”

And Marjorie Kelly says, in *Owning The Future*, that worker co-ops can be part of the “foundation for a generative economy . . . one whose fundamental architecture tends to create beneficial rather than harmful outcomes. Ownership is the ultimate realm of economic power. We all belong there – in the same way that we all belong in the halls of democracy. It’s time for us to own this place we call an economy. When more and more of us become comfortable entering the seemingly forbidden space of ownership – daring to dream together of remaking it – that’s when we will truly own our future.”

The worker co-op conversion process can be an exhilarating way to chart the course to a stable and satisfying future for your company.

We look forward to working with you to guide this adventure. Our process begins with a no-charge meeting to establish goals and test readiness and chemistry. We are available for questions or to schedule an initial meeting at your convenience.

Resources

A Brief Reading List

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