

THINK OUTSIDE THE BOSS

How to Create a Worker-Owned



Business

Created by:



Sustainable
Economies
Law Center

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DISCLAIMER: THIS MANUAL HAS BEEN PREPARED AS A HANDOUT FOR A 2015 WORKSHOP ON STARTING A WORKER-OWNED BUSINESS. THE CONTENTS OF THIS MANUAL SHOULD NOT BE RELIED ON AS LEGAL ADVICE. ALSO, SOME OF THIS INFORMATION COULD BECOME OUTDATED, AND LAWS VARY FROM PLACE-TO PLACE. FURTHERMORE, ALTHOUGH WE TRIED TO COLLECT ACCURATE INFORMATION AND GIVE THE LAWS OUR BEST INTERPRETATION, SOME INFORMATION IN THIS BOOKLET COULD EVEN TURN OUT TO BE INCORRECT OR SUBJECT TO OTHER INTERPRETATIONS BY COURTS OR REGULATORS! WE SURE HOPE THAT'S NOT THE CASE, BUT, WHAT CAN WE SAY? LAW IS COMPLICATED STUFF! THAT'S WHY WE STRONGLY RECOMMEND THAT YOU CONSULT WITH AN ATTORNEY BEFORE USING THIS INFORMATION TO FORM OR OPERATE A COOPERATIVE.

Think Outside the Boss: How to Create a Worker-Owned Business

TABLE OF CONTENTS

INTRODUCTION: WORKER COOPERATIVE ENTERPRISES.....	1
ENTITY FORMATION: HOW DO YOU CREATE A COOPERATIVE BUSINESS ENTITY?	8
ENTITY CONVERSION: HOW TO CONVERT YOUR EXISTING BUSINESS TO A COOPERATIVE	21
NONPROFIT ORGANIZATIONS INCUBATING WORKER COOPERATIVES	29
MANAGING YOUR COOPERATIVE BUSINESS.....	43
COOPERATIVES AND EMPLOYMENT LAW.....	48
FOR MORE INFORMATION: SEE APPENDIX A: NEW EMPLOYER CHECKLIST	65
GETTING THE GREEN: FINANCING A WORKER CO-OPERATIVE	66
PART I: BANK LOANS AND ALTERNATIVE FINANCING	66
GETTING THE GREEN PART II: SECURITIES LAW.....	70
HOW DOES MONEY FLOW THROUGH A COOPERATIVE?	77

GLOSSARY OF USEFUL TERMS	84
APPENDIX A: NEW EMPLOYER CHECKLIST	86
APPENDIX B: SAMPLE BYLAWS OF GREEN COMMONWEALTH COOPERATIVE, INC.....	90
APPENDIX C: SAMPLE ARTICLES OF INCORPORATION	110
APPENDIX D: SAMPLE DISCLOSURE DOCUMENT.....	110
APPENDIX E: 28 QUESTIONS TO CONSIDER BEFORE MEETING A LAWYER	117
APPENDIX F: REFERRAL LIST	119
APPENDIX G: COOPERATIVE BUSINESS PLANNING RESOURCES FROM PROJECT EQUITY.....	121
APPENDIX H: OTHER RESOURCES	129
Think 'Outside' the Boss: 'How to' Create 'A Worker-Owned' Business	

INTRODUCTION: WORKER COOPERATIVE

ENTERPRISES



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What Are Worker Cooperatives?

Worker cooperatives are business entities that are (1) owned by their workers, (2) governed by their workers, and (3) operated for the benefit of their workers. Because worker cooperatives are owned and controlled by and for the people who work there, they operate differently from traditional businesses in some key ways.

- (1) **Joint Ownership:** In traditional for-profit businesses, the owners are sole proprietors or shareholders whose main interest is in generating a profit. Worker cooperatives are

interested in making money too, but they are also invested in making sure that the business meets the needs of its members, such as paying fair wages, providing a sustainable livelihood, investing in the local community, and promoting a healthy environment.

- (2) **Democratic Control:** In typical business enterprises, elections are held and major decisions are made by investors who cast votes based on the number of shares they own. In worker cooperatives, directors are elected and major decisions are made by the workers, on a one-member, one-vote basis. Therefore, control is vested with each member, not each share of stock. No member has a larger or more influential vote because she invested more money in the business.
- (3) **Cooperative Distribution of Earnings:** In investor-owned businesses profits are distributed based on how many shares each person owns. Worker cooperatives instead distribute surplus earnings based on a patronage system. This means profit is distributed equitably based on factors such as hours worked or value of work provided. Profit distribution is thus based on labor input, not on capital contribution. Workers generally do not receive a greater profit share by contributing more money directly to the business or by purchasing shares.



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Benefits of Worker Cooperatives:

When efficiently organized and managed, worker cooperatives convey the following benefits to the people who work there:

- *Employment and the ability to generate income.* A worker cooperative gives groups of people an opportunity to become economically independent in a mutually beneficial way.
- *Control over the way their work is organized, performed, and managed.* Worker cooperatives provide an opportunity to balance workers' needs and concerns with the need for profits and efficiency. Worker cooperatives also emphasize the training and development of the worker-members.
- *Employment security,* provided that the business is financially viable. Worker cooperatives are managed to generate income *and* provide stable employment for their members. When faced with a tradeoff between pursuing profits and maintaining employment, worker coops often choose the latter.
- *A financial and ownership stake in the enterprise in which they work.* Worker-members contribute directly to building the enterprise and sharing in its success. • *An opportunity to practice democracy in the workplace.* Worker-members participate directly in decisions that affect them in their workplace as well as those that determine the growth and success of the business.

Cooperative businesses manifest in a variety of ways. The term “cooperative” can refer either

to a specific type of business entity recognized under the law or to the internal governance structure of an organization.

(1) **Cooperatives, as a legal entity:** “Cooperative” may refer to a specific type of corporation, recognized under the law. The legal requirements for forming a cooperative corporation vary from state to state. In California, cooperatives generally form as a corporation under the California Cooperative Corporation statute. The rules governing this type of corporation are found in the California Corporations Code provisions beginning with section 12200. In California, you cannot legally have the word “cooperative” in your name, unless you have formed under this statute.

(2) **Cooperatives, as a legal structure:**

Many organizations operate like cooperatives, but, for a variety of reasons, chose an entity other than a cooperative corporation. For example, some cooperatives form as Limited Liability Companies (LLCs) or Nonprofit Mutual Benefit Corporations, and incorporate cooperative principles and practices into their governing documents (their Articles of Organization, Articles of Incorporation, Operating Agreement, and/or Bylaws).

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(3) **Cooperatives, as a set of practices and values:**

Some organizations or groups call themselves “cooperatives,” without having formed a cooperative corporation, or for that matter, without having formed an independent legal entity at all. For example, a group of tenants might create a housing cooperative, simply by adopting highly participatory and democratic ways of operating. Similarly, workers at a non-profit organization or fiscally sponsored project may elect to operate through cooperative, democratic principles, such as one-person one-vote. This type of cooperative organization may or may not have the other cooperative attributes of joint ownership and cooperative distribution of earnings, described above.

Why Form Worker Cooperatives?

In certain ways, worker cooperatives operate like regular businesses: they develop products or services to sell to the public, with the goal of generating a profit to support the business and its owners. Like conventional businesses, cooperatives typically incorporate or file formation documents with the state, apply for appropriate business licenses, pay taxes, hire employees and/or independent contractors, and engage in other regular businesses activities.

However, worker cooperatives are unique in some key ways. In particular, cooperatives are more likely to create stable fair-paying jobs, adopt environmentally sustainable business practices and invest in the local community. Because they often evaluate success based on a variety of metrics in addition to profit, such as worker health and happiness, sustainability, and community benefit, worker cooperatives are often said to have “multiple bottom lines.”

- **Local Ownership.** Typical large corporations are owned by shareholders who do not live in the communities in which the business operates or from where it sources its products. These shareholders are usually less concerned about maintaining healthy workplaces and making sure the business does not harm its community than the worker-owners of a local cooperative business.
- **Increased Job Security in Economic Downturns.** In economic downturns, most corporations are narrowly focused on maintaining value for their shareholders, rather than maintaining employment for their workers. By contrast, because worker-owners call the shots in their cooperative, they value preserving jobs foremost, rather than maintaining shareholder value. Because they have increased job security as owners of the business, they can also plan for the long-term and invest in the continued health of their business and their community.
- **Worker Health and Happiness.** Because workers have an ownership stake in the cooperative business, they can make business decisions that directly promote and support worker health and happiness. Even the most benevolent owner/employer is unlikely to make business decisions that benefit workers if such decisions have a negative impact on profit. Conversely, worker-owners are interested in generating a profit, but also invested in ensuring that they work in a healthy environment,



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characterized by job stability, fair wages and benefits, and safe business practices.

- **Environmental Responsibility.** The people who own and run worker cooperatives also tend to live, work, and play in the neighborhood where the business is located. Because worker cooperatives are deeply rooted in the local community, they are less inclined to engage in environmentally destructive business practices than companies controlled by outside investors. Using toxic chemicals, squandering natural resources, or damaging open spaces would have a negative impact on the very people in control of the business, as well as on their families, friends, and neighbors.
- **Contribution to Community.** Worker cooperatives help build community wealth through local ownership. Workers who own their jobs have a direct stake in the local environment, and the power to decide to do business in a way that creates community benefit. Worker cooperatives are likely to form relationships with other local businesses, hire local workers, and reinvest their profits back into the neighborhood.

Breadth of Worker Cooperative Enterprises

Successful worker cooperatives are found in many different business sectors including:

housecleaning, restaurants, taxis, grocery stores, bakeries, bookstores, bike shops, nursing and construction. This is just a small list of examples. Worker cooperatives come in many different shapes, sizes, and industries. The US Federation of Worker Cooperatives estimates that there are over 300 worker cooperatives in the United States, which collectively employ over 3,500 people.

In the San Francisco Bay Area there are many notable worker cooperatives, including: The Cheese Board Collective and Arizmendi Bakeries (worker-owned pizza shops and bakeries), DIG Cooperative (gray water systems design), and Rainbow Grocery Cooperative (full service grocery store including both bulk and prepared foods), and many more. In addition, there are a number of Limited Liability Companies (LLCs) that are structured as worker cooperatives including WAGES (green home-cleaning services) and Teamworks (green landscaping).

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Worker Cooperatives Might Not Be For Everyone:

A word of caution – worker cooperatives may not be the right fit for every organization or business entity. A worker cooperative may not be right for you if:

You do not want to make decisions democratically (through majority vote, super-majority vote, consensus, or modified consensus). If you are not comfortable sharing decision-making power with a group, a worker cooperative is probably not right for you.

You do not want to observe certain business “formalities” (such as holding regular governance meetings, complying with rules about meeting notice, keeping meeting minutes, holding elections, or recognizing officers). Establishing a cooperative corporation business entity will require adherence to certain rules and regulations. If you would prefer to keep things more informal then you should look into the Limited Liability Company form of organization (see the section on Entity Formation).

You do not want to deal with more complicated record-keeping and accounting. The cooperative corporation often involves more complicated record keeping and accounting. You may find it necessary to work with a bookkeeper or accountant who specializes in worker cooperatives.

Please refer to the “28 Questions to Consider Before You Meet a Lawyer” resource in the Appendix section of this manual for more issues to consider.

Key Considerations in Forming Worker Cooperatives

Worker ownership can be a successful business model in nearly any industry. But, it is not for everyone and there are some important considerations to think about when deciding whether a worker cooperative model is right for you. A fundamental aspect of worker cooperatives is balancing the entrepreneurial and independent spirit needed to start and run a new business with an appreciation for and commitment to the values of shared ownership. The essence of democratic control is that no one person has the final say.

The US Federation of Worker Cooperatives has developed a useful list of factors to help determine whether worker ownership is right for you (this is not exhaustive):

- Your members have a clear commitment to and understanding of worker-ownership and cooperative principles.
- Your members provide a product or service that is in demonstrated demand by the market; you have a viable business concept.



- Your cooperative has access to adequate financing, including meaningful capital contributions from members, in the form of cash, labor, or both.
- Your cooperative selects and develops a quality management team, either by recruiting from outside the firm or by consciously developing from within. Quality managers do not necessarily need to be MBAs, but they should have a firm understanding of the business and the environment in which it operates.
- Your cooperative provides membership to individuals with the technical skills and knowledge to make the business a success, and provides those individuals with the tools and environment necessary to succeed.
- Your cooperative places an emphasis on electing experienced directors with a clear commitment to building a fiscally sound organization and working on behalf of the membership overall.
- Your cooperative can aggressively position itself for changes in operations, markets, and member needs.

Of course, you can create a successful worker cooperative without having each of these factors in place, but this list represents good principles to strive toward. In addition, it can be challenging to establish a worker-owned business in an industry with high turnover or where work is generally seasonal. However, some worker cooperatives have been established in such industries for the specific purpose of countering such trends and ensuring workers can earn a livelihood throughout the entire year.¹

International Cooperative Alliance's Cooperative Principles

(1) Voluntary and Open Membership

Cooperatives are voluntary organizations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political or religious discrimination.

(2) Democratic Member Control

Cooperatives are democratic organizations controlled by their members, who actively participate in setting policies and making decisions. Men and women serve as elected representatives and are accountable to the members. In primary cooperatives members have equal voting rights (one member, one vote).

(3) Member Economic Participation

Members contribute equitably to, and democratically control, the capital of their

cooperative. At least part of that capital is usually the common property of the

¹SOURCE: *Worker Cooperative Toolbox*, Published by Northcountry Cooperative Foundation in partnership with Northcountry Cooperative Development Fund.

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cooperative. Members usually receive limited compensation, if any, on capital invested as a condition of membership. Members allocate surpluses for any or all of the following purposes: developing their cooperative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their work for the cooperative; and supporting other activities approved by the membership.

(4) Autonomy and Independence

Cooperatives are autonomous, self-help organizations controlled by their members. If they enter into agreements with other organizations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintaining their cooperative autonomy.

(5) Education, Training and Information

Cooperatives provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of their cooperatives. They inform the general public – particularly young people and opinion leaders – about the nature and benefits of cooperation.

(6) Cooperation Among Cooperatives

Cooperatives serve their members most effectively and strengthen the cooperative movement by working together through local, national, regional and international structures.

(7) Concern for Community

Cooperatives work for the sustainable development of their communities through policies approved by their members.

Useful Resources:

Additional online tools and worker cooperative start-up guides are available at:

- <http://american.coop/startup>,
- <http://institute.usworker.coop/resources>,
- http://cultivate.coop/wiki/Main_Page,
- <http://cooperative-curriculum.wikispaces.com/>,
 - <http://co-oplaw.org>,
 - <http://cooperationtexas.coop/>,
 - <http://datacommons.find.coop/vision>
- http://ccd.coop/files/worker_coop_toolbox.pdf



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ENTITY FORMATION: HOW DO YOU CREATE A COOPERATIVE BUSINESS ENTITY?

Selecting what kind of legal entity you want to form is an important first step in creating your cooperative business. However, before such a decision can be made you will want to do some *preliminary* research not only into whether the cooperative form of business is the right choice for you, but also into the financial viability of your business plan. In other words, some work must be done to determine whether your business idea is profitable, which is the foundation of any business whether cooperative or traditional!

We have included a business planning guide in Appendix G: Cooperative Business Planning Resources from Project Equity, which provides some helpful tools to assist you in thinking through the goals and key questions you should address in your cooperative business planning. We strongly recommend that you use these guidelines to assess your business plan before you take steps to formalize the business itself. Some of the questions that are important to consider, include:

Preliminary Business Planning Questions:

- 1) Why are you starting a business?**
- 2) What product or service will you offer?**
- 3) Why do you want to organize your business as a cooperative?**
- 4) What is your business model?**
- 5) Is there a market for your business?**
- 6) Can you get enough of a “share” of this market for your business to be viable?**

Now that you have considered these key questions, and determined that your business plan is viable, it's time to consider what form your business should take.

What is a business entity? Why is it important to choose the right entity when forming your business?

A business entity is the legal structure under which a business operates. If you wish to start a cooperative business, there are a number of considerations in choosing the right entity, including governance, employment, liability and tax issues. This chapter includes a very broad overview of these considerations; for additional discussion, please refer to the other relevant chapters in this manual.

What if I start doing business before forming an entity?

Don't Forget the Minimum Tax:

If you form an LLC or corporation in CA, your business is generally subject to a minimum CA franchise tax of \$800.

If you start doing business before officially forming an entity, the law presumes that you are either a sole proprietorship (if there is one business owner), a general partnership (if

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there are multiple owners of the business) or, in certain cases, an unincorporated association. Sole proprietorships, general partnerships and unincorporated associations have UNLIMITED liability: that means the owners of these types of businesses are at risk, because someone who sues them can reach not only the assets of the business, but also the personal assets of the owners, such as their car, bank account, or home.

When thinking about whether you need to limit your personal liability exposure, think about the activities your business will engage in and the risks these activities may create. For example, will you be serving food to people? Will they be walking into your store? Will you be doing work on someone else's property? Will you have employees? Think about what could possibly go wrong in all of these scenarios, and then prepare yourself for the chance that you or your business may get sued.

So how do I protect my personal assets?

Form an entity that is protected by the limited liability shield. The most common limited liability entities are limited liability companies (LLCs) and corporations. In most cases, if you form and properly maintain your business as a separate limited liability entity, you can protect

your personal assets; thus even if the business is successfully sued, you will only lose what you invested into it.

In order to maintain your entity's separate limited liability status, you must observe corporate formalities, avoid mixing personal assets with company assets, and provide adequate funding for the business to operate. Corporate formalities include filing the correct papers with state and local governments, keeping a record of your meetings, maintaining separate bank accounts and financial records and contracting in the entity's name, not your own name.

Beware though—forming and maintaining a limited liability entity usually costs money. In California, for example, such entities are generally subject to a minimum annual franchise tax of \$800. This is in addition to income taxes paid at the state and federal level.

What about insurance?

Even if you have a limited liability entity, you should still get insurance. While the liability shield will protect your personal assets, it will still cost money to defend yourself or your business if you get sued. A good insurance policy can cover those legal expenses. The main type of insurance you should consider is general liability insurance, which covers bodily injuries, property damage and other losses that could occur as a result of the operation of your business. It may also be advisable to carry workers' compensation insurance, if you have employees (see the employment law section of this handbook); product liability insurance; and commercial automobile insurance if your business uses vehicles.



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Helpful Tip:

Remember: Anyone can sue you for anything. Even if the claim is frivolous and gets dismissed, you'll still spend money on lawyers. Insurance can help cover these costs.

If I am starting a worker-owned business, which entity should I choose? As discussed above, the business should probably form as some type of limited liability entity. These include the domestic stock corporation, LLC, cooperative corporation, flexible purpose corporation or benefit corporation. In limited situations, if the business will not be distributing its profits or is going to be operated for charitable or educational purposes, the members could also consider forming as a nonprofit mutual benefit corporation or a nonprofit public benefit corporation. Before choosing which entity is appropriate for your

business, it is helpful to have a solid understanding of the proposed business model.

The most common form of business entity: General Corporation

The general corporation is the most common form of business entity. In California it is known as the general stock corporation. It is owned by shareholders, governed by a board of directors, and its general purpose is to make a profit for its shareholders. Shares of stock are usually issued in exchange for capital contributions and voting power of individual shareholders is directly related to the number of shares they own. At first glance, general corporations do not appear to provide for the kind of democratic voting rights found in a cooperative; however, it is possible to create a democratic and cooperative structure in a general corporation. For example, the corporation could restrict individuals to own the same number of shares, so that each shareholder would have equal voting power. A similar result would also be possible through a Shareholders' Agreement. A Shareholders' Agreement is a written agreement among all the shareholders with provisions regulating a variety of shareholder rights and responsibilities, including but not limited to voting rights and transfer of shares. A Shareholders' Agreement could include a provision for voting rights based on a "one shareholder-one vote" system, giving each shareholder equal voting power, and it could also prohibit the transfer of shares to outsiders. Shareholders' Agreements can be complicated to draft and you should seek an attorney's advice if you are looking to create a cooperative structure via the use of a Shareholder's Agreement.

General stock corporations are usually taxed as "C-Corporations", which are taxed as a separate taxpayer from the shareholders. This can lead to double taxation because the corporation pays tax on its profits and the shareholders also pay a tax when those profits are distributed to them as dividends. To avoid this, a corporation can elect to be taxed as an "S corporation." There is usually no federal income tax for S-corporations, and tax liability is passed to shareholders, meaning that income and losses flow through to the shareholders

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and they are assessed taxes at their individual income tax rates.² A corporation must meet a number of requirements in order to qualify for S-corporation status, such as having 100 or fewer shareholders and issuing only one class of common stock, though options and differences in voting rights are generally permitted. Thus an S-Corporation could have a Shareholder's Agreement in which the shareholders agree to alter the voting rights to create a cooperative and democratic structure.

The most common entities for worker-ownership: LLC and Cooperative Corporation

Because the main purpose of most worker-owned businesses is to create economic wellbeing and jobs for their worker-owners, the legal entities they form allow the worker-owners to share in the profits of the business and give each member a vote in the governance of the business. Both the limited liability company (LLC) and the cooperative corporation provide

for these options.

- **Cooperative Corporation:** The cooperative corporation is the entity in California that best incorporates the cooperative principles of democratic decision-making and worker-ownership. As of January 1, 2016, a California cooperative corporation may designate itself as a worker cooperative in its articles of incorporation. California law requires that all worker cooperatives must have at least 51% of its workers be members or candidates. Moreover, each member of the cooperative is required to have a vote for the board of directors and is entitled to share in the profits of the cooperative, if any are distributed, based on the member's "patronage" (i.e., hours worked for the cooperative). Cooperative corporations have to follow certain requirements that are described in the law related to governance, meetings, board of directors, officers and distribution of net earnings.
- **Limited Liability Company (LLC):** LLCs are business entities that have limited liability, but are not subject to the same tax principles and formalities as corporations (including cooperative corporations). They are governed primarily by a contract between all of the members of the business, called the Operating Agreement, which can adopt cooperative principles like "one member, one vote" and profit distributions based on labor-contributions. Because the Operating Agreement is a contract between the members, future members could decide to change the agreement and remove the parts that make it operate like a cooperative, such as governance and profit-sharing based on membership and labor.

Before we explore the differences between these two forms further, let's clarify why cooperatives are traditionally not considered "nonprofits," or other types of social enterprises.

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² See IRS on S Corporations, <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/S-Corporations>



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Will the business be “nonprofit,” and if so, will it be “charitable” or for the public benefit?

If the primary purpose of the cooperative is to create economic benefit for the worker members, you should probably form a for-profit entity (likely the LLC or the cooperative corporation) or a nonprofit mutual benefit corporation. But if the main purpose of the business is to serve charitable or educational goals (such as job-training for low-income individuals), a better choice would likely be a nonprofit public benefit corporation, which could likely be granted exemption from paying federal and state income taxes.

Nonprofit Mutual Benefit Corporations: A Special Type of “Nonprofit” The mutual benefit corporation is a “nonprofit” that is unlike your typical nonprofit. The purpose of the mutual benefit corporation is to benefit its members, not the general public. Thus, it cannot receive a 501(c)(3) tax exemption (discussed below). Mutual benefit corporations are “nonprofits” because they cannot distribute any net earnings (i.e., profits) back to their members. Mutual benefit corporations have many attractive features for people who want to start cooperatives. Like cooperative corporations, they incorporate governance principles of “one member, one vote”, and are designed to benefit their members. Unlike cooperatives, however, mutual benefit corporations can’t distribute any of their profits to their members (unless the corporation is dissolved). Mutual benefit corporations are frequently used to form condo associations, business districts, social clubs, or homeowners associations. They may be attractive to worker-members who do not intend to distribute profits, but rather want to create an institution, such as a maker space, that will be democratically governed for the benefit of its members. Because mutual benefit corporations directly benefit their individual members (not the public at large), they will not qualify for 501(c)(3) tax-exempt status, and thus won’t be able to receive tax-deductible donations. However, it may be possible for a mutual benefit corporation to receive federal tax exemption under 501(c)(6), as a business league, under 501(c)(7), as a social or recreational organization, or under a variety of other categories of tax exemption. It may also qualify for exemption from California income taxes.

Nonprofit Public Benefit Corporations: 501(c)(3)-eligible nonprofits By contrast nonprofit public benefit corporations are operated for a public or charitable purpose and are prohibited from distributing assets and profits to their members. These corporations can apply for tax-exemption from the federal and state government by filing applications that describe how their activities will be dedicated to a public or charitable purpose. It will be difficult for most cooperative businesses to achieve 501(c)(3) tax-exemption, because such businesses are typically operated for the benefit of their individual members and not the general public.

While important to note these key differences between cooperatives and nonprofits, the two distinct entity forms can work well together, particularly through nonprofit incubation of cooperative businesses. This unique model is explored in further detail below in the “Nonprofit Organizations Incubating Worker Cooperatives” chapter.

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Many People Are Curious About California’s Two New Types of Corporations...

Traditional corporations are formed to generate profit for their shareholders, often to the exclusion of pursuing benefit for the community and environment. Two new “hybrid” corporate entities in California – the Benefit Corporation and Flexible Purpose Corporation

(FPC) – allow for other purposes to be included in the articles of incorporation. These are called “hybrids” because they are a blend between traditional for-profit businesses that are designed to maximize the wealth of their shareholder-owners, and traditional nonprofit organizations that pursue social and environmental missions.

While both of these “hybrids” represent an important departure from the traditional corporation, neither is well-suited for worker-ownership. Both the benefit corporation and the FPC are based on the typical model of shareholder ownership- i.e., ownership and profit distribution based on the number of shares owned. FPCs and benefit corporations were intended to give traditional corporations the flexibility to pursue socially beneficial goals instead of only pursuing profit for their shareholders, whereas cooperative corporations and cooperative LLCs embody the principles of worker-ownership, as opposed to shareholder ownership. In order to structure a shareholder-based corporate entity as a worker-owned cooperative, you would need to draft a shareholder agreement. The shareholders’ agreement would have to provide for worker-members as shareholders and incorporate the cooperative principles of “one member, one vote” and cooperative profit sharing. Essentially, this would be recreating what is already provided in the California Cooperative Corporation. Nevertheless, what follows is a brief description of each type of entity:

Benefit Corporation: The Benefit Corporation is a new corporate form that was adopted in California in 2012 to promote social enterprise. To be a benefit corporation a company must be committed to pursuing a “general public benefit” and must take a broad range of interests into account when making business decisions. Instead of the traditional corporate duty to make a profit for shareholders, benefit corporations must consider how the business will affect its employees and suppliers, the local community, and the environment. Additionally, benefit corporations must publish an annual report that uses a third party standard to assess how the company is pursuing its public benefit purpose.

The benefit corporation is NOT the same as a Certified B Corp., which is a company that completes a certification process by an independent third-party nonprofit organization, called B Lab, and pays for the use of the B Corp. logo. Any company, including LLCs, FPCs and cooperative corporations can apply to be a Certified B Corp.



Benefit Corporations are not B Corps.

Many people confuse the new Benefit Corporation entity with B Corp. While the names are unfortunately very similar, they are very different concepts. A Benefit Corporation is a legal entity that has specific requirements by law it has to abide by, while the B Corp is a certification by a nonprofit organization (B Lab) that the company meets rigorous standards of social and environmental performance, accountability, and transparency. Any company (corporations, LLCs, cooperative corporations, etc.) can apply for (and pay for) B Corp. certification, and forming as a Benefit Corporation does not mean that you meet B Corp. standards.

Flexible Purpose Corporation (FPC): The FPC, another new legal entity created in 2012 to promote social enterprise, requires that the corporation pursue a “special purpose,” i.e., a specific social or environmental mission beyond simply making a profit for the company’s shareholders. For example, a worker-owned business could choose a special purpose that designates that the corporation’s purpose is to promote the wellbeing of its local community or environment. Allowing the company to precisely tailor its special purpose makes this form more flexible but less comprehensive than the benefit corporation. To promote transparency and accountability, an FPC must also publish an annual report disclosing how well it has achieved its special purpose.

How do an LLC and a cooperative corporation differ?

The choice between an LLC and a cooperative corporation depends on each cooperative’s specific circumstances. The following are some of the main differences between these two types of entities.

Naming the business

In California, only businesses incorporated under the California Cooperative Corporation Law may use the word “cooperative” in their name. Thus, if you want to include the word “cooperative” in your business’s name, you should incorporate as a cooperative corporation. An LLC may not use the word “cooperative” in its name, but it may use related words like “collective” or “collaborative.”

Employment status

The question of whether cooperative corporation members are employees is a complicated legal issue discussed in the employment law section of this handbook. Sometimes, however, the members who form a cooperative corporation and work for that cooperative corporation are presumed to be employees. If those members are indeed treated as employees, then they would have to be paid at least minimum wage. The cooperative corporation would also have to comply with other employment requirements, including making payroll tax deductions, issuing W-2s, purchasing workers’ compensation insurance, and paying overtime.

In contrast, the members of an LLC are not generally considered employees. Therefore, a worker-owned business that is formed as an LLC may have more flexibility with respect to minimum wage, overtime, payroll withholding, and workers' compensation insurance.

Governance structure

The LLC also tends to be more flexible than the cooperative corporation in terms of governance. The rules governing the operation of an LLC are contained in the LLC's Operating Agreement, which is agreed to by the worker-members of the LLC. The cooperative principles of "one member, one vote" can be written into this Operating Agreement. However, because the Operating Agreement is so flexible, there is a risk that future worker-owners could change and remove the cooperative provisions, unless the Operating Agreement is structured carefully to avoid such possibilities. Conversely, the cooperative corporation has the ideals of "one member, one vote" embedded in its DNA. Although cooperative corporations thus sacrifice some structural flexibility, this bedrock principle ensures that worker-owners will continue to own and control the business. In addition, a cooperative corporation must have a board of directors; an LLC may or may not have a board of directors.

Profit-sharing and taxes

Both the LLC and the cooperative corporation allow for worker-owners to share in the profits of the business. Members of a worker cooperative share in the profits based on "patronage," which most worker cooperatives measure based on the number of hours each member works. The more "patronage" a member has (for example, the more hours you work), the greater the share of profits to which that member is entitled. Both an LLC and a cooperative corporation could also include other factors such as "job creation" or a "founder's multiplier" in considering how to distribute profits, based on how the business decides to calculate the value of each worker-owner's contribution for a given year.

LLCs and cooperative corporations both have tax advantages when compared to other corporate entities, because both are able to avoid double taxation. The profits of typical domestic stock corporations are taxed twice: first at the corporate level, and then again when shareholders receive dividends. However, if it meets the requirements of Subchapter T of the Internal Revenue Code (discussed later in this manual), then a cooperative corporation can avoid double taxation on profits that are derived from members' labor and paid out to the members as patronage distributions.

In comparison, an LLC is generally considered a "pass-through" entity, in which profits and losses are not allocated at the entity level, but directly accounted to the members. However, the tax flexibility involved with an LLC can also result in complex accounting and tax issues in cases of larger LLCs, where members are joining and leaving the organization. This could result in higher administrative costs to manage the organization. Cooperative corporations are somewhat easier to manage when they grow larger because when members leave, the cooperative's bylaw provisions will address how to pay out the member's capital contribution. The member usually does not have a further claim on the cooperative's assets.



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There are some other tax differences between LLCs and cooperative corporations, so it's a good idea to check with an accountant familiar with coops to find out if one will serve your business needs better than the other.

Contractor's license

In 2010, California passed a law that allows LLCs to obtain contractor's licenses. However, if you are considering forming a business that requires a contractor's license, the cooperative corporation may be a better option because an LLC must pay higher insurance and bond postings than a corporation.

Which should you choose: LLC or Cooperative Corporation?

Choosing an appropriate entity to carry out your anticipated activities is one of the most important first steps in establishing your cooperative business. The ultimate decision about which legal form to use will depend on specific facts and circumstances about your business plans and long-term goals.

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	Cooperative Corporation	Limited Liability Company (LLC)
Ownership	1 or more persons or entities	1 or more persons or entities
Documents necessary to form entity	File Articles of Incorporation with the State	File Articles of Organization
Governance	Statutory requirement of one member one-vote; must have a board of directors	Flexibility in choosing governance-need not have a board; need not have one member, one-vote. Can have creative alternative arrangements

Employment status	Working members are likely to be considered employees of the cooperative for immigration and minimum wage purposes	Working members need not be classified as employees, can be classified as “partners”
Management	Corporation's Board of Directors, which may be all members/workers	Can be member-managed or manager managed
Maintenance document requirements	Need to maintain minutes of meetings and by-laws	Need to draft and comply with an "Operating Agreement"
Lifespan	Unlimited (perpetual) existence, unless dissolved by directors or revoked by state for non compliance	Can be for a specific agreed-upon time period, or it can be unlimited (perpetual)
Liability	Members' liability is limited to their investment in the corporation	Members are limited to the amount of investment in the company, or as specified in Articles of Organization
Taxation	Corporate taxation. May qualify for subchapter T tax treatment. Subchapter T: corporation taxed on profits, patronage refunds may qualify for federal deductions. Must file corporate income tax return - Form 1120- C	Partnership or corporate taxation. If partnership taxed, then members taxed on share of company income (profits). Taxes paid on personal tax return - Form 1040. If corporate taxed, may qualify for subchapter T tax treatment.



<p>Advantages</p>	<ul style="list-style-type: none"> • Legal entity separate from individuals • Equality of management rights for individual members • Tax deductions may be available • May benefit patrons other than members • Exemption from CA securities qualification for offerings to members (up to \$300) 	<ul style="list-style-type: none"> • Legal entity separate from individuals • More flexible entity for governance purposes • More recognizable entity, thus easier to raise capital than a cooperative • If partnership taxed, then no corporate income tax, but must pay state minimum franchise tax (\$800) • Net operating loss is deductible by members • Less "formal" record-keeping requirements - no need to hold an annual members meeting
<p>Disadvantages</p>	<ul style="list-style-type: none"> • Members are likely to be considered employees for most purposes • Distribution of patronage can get complicated • Must comply with statutory rules around meetings, notice and one-member, one-vote • Difficulty in raising capital • Unfamiliar corporate form 	<ul style="list-style-type: none"> • Profit distributions based on patronage and one-member, one-vote not provided by statute, so future members can change the operating agreement so that the LLC is no longer operating as a cooperative • Cannot raise capital through issuance of stock • Accounting can get complicated with many members in the company, especially if there is high turnover among members
	<p>Cooperative Corporation</p>	<p>Limited Liability Company (LLC)</p>
<p>Who finds this the best way to do business?</p>	<ul style="list-style-type: none"> • Owners who see themselves operating on a cooperative business • Desire to use the name "cooperative" • Interested in patronage distributions and flexibility of retaining earnings in the capital account- which may be taxed at a lower rate 	<ul style="list-style-type: none"> • Owners who want flexibility • Don't want to be considered employees <ul style="list-style-type: none"> • Less traditional cooperative forms may incorporate outside equity investors • Not available for certain licensed professions

What are the steps towards forming a cooperative corporation?

(1) Steps Before Incorporation

- a. Choose a business name (one that includes “Cooperative” and an abbreviation that indicates that the co-op is a corporation, such as “Incorporated” or “Inc.”) and check with the California Secretary of State’s office regarding its availability.
- b. Identify initial members and/or directors.
- c. Decide whether and how to issue membership shares.
- d. Prepare bylaws for the cooperative (See Appendix for Sample Bylaws).
- e. Draft a membership agreement (“disclosure document”) and receipt, to be given to prospective members (See Appendix for Sample Disclosure Document).
- f. Determine whether any licenses, permits, and insurance must be procured.
- g. Prepare and file Articles of Incorporation with the Secretary of State; the filing fee is \$30.
- h. Within 90 days of filing the Articles, file a Statement of Information with the Secretary of State; the filing fee is \$20.

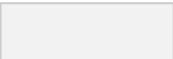
(2) Steps After Incorporation

- a. Hold the first meeting of the Board of Directors, for the purpose of adopting the bylaws, appointing officers, and discussing other business plans (note that the members may jointly govern the cooperative by making each member a director).
- b. Obtain an employment identification number (EIN) with the IRS and an employer account number with the state.
- c. Open a bank account for the cooperative.
- d. Obtain the necessary licenses, permits, and insurance.
- e. Hire or retain an accountant or bookkeeper to manage the company’s finances.
- f. Maintain up-to-date membership records, including names and addresses.
- g. Implement an operational and management structure, including designating committees or managers for the business’s day-to-day operations.

What are the steps towards forming an LLC?

The legal steps to form an LLC in California are as follows:

- a. Choose a business name (which includes an LLC designator, such as “Limited Liability Company” or “Limited Company” or an abbreviation of one of those phrases, such as “LLC” or “Ltd. Liability Co.”) and check with the Secretary of State’s office regarding that name’s availability.
- b. Prepare and file Articles of Organization with the Secretary of State using Form LLC 1; the filing fee is \$70.
- c. Within 90 days of filing the Articles, file a Statement of Information with the Secretary of State using Form LLC-12; the filing fee is \$20.
- d. Negotiate and execute an Operating Agreement among the worker-owners, establishing rules for how the LLC will operate.



Note that a number of steps are critical to successfully launching *any* new business enterprise. The foregoing was a rundown of some key *legal steps* towards starting a worker owned business. For a detailed outline of the *business steps* towards starting a worker cooperative, we recommend the *Steps to Starting a Worker Co-op* Manual, published by the Center for Cooperatives at the University of California, Davis and the Northwest Cooperative Federation, which is available at:

http://www.usworker.coop/public/documents/start_worker_coop.pdf.

One more thing: Can I convert from an LLC to a cooperative corporation or from a cooperative corporation to an LLC?

Yes. There is a \$150 fee for conversion, as well as some tax and accounting hurdles. We advise our clients to choose one entity type and plan to remain as that entity type, as there may be negative tax consequences for conversion from one entity to another because certain transfers of assets may be subject to capital gains taxes.

Useful Resources:

Additional resources on entity formation can be found at:

- Legal Sourcebook for California Cooperatives: Startup and Administration.
<http://www.cccd.coop/files/LegalSourcebookForCaliforniaCooperatives.pdf>
- NOLO legal encyclopedia: <http://www.nolo.com/legal-encyclopedia>

ENTITY CONVERSION: HOW TO CONVERT YOUR EXISTING BUSINESS TO A COOPERATIVE³

Many worker cooperatives are start-ups: new business entities created out of whole cloth. However, forming a new business entity is not the only way to create a cooperative business. Existing businesses with traditional capitalist ownership structures can also be converted into worker cooperatives, with significant potential advantages for the existing owners and their employees.

The experience of Select Machine—a small Ohio-based manufacturer, vendor, and distributor of custom parts for construction and demolition equipment—is a textbook example of a conversion. Select Machine’s two owners founded the company with the goal of creating a strong community and an employee-friendly workplace. When the owners decided they were ready to sell the business, they found several potential purchasers. However, these would-be buyers were primarily interested in the company’s customer list; they planned to consolidate production, shut down Select Machine’s plant and leave its employees out of

work. This was not what the owners had in mind, so they turned to the Ohio Employee Ownership Center, who teamed with attorneys Mark Stewart and Eric Britton to facilitate the sale of Select Machine to their employees. This chapter borrows heavily from the writings of Mark Stewart and Eric Britton published subsequent to the Select Machine conversion.

Why Do It?

For the owner:

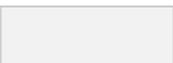
- *Defer capital gains taxes:* Normally, sellers of ownership shares in a company must pay capital gains taxes on their sale proceeds. However, Section 1042 of the Internal Revenue Code⁴ allows owners to defer paying these taxes if they sell their shares to an Employee Stock Ownership Plan (ESOP)⁵ or a qualifying worker cooperative. The mechanics of a “Section 1042 rollover” are described below.
- *Maintain the company culture:* As the Select Machine experience demonstrates, many potential purchasers have very different plans for a business than its existing owners. If the owners want to maintain the direction of their business, however, one option is selling to the business’s existing employees, who may have longstanding professional and personal relationships with the owners. It should be noted, however, that

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³ Acknowledgement: The legal issues and transaction structure outlined in this chapter borrows heavily from the transaction developed by the Ohio Employee Ownership Center and attorneys Mark C. Stewart and Eric D. Britton.

⁴ 26 U.S.C. § 1042 (2012).

⁵ ESOPs are a form of defined-contribution retirement plan in which employees take an ownership interest in the company. The employees’ shares are held in the ESOP trust until an employee retires or leaves the company. ESOPs allow for long-term deferral of taxes on employees’ earnings, but they are expensive to establish and maintain and must follow detailed regulations under the Employee Retirement Income Security Act (ERISA). Thus for many small businesses ESOPs are not a viable option.



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transitioning to worker ownership and management itself will entail significant changes to a business’s governance and corporate culture.

- *Gradual transition from full-time management responsibilities:* Many business owners want to devise an exit strategy without getting out immediately and entirely. Cooperative conversions can be structured to allow the owners to make such a gradual transition. Moreover, owners who wish to keep working at the business can also become members of the cooperative.

For the employees: For the employees in a traditional capitalist business, converting to a worker cooperative presents them with all the potential benefits of worker-ownership—capturing the full value of their labor and sharing in the business’s profits; participating in the business’s management and decision-making; and working for a business that operates for their benefit.

Conditions for Success

Not all existing businesses are well suited to a worker cooperative structure. If a business has high employee turnover or low employee loyalty, selling to the employees will not be a good option. Additionally, for many large or capital-intensive businesses, securing financing for a sale to the employees may not be feasible.

However, in businesses with a smaller number of dedicated employees, and particularly companies where employees bring specific skills to the workplace—for example, in many small manufacturing, craftsperson, artisan, or specialized services industries—cooperative conversion may be a good fit. Conversions are particularly likely to succeed for companies where the existing owners take an active management role and have identified employees willing and able to take on those responsibilities.

The Legal Framework

Section 1042: As mentioned above, a special provision of the Internal Revenue Code, introduced in 1984, provides business owners with an incentive to sell their businesses to their employees. Section 1042 allows owners of closely held businesses⁶ who sell at least 30% of more of their stock to their employees (through an ESOP or “eligible worker-owned cooperative”) to shelter their capital gains from taxation if they roll over the sale proceeds into other qualified domestic securities within 12 months of the sale. To qualify for a “1042 rollover,” the seller must have owned the stock for more than three years; the seller must reinvest in a portfolio of domestically operating companies; and the buyer must purchase at least 30% of the outstanding shares.

Subchapter T / State Cooperative Law: Owners can take advantage of the tax benefits provided by Section 1042 if they sell their shares to their workers as a cooperative that comports with the provisions of Subchapter T of the Internal Revenue Code.⁷ Subchapter T prescribes certain requirements regarding the tax treatment of the cooperative’s income and the

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⁶ A closely held business is a business with a small number of controlling shareholders.⁷ 26 U.S.C. §§ 1381–88 (2012).

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members’ patronage income, which are described elsewhere in this manual. In addition to following these provisions, a converted cooperative will also have to comply with the relevant law governing cooperatives in the state in which the cooperative is incorporated.

Challenges to Conversion

Selling a business to a worker cooperative is an attractive option for many businesses, and presents advantages for both the selling owner and potential worker-owners. However, there are also challenges associated with cooperative conversion that require some creative solutions.

Risk Disclosure: Whenever ownership of a company changes hands, there are significant risks

involved—the new owners generally will not be familiar with the business’s finances, and the business could have unexpected liabilities. Disclosing these risks is an important part of business transactions. In an ESOP, a trust that manages the employees’ ownership interest has fiduciary duties to the employees; that is, it is obligated by law to act in the employees’ best interests, mitigating some of the risks of assuming ownership. In addition, transactions regulated by the federal securities laws often require elaborate disclosures of finances and liabilities. By contrast, converting a closely held business to a worker cooperative and then selling shares to the members, just like the sale of any security or business, is more a case of “buyer beware.” Thus a cooperative considering a buyout should engage professional advisors to conduct the necessary due diligence, and insist on disclosures and warranties from the selling owner.

Financing: Although the selling owner may have identified employees who are enthusiastic about purchasing the company, the would-be worker-owners often lack the capital to purchase the business outright. The employees will have to choose a financing strategy that suits their particular circumstances. Possible sources of capital include issuing non-voting equity, acquiring a note from the sellers or a commercial lender, redeeming stock with future cash flows, or any combination of these sources.

Interested employees will often have to turn to a commercial lender in order to finance the purchase. Many lenders, unfamiliar with cooperative conversion, will be nervous about making such a loan and will demand some type of guarantee. The bank may require the cooperative to pledge its assets or stock, place limitations on patronage distributions until the debt is repaid, and, where the conversion entails the seller exiting the business completely, receive ongoing business consultation (to ensure that the business will remain profitable under the new, inexperienced cooperative management).

The Select Machine conversion is an excellent example of how a conversion can be structured to utilize multiple sources of capital. Select Machine structured the sale through several stock redemptions spread over a period of several years. The stock redemptions were financed through several different means. The first block of stock was financed by a note from a local bank. Later, the cooperative was able to purchase stock with cash from its business operations. The final stock redemption was financed by a note from the sellers themselves.

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It is possible to sidestep traditional lending sources altogether. The employees of Real Pickles, a Massachusetts-based pickle manufacturer, raised enough capital from the issuance of preferred shares to purchase the business from the founders in a single transaction. The shares were structured on flexible terms which gave the company discretion in paying down their debt burden. The shares paid a cumulative dividend and were redeemable at a set price after a predetermined period of years. The investors came entirely from the local community.

Ownership-Control Disconnect: If a conversion is structured to sell the business through multiple transactions and to utilize the Section 1042 tax deferral, the multi-step nature of cooperative conversion can present a dilemma for the selling owner: after the first step (minimum 30% sale), the owner may still retain a majority ownership interest in the business. However, to take advantage of Section 1042, the members (a majority of whom must be employees) must elect a majority of the newly converted cooperative's board on a one-person, one-vote basis.⁸ In other words, the majority owner no longer has majority control. The interests of the selling owner can be protected by including in the sale agreement assurances that the cooperative will act so as to protect the owner's remaining ownership interests. In addition, the cooperative's governance documents will often build in safeguards such as supermajority voting requirements for decisions affecting the owner's proprietary interests.

Business Planning: Conversion to a cooperative will not only transform how a company is governed, it will also affect every aspect of how the company does business, from its day-to-day operations to its determination of how salaries and profits are distributed. Especially for selling owners and employees who lack experience with worker cooperatives, it may be difficult to anticipate how the business might change post-conversion. As part of the conversion process, the sellers and buyers should collaborate on forward-looking business planning.

The Steps Towards Executing a Cooperative Conversion

Often, the decision to convert to a worker cooperative begins with the owners. As mentioned above, the Section 1042 sale may be an attractive option for owners who are looking to preserve their business while transitioning away from it and sheltering their capital gains from taxation. However, the "qualified securities" requirement of Section 1042 may be too cumbersome for some owners, who may opt to forego the rollover. For owners who do not take advantage of Section 1042, there may be other equally powerful motivations, such as the gratification that comes with knowing that the business they founded will continue after they exit and the knowledge that a conversion will help their employees keep their livelihood. Perhaps most importantly for such owners, the employees may be the only willing buyer in a depressed market.

⁸ 26 U.S.C. § 1042(c)(2).

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If the owners decide to pursue a cooperative conversion, the process of a conversion may take the following steps⁹:

1. *Owner's Decision.* First, the owner should decide to sell the business to the employees, based on an understanding of the benefits of cooperative conversion as well as the

attendant risks.

2. *Cooperative Steering Committee.* Next, the owner should approach employees who are potentially interested in becoming members of the cooperative. Once the owner has identified a “critical mass” of interested employees, those employees should form a cooperative steering committee that is authorized to act on their behalf. A company with few employees may not need a steering committee.
3. *Professional Advising and Appraisal.* The Steering Committee should engage professional advisors, such as lawyers and accountants, to investigate the feasibility of a cooperative conversion, the financial health of the business and its actual and potential liabilities. This will require the cooperation of the selling owner. The Committee should also obtain an independent appraisal of the value of the company’s stock.
4. *Draft and Sign a Sales Agreement.* The sales agreement should articulate the terms of the sale, including a list of assets belonging to the business and the agreed upon sales price.¹⁰ The sales agreement may also include such representations as demanded by the transacting parties or the lenders. The sales agreement should establish a date for the closing meeting, where the parties will sign documents to transfer ownership to the employees and reorganize the business into a cooperative.
5. *Closing Meeting.* At a minimum, the business ownership should transfer at the closing meeting. However, it is not unusual for several distinct events to occur at the closing meeting: in addition to a transfer of ownership, the business will be reorganized into a cooperative, and the lenders and the cooperative will sign a lending agreement.

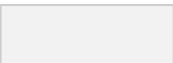
Stock Redemption Agreement. The parties will sign a stock redemption agreement to transfer ownership, in the form of shares, from the sellers to the employees. The agreement should stipulate the terms of the deal, including the number of shares, the share price, and any other representations and warranties required by the parties or the lender. The agreement may also describe how the owner will support the employees’ financing of the stock purchase. In the case of a multi-stage sale, the agreement may articulate the future steps to complete the cooperative’s purchase of the owner’s stock.

Amend Governance Documents. The sellers or the buyers (depending on whether the reorganization is planned to occur before or after the transfer of

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⁹ The process outlined herein is not an all-encompassing. Each conversion is unique and the parties involved must evaluate which steps are necessary given their particular circumstances.

¹⁰ See Nolo guide on selling a business, accessible at <http://www.nolo.com/legal-encyclopedia/selling-business-eight-steps-30143.html>.



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ownership) should amend the business’s key founding and governance

documents to adopt a cooperative structure. In California, the business must file a Certificate of Amendment of Articles of Incorporation with the Secretary of State to amend its articles.¹¹ In addition, the business will require new bylaws provisions regarding, for example, membership, the board of directors, how shares are voted, and how profits are distributed. The bylaws should also comport with the requirements of Subchapter T as well as the relevant state cooperative law. At this point, the business is officially a worker cooperative, at least on paper.

Offering Statement. The offering statement is a document prepared by the seller for the prospective worker-owners disclosing all the relevant risks associated with the transaction. (This addresses the “buyer beware” problem described above.) An offering statement will outline the risks of selling shares and transferring control; the risks of employee investment in the company; the terms of the Stock Redemption Agreement; and the securities and tax law issues surrounding the transaction and the continuing operation of the business. It will also describe the company’s reorganization into a worker cooperative, including attaching the new articles and bylaws (spelling out the terms and conditions of membership), as well as its business planning and finances. The purpose of the Offering Statement is to make a fair disclosure to potential members of the risks and responsibilities of becoming a worker-owner; it also provides lenders with a clearer understanding of the transaction.

Secure Financing. Before closing, the sellers and employees will have already assessed and identified lending sources. As mentioned above, lenders may require some form of support or guarantee from the seller or the cooperative. As such, the lender may be present at the closing meeting to formalize the lending documents and to ensure that their interests are represented in the other transaction documents, such as the stock redemption agreement, governance documents (limiting patron dividends), insurance certificate (for secured assets), employment contract, or consulting contract.

6. *Elect Federal Taxation Under Subchapter T.* Following the reorganization and redemption of the owners’ stock, the converted cooperative should terminate its existing election under the federal income tax laws and instead elect to be taxed under Subchapter T. This will enable the partial pass-through taxation characteristic of worker cooperatives, and permit the selling owner to take advantage of the tax benefits under Section 1042.
7. *Selling Owner: 1042 Election.* If applicable, after the initial sale of shares to the cooperative is executed, the selling owners should elect to have their capital gains income from that sale taxed under Section 1042. As mentioned above, if the owners

¹¹ See Cal. Corp. Code §§ 900–910 (West 2012).

reinvest their sale proceeds within one year, taxes on those capital gains will be deferred.

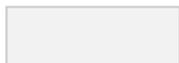
8. *Future Operations/Loan Repayment.* The converted cooperative will continue its business operations, albeit with a new board, new governance structure, and new system of distributing profits. The selling owners can continue as members of the cooperative, provided they meet all the conditions of membership (such as working for the cooperative full-time). In the years following the transaction, the cooperative will need to dedicate its profits towards repaying the loan that financed the transaction. This will depress the cooperative's cash flow, thus most of the patronage allocated to members will be in the form of equity interests rather than cash payments until the loan is repaid (although Subchapter T requires that 20% of all patronage allocations must be in cash). The decrease in their disposable income will affect the members' own financial planning, and during this time the members will be exposed to the enterprise risk of the business.

Conclusion

Converting an existing business to a cooperative is a complex transaction involving a number of legal and financial issues and risks. Indeed, successfully executing a conversion may require some novel, outside-the-box thinking. But the potential benefits of cooperative conversion are enormous—not least of which is the fact that the now-cooperatively managed business is already up and running. More broadly, establishing conversion as a viable model for selling a business could encourage more businesspeople and lawyers to challenge the conventional wisdom and consider cooperative conversions when thinking about how to structure their deals.

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Think 'Outside' the Boss: How to Create a Worker-Owned Business

COOPERATIVE AND SHELTERING CAPITAL GAIN: THE IRC § 1042 ROLLOVER (Jan. 14, 2010).¹²

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¹²This article can be accessed at: [http://www.slk-law.com/portalsresource/lookup/wosid/cp-base-4-5708/media.name=/MCS.SLK_TOL-_698879-v1-F__HOME_CDEMSKI_MCS_Employee_Cooperative_Journal_Article_doc\[1\].pdf](http://www.slk-law.com/portalsresource/lookup/wosid/cp-base-4-5708/media.name=/MCS.SLK_TOL-_698879-v1-F__HOME_CDEMSKI_MCS_Employee_Cooperative_Journal_Article_doc[1].pdf).

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NONPROFIT ORGANIZATIONS INCUBATING WORKER COOPERATIVES

Why Incubate?

Many nonprofit organizations are considering worker-owned business development as a powerful tool for community economic development. This is because worker-owned businesses and cooperatives align with the mission of those nonprofit organizations that are seeking to build economic empowerment and opportunity in low-income and marginalized communities.

However, nonprofits should be aware of the risks that come with business development in general and worker-owned business development in particular. The most important legal risks from the nonprofit's perspective include jeopardizing the organization's tax-exempt status and becoming liable for the actions of the cooperative.

It is important to consider that a worker-owned cooperative is primarily organized for the benefit of its members, who are private individuals. Although in California a cooperative corporation is not technically a "for-profit" corporation, it is also not a nonprofit. Unlike a nonprofit organization, a cooperative's main purpose is not to benefit the public, but rather its members. Thus a nonprofit seeking to incubate such businesses will have to show that the beneficiaries of the cooperative's operation are a "charitable class" of people or that developing the cooperative will further the nonprofit's "charitable purpose." We will discuss below the definitions of these terms.

Although it's a frequent reminder, it's important for a nonprofit interested in starting a new business to consult with an attorney who specializes in nonprofits. This will prevent the nonprofit from getting into activities that may jeopardize its tax-exempt status.

An Example: Green Landscaping Cooperative

Green Commonwealth Cooperative ("Green") is a new worker-owned cooperative that has been incubated by Jobs Now, a community-based nonprofit. The nonprofit's mission is to bring employment opportunities to low-income, minority, and disadvantaged people in the East Bay, by providing jobs training assistance to disadvantaged workers and businesses that employ disadvantaged workers. Green will employ low-income day laborers who have trouble finding

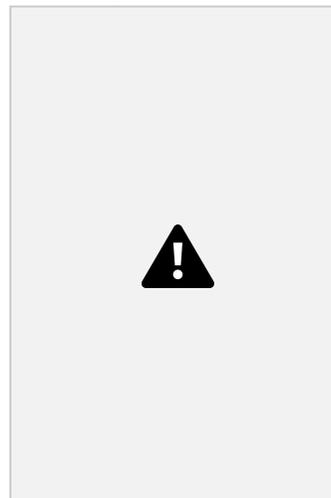
work and do not have the resources to start their own business. Green will ultimately be owned by the day laborers

as a worker cooperative. Jobs Now is providing the cooperative a start-up loan and business development services including helping them to organize, providing business training, assistance with maintaining financial, and

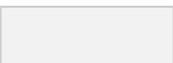
accounting records, and providing an office space. As Green

Landscaping becomes profitable, it will repay the nonprofit for services received through reduced rent and reduced fees.

The next sections of the manual analyze whether Jobs Now's assistance to incubate Green fits within the



nonprofit's tax exempt purpose.



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What Is a Nonprofit?

A nonprofit organization in California can be a public benefit corporation, a nonprofit religious corporation, or a mutual benefit corporation. For the purpose of this chapter, we will focus on public benefit corporations because they can get tax-exempt status under section 501(c)(3) of the Internal Revenue Code. Public benefit corporations in California are established to engage in public or charitable work.

Although the public benefit corporation is a matter of California state law, tax exemption is largely a matter of federal law. The most familiar type of tax exemption falls under section 501(c)(3). To obtain tax exemption under section 501(c)(3), the organization must be organized and operated for a limited set of purposes, the most common of which are charitable, educational, scientific, or religious.

Beyond 501(c)(3)

Note that there are many other types of tax exemption under section 501(c) of the Internal Revenue Code. Tax exemption under section 501(c)(3) has a unique benefit, in that donations to the organization are tax deductible to the donors. However, tax exemption under sections 501(c)(4), 501(c)(5), 501(c)(6), 501(c)(7), or another section may afford an organization greater flexibility and allow a broader range of purposes. It is also possible for a nonprofit corporation to operate without obtaining tax exemption, in which case the corporation would be taxed like a normal business.

Nonprofits Doing Economic Development Work in General

The IRS has provided guidance to nonprofits that want to do economic development work, such as providing resources and assistance to for-profit businesses in low-income communities. The IRS issues what are known as “Revenue Rulings,” which are public rulings that apply the tax laws to particular cases. These rulings can be relied on by the public to analyze how the IRS would view a similar case in the future. We use these rulings to try to understand how the IRS would view a nonprofit that is trying to do for-profit activities and what factors the IRS uses to determine whether these activities have a tax-exempt or “charitable” purpose.

In analyzing nonprofit organizations providing business development services, the main question that the IRS is seeking to answer is whether this work is primarily charitable in nature and helping the public, which would qualify for tax exemption, or whether it is primarily benefiting private individuals, which would make it a non-exempt activity.¹³

IRS definition of “charitable”

The IRS has interpreted the term “charitable” to include the following purposes: • relief of the poor,

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13 See, e.g., Robert Louthian and Marvin Friedlander, “Economic Development Corporations: Charity Through the Back Door” (an IRS publication), (providing that the IRS recognizes the charitable purpose of economic development activities that benefit for-profit companies where “the ultimate good received by the general public outweighs the private benefit accorded to the direct beneficiaries”), available at <http://www.irs.gov/pub/irs-tege/eotopicg92.pdf>.

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- lessening the burdens of government,
- promotion of social welfare by organizations designed to lessen neighborhood tensions, eliminate prejudice and discrimination, or combat community deterioration and juvenile delinquency.¹⁴

A nonprofit organization that seeks to develop for-profit businesses, such as cooperatives, as a charitable activity, would likely want to argue that the activity advances a charitable purpose related to those listed above.

Private Inurement

The IRS is concerned that a nonprofit may use its tax-exempt funds to benefit a private individual, especially someone who has a relationship with the organization. This is called “private inurement” and is a concern when a nonprofit is doing business development work that will benefit a group of private individuals. Moreover, an organization whose **primary purpose** is to render services to individuals in their private capacity generally cannot qualify as a tax-exempt, charitable entity.

The exception to this general rule is where the private individuals receiving the benefit are members of a “charitable class,” or if they are not part of this class, then the individuals are a means for advancement of a charitable objective. Finally, the IRS also looks to see if the private benefit involved is incidental to or unavoidable in pursuit of the charitable purpose.

Charitable Class

A “charitable class” of people includes terms like “poor and distressed,” “minority,” and “disadvantaged.” In our modern parlance that usually refers to low-income people, people of color or other marginalized individuals. If the nonprofit can show that the direct beneficiaries are charitable, i.e., the worker-members of the new cooperative are limited to a charitable class of people, then it has a much stronger argument for why its business development work with the cooperative is “charitable.” This is because by helping such people form their own business, the nonprofit can show that its activity is contributing to relief of the poor or disadvantaged.

Charitable Purpose

By contrast, if the nonprofit is not working directly with disadvantaged or low income people, then the nonprofit will want to show that its assistance to these individuals to form a cooperative will accomplish a charitable goal such as combating community

deterioration. It would be even stronger if the nonprofit could show that by aiding non-poor people in creating a cooperative, the nonprofit's activities are aiding a business that will locate in an economically depressed or blighted area, for example.

In such cases, the nonprofit should show that the assistance they are providing is *primarily* relieving poverty and lessening tensions caused by the lack of jobs in the area;

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¹⁴ IRS Regs. 1.501(c)(3)-1(d)(2).

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Think 'Outside the Boss: How to Create a Worker-Owned Business

lessening prejudice and discrimination against minorities; or some other similar charitable purpose.

The main lesson is that the nonprofit should not be providing business development assistance to non-poor or non-disadvantaged people without showing that this assistance is achieving a greater, *charitable* purpose.

The Factors That the IRS Considers

When the IRS analyzes tax-exempt organizations that are doing economic development work, the following factors are very important in determining whether the organization is primarily accomplishing charitable purposes, despite the fact that private individuals are benefiting from the work. The IRS looks to see if the nonprofit's assistance is **targeted to**:¹⁵

- (1) **benefit a "charitable class,"** such as minorities, the unemployed or underemployed, or other disadvantaged groups (i.e., by providing them training);
- (2) **aid an area** that is economically depressed or blighted;

HELPFUL TIP:

BEWARE: Job training and creation is not always a tax-exempt activity!

- (3) **aid businesses** that would locate or remain in the economically depressed or blighted areas and provide jobs and training to the unemployed or underemployed from such area only if the nonprofit's assistance was available; and
- (4) **aid businesses** that have actually experienced difficulty in obtaining conventional financing **due to**
 - a. the **deteriorated nature of the area** in which they were or would be located or

b. their **composition by minority** or disadvantaged people.¹⁶

While all of these factors are important, the IRS generally considers the first factor to be most important because it provides a **direct link** between the economic development activity and assistance to the disadvantaged through the provision of jobs.

Nonprofits Making Money

Thus far we have discussed the issue of whether a nonprofit can provide business development services to a worker-owned cooperative. But we must also address the question of whether the nonprofit can engage in business itself, either within the nonprofit or by forming a subsidiary. This is because the nonprofit may want to create the cooperative as a part of the nonprofit's activities, or eventually spin it off as a "subsidiary" business.

¹⁵ See Robert Louthian and Marvin Friedlander, "Economic Development Corporations: Charity Through the Back Door" (an IRS publication), available at <http://www.irs.gov/pub/irs-tege/eotopic92.pdf>. ¹⁶ See IRS Rev. Rul. 74-587, 1974-2 C.B. 162; Rev. Rul. 76-419, 1976-2 C.B. 146; and Rev. Rul. 77-111, 1977-1 C.B. 144.

32.....*For informational purposes only, not to be relied on as legal advice.*
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Related Versus Unrelated Business

The law allows nonprofits to operate income-generating businesses of two sorts: 1) **related** (the income from which IS NOT taxed) and 2) **unrelated** (the income from which IS taxed). The main point to take from nonprofits doing business is: **it's not what you do WITH the money, it's what you do TO EARN the money.** Many organizations believe that their business should be tax exempt simply because they reinvest all profits into the nonprofit organization. However, this is a given with any nonprofit – the earnings should not be distributed to private individuals. What matters to the IRS is the nature of the activity that earns the money, and whether the activity is operated with the primary purpose of achieving a tax-exempt, or charitable purpose.

Related Business

A "related" business is one in which the primary purpose behind the conduct of the activities is **substantially related to the tax-exempt purpose of the organization, as discussed above.** The primary purpose of the activity must be to further the exempt purpose, and it must have a **substantial causal relationship** to achieving those purposes. The primary motivation behind the activity and its primary impact should be the furtherance of the tax-exempt purpose. **The money that you earn must be incidental to, and not the primary goal of, the project.** When the nonprofit makes decisions about the business activity, it should be with the question: "What will most help us achieve our educational or charitable goals?" and not "How can we earn the most money?" The IRS wants to ensure that nonprofit business activities do not unfairly compete with for-profit businesses. A nonprofit's **business activity should not be operated on a scale that is larger than necessary** to achieve the tax-exempt purposes.

An example of a "related business" according to the IRS was a nonprofit's sale of a

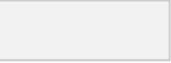
software program when its charitable purpose was to make new technology available for the benefit of the public. The IRS noted that the software program constituted only 2.3% of the nonprofit's total operations and that the budget for the software program showed that the program's expenses exceeded its revenues. This helped persuade the IRS that the primary purpose of the program was not to earn money.¹⁷

It is important to note that the nonprofit is not insulated from liability for the actions of a related business, and so the nonprofit may be responsible for covering liabilities with its own insurance or assets if someone were to sue the related business.

Unrelated Business

In contrast to a "related" business, an "unrelated" business can be operated with the primary goal of earning money for the nonprofit, so long as it's a small portion of the nonprofit's total activities.

¹⁷ I.R.S. Priv. Ltr. Rul. 85-120-84 (Dec. 31, 1984).

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Think'Outside'the'Boss:'How'to'Create'A'Worker-Owned'Business

The IRS has provided guidance to show when a nonprofit's work on behalf of a for profit is an unrelated business. The following activities tend to show an unrelated, or commercial purpose:

- Competition with commercial firms
- Lack of voluntary financial contribution from the public
- Presence of net profits
- Failure to offer any free or below-cost services
- Failure to limit its clientele to exempt organizations.¹⁸

In general, the more the business looks like a competitive, commercial business rather than just one that furthers the nonprofit's exempt purpose, the more likely the IRS is to consider it an unrelated business. In addition, if the activity itself is not substantially related to the organization's exempt purpose, regardless of how the money earned from the activity is used, the activity is likely an unrelated business. In one instance, the IRS ruled that a nonprofit's provision of veterinary services was an unrelated business because the nonprofit's exempt purpose was to prevent cruelty to animals but the services were not provided to animals that were unwanted or victims of cruel treatment.

Income from such a business is subject to Unrelated Business Income Tax (UBIT), and must be reported in the organization's annual 990 filing. The purpose of UBIT is to ensure that nonprofits do not gain an unfair advantage if they are competing in a regular market. The most important thing to remember about unrelated business is that it should not become substantial in relation to the nonprofit's total activities. There is no bright

line rule for determining when the unrelated business has become “substantial,” but the safest thing to do is keep it at less than 10% or 15% of the organization’s activities or income. If the activity grows and is successful in generating income, the organization may want to create a for-profit subsidiary. If the unrelated business is “substantial,” and the nonprofit does not create a for-profit subsidiary, it may be in danger of losing its tax exemption.

Is the Green Cooperative a charitable activity of Jobs Now?

In the example of Jobs Now and the Green Landscaping Co-op, the first question to consider is whether the primary purpose of the organization is to provide business development services to a charitable class of people. Jobs Now can probably show that its business development work with low-income day laborers will contribute to relief of the poor by showing that:

- it is **directly benefiting** a charitable class of individuals,
- its services are **targeted to assist** that class,
- it is **not in competition** with commercial firms,
- it is providing services that are **free and below-cost**,
- it is **not making net profits off its work**; and
- it has **support from the public**.

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¹⁸ See B.S.W. Group, Inc. v. Comm’r, 70 T.C. 352 (1978).

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Think'Outside'the'Boss:'How'to'Create'A'Worker-Owned'Business

By helping these workers to create their own business, it is **directly benefiting** the charitable class of low-income and disadvantaged people. In addition, Jobs Now can show that its services are **targeted to assist** disadvantaged people, not just anyone who wants a job.

In addition, Jobs Now should show that its assistance to the cooperative is *not in competition* with commercial firms, because there are no commercial firms that would provide free or below-cost support to help day laborers start their own businesses.¹⁹ Finally, Jobs Now should show that it is **not making net profits off** of the business development services it provides; and that Jobs Now has support in the form of voluntary contributions from the public. All of these factors suggest that Jobs Now’s business development activity is charitable in nature.

Beware: Jobs training is not always an exempt activity!

While we’ve given examples of where the IRS permits nonprofits to operate related businesses that are conducted for the primary purpose of providing skills training to the disadvantaged, the IRS is not always consistent!

For example, in one case, the IRS deemed a nonprofit’s business to have a charitable purpose because it trained and provided employment to people who were unemployed or underemployed. In that case the nonprofit manufactured and sold toy products using the labor of disadvantaged residents. The trainees were placed in permanent positions in the community as soon as they were adequately trained.²⁰

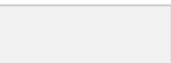
But in another case, the IRS denied tax-exempt status to a nonprofit that provided job training to unemployed residents. In that case the nonprofit operated a low-price grocery store in which only a small portion of earnings was allocated to provide job training to unemployed residents from the surrounding low-income community. The nonprofit made a profit off of food sales, although they were sold at low prices to the community. However, food was not distributed free or at reduced cost to those who could not afford to pay. For these reasons, the IRS found that running the grocery store was not a tax-exempt purpose.²¹

We can distinguish these two cases because in the first case the *primary purpose* of the nonprofit's business was to train disadvantaged people, not to operate the business. In the second case, the nonprofit's activities were not primarily motivated by a desire to help unemployed or disadvantaged people. However, because conducting business activities as a nonprofit can be tricky, it is important to carefully plan your business such that it meets the IRS requirements. Consult a nonprofit attorney for assistance with setting up any business your nonprofit may want to operate.

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¹⁹ See IRS Rev. Rul. 69-572 for an example of where a nonprofit differentiates its services from those offered by for-profit providers. Please note that the issue of competition applies to the non-profit's activities, not those of the cooperative. It is assumed that the cooperative business itself will be competing with other businesses, and helping it compete may in fact be the goal of the nonprofit providing technical assistance.²⁰ IRS Rev. Rul. 73-128, 1973-1 Cu. Bull. 222 (1973).

²¹ IRS Rev. Rul. 73-127, 1973-1 Cum. Bull. 221 (1973).



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What Is a Subsidiary?

Often nonprofit organizations choose to form subsidiary entities to undertake business activities. Forming a subsidiary can help to protect a nonprofit's tax-exempt status. If the nonprofit seeks to engage in business activity that is not related to the nonprofit's tax exempt purpose, then forming a subsidiary can be a good strategy. Another reason for forming a subsidiary is to protect the nonprofit from liability.

A subsidiary is usually owned or controlled by the nonprofit "parent" entity. The nonprofit exerts control over the subsidiary in a variety of ways. Usually the nonprofit controls the new entity by owning the stock, received in exchange for capital contributed by the nonprofit. This allows the parent nonprofit to select the subsidiary's board of directors and officers. Additionally, the nonprofit may incorporate the subsidiary, choose the subsidiary's business purpose, and create bylaws that protect the parent's ability to control the subsidiary. By controlling the board of directors, the nonprofit ensures that its vision is carried on in the subsidiary's activities.

The importance of corporate formalities

In order to prevent the nonprofit from becoming liable for the subsidiary's activities,

the two should be treated as distinct entities. This means observing “corporate formalities.” Corporate formalities include ensuring that both the nonprofit and the subsidiary have their own boards of directors with separate meetings and minutes; have separate officers and employees; maintain separate bank accounts, bookkeeping, records, and financial accounts; and use separate stationery. In addition, the subsidiary should enter into transactions in its own name. If these procedural formalities are followed, then the two entities will be treated by the courts as separate legal entities. If anyone tries to sue the nonprofit parent organization for the actions of the subsidiary, the lawsuit will likely fail because the parent will usually not be liable for the actions of the subsidiary.

Are worker cooperatives subsidiaries?

It is not advisable to structure the relationship between a nonprofit and a worker owned cooperative as a parent-subsidiary relationship. A worker-owned cooperative is supposed to be an entity that is owned by its members, who are the workers. Thus, if a nonprofit is the “parent” and wholly-owns the cooperative, this would defeat the purpose of creating the cooperative in the first place. Instead, it is better to have the nonprofit become a member of the cooperative or have control over the board of the cooperative, as we discuss in the next section.

Nonprofits Creating Cooperatives

In California, when someone incorporates a corporation, that person (known as the “incorporator”) has the power to appoint the cooperative’s initial board of directors. California cooperative law provides that only “natural persons” may hold seats on a cooperative’s board of directors. This means that a nonprofit entity cannot be a member of the cooperative’s Board.²² However, the cooperative law allows for a “specified designator”

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²² Cal. Corporations Code Section 12233.

36..... *For informational purposes only, not to be relied on as legal advice.*
Think 'Outside' the 'Boss': How to Create A Worker-Owned Business

to choose “all or any portion of the directors authorized in the articles or bylaws” of the cooperative.²³ By selecting itself as the specified designator of board seats for the new cooperative, the nonprofit can ensure that, after the initial board of director’s term expires, it retains indirect influence over the activities of the cooperative through representation on the Board. However, by asserting excessive control over the cooperative’s board, the nonprofit risks violating the fundamental principles of a worker cooperative, which grants governing authority to the workers.

The Nonprofit as Member

California cooperatives allow for different classes of membership. This means that the nonprofit could create a class of membership for the workers and a class for itself, as an organizational member. However, how the IRS would view a nonprofit member of a California cooperative corporation is not completely clear. In the LLC context, the IRS views nonprofit members of LLCs as entering into a joint venture with the other LLC

powers in all respects. In addition, the nonprofit should not reserve to itself, as “specified person,” excessive power over the board of directors or over changes to the bylaws. As the cooperative becomes established, the nonprofit may want to designate itself to appoint no more than a minority of the board seats and let the balance be elected by the workers. By allowing the workers to elect a majority of the board seats, and thus retain democratic control of the board, the nonprofit will be well-positioned to show that the cooperative is not its subsidiary.

Services provided to the cooperative

The nonprofit can provide essential services to ensure the success of the cooperative such as: pre-startup business development planning and analysis, investment of start-up capital, development of business systems, management of human resources, strategic planning, start-up financing, public education, and creating strategic partnerships for the cooperative. If desired, staff members of the nonprofit can be independent consultants or employees of the cooperative.

If the nonprofit plans to provide certain services for free or below-cost to the cooperative, the nonprofit should make sure that such services are in furtherance of the nonprofit’s tax-exempt purpose. If the nonprofit is a charitable organization focused on assisting disadvantaged people, the nonprofit can show this by having the cooperative restrict its membership to such a disadvantaged class of people. However, if this is not possible, then it is important that the nonprofit be paid by the cooperative for the fair market value of the services it provides. Similarly, if the cooperative is the subsidiary of the nonprofit, then the nonprofit should make sure to charge market rate for its services to the subsidiary, so as to avoid an improper benefit to the cooperative.

Note that some of the services provided to the cooperative by the nonprofit would be considered “related business” activities (described near the beginning of this section), which means the nonprofit would not pay tax on any income for those services. However, some of the services may be considered operation of an “unrelated business,”

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²⁶ Rev. Ruling 68-26 (finding that even though a technical parent-subsidiary relationship did not exist between two nonprofits, the parent-subsidiary relationship can be present if a “substantially similar relationship does in fact exist through the control and close supervision of its affairs.”).

in which case the nonprofit would need to pay taxes on the income (including any patronage dividends) derived from those services.

Cooperatives should “operate on a cooperative basis”

The purpose of a cooperative is to be democratically controlled by its members. Although the nonprofit may exert control over the cooperative through designating the board of directors, it should not fully control the cooperative. The other worker members should have the ability to control the cooperative through electing the board of directors

and having a voice in the daily operations of the cooperative. If the nonprofit exerts too much control, this may violate fundamental cooperative principles as well as violate IRS provisions in Subchapter T of the Code.

As discussed in the “How the Money Flows” chapter, one of the advantages of Subchapter T is that the cooperative may deduct patronage dividends that are distributed to members based on their contribution to the cooperative.

The IRS allows Subchapter T tax treatment for cooperatives that are “operating on a cooperative basis.” This means that the cooperative should: (1) subordinate capital, (2) have democratic control by members, and (3) allocate and distribute net earnings to members.²⁷ In order to “subordinate capital,” the cooperative should place the control and direction of the organization in its members, not outsiders. Similarly, member democratic control requires the cooperative to generally govern itself on a one-member, one-vote basis. Thus, the nonprofit should avoid undue control over the cooperative, either through control of the board of directors or unequal voting power, which may violate the IRS requirements that the cooperative operate on a cooperative basis. However, this is a disputed topic and deserves more discussion. In some cases it may make sense for the nonprofit to exert control in the initial stages of the co-op’s development, to ensure that the business is successful.

The third principle, allocate and distribute net earnings to members, means that in general the profits of the cooperative should be allocated or distributed to the members’ accounts.

Be careful about how much the nonprofit controls.

In sum, it may not be a good idea for the nonprofit to have too much control over the new cooperative it creates for several reasons. How much is too much? This is a gray area and deserves more attention than can be given in this manual. Some argue that the nonprofit needs to retain control in the startup years of the co-op to ensure that the co-op is successful. This is especially true if the co-op’s members are disadvantaged workers who may lack access to the business and financial resources required to run a business. As we have discussed above, however, too much control over a Subchapter T governed cooperative may violate IRS rules about “operating on a cooperative basis.” Because this

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²⁷ The Internal Revenue Code does not define “cooperative” or “operating on a cooperative basis.” Instead case law and IRS guidance have provided the determining criteria. The seminal case which provided these three factors is *Puget Sound Plywood, Inc. v. C.I.R.*, 44 T.C. 305 (1965); see also Charles Autry and Roland Hall, *The Law of Cooperatives*, American Bar Association, (2009), pg.88.



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has not yet been tested, we recommend you consult with an attorney about incubating a worker cooperative corporation subject to IRS Subchapter T rules.

Protecting your tax-exempt status

In sum, take care to ensure that the business development work falls into the

nonprofit's tax-exempt purpose. Then make sure that all services provided to the cooperative from the nonprofit are "arms-length," that is that they are fair to both the nonprofit and to the cooperative. If the cooperative is composed of a charitable class of individuals, then the nonprofit can offer these services free or at substantially lower costs. If these two conditions are met, then the non-profit is unlikely to face a threat to its tax-exempt status.

Steps To Take If Your Nonprofit Wants To Get Involved In Business Activities

Review your nonprofit's incorporation documents and tax exemption determination

Before your nonprofit undertakes to provide business development services for the development of new worker cooperatives, review your nonprofit's articles of incorporation to make sure that this activity fits within your organization's charitable purpose.

- Review the Articles of Incorporation to see if it contains a specific purpose clause that would encompass the contemplated activity. For example, the specific purpose might be to promote employment opportunities for the disadvantaged or poor, in which case a business that employs significant numbers of this charitable class may be consistent with this narrow purpose.
- Review the Articles of Incorporation to see if there is a broad purpose clause permitting the organization to engage in "any activities that further its charitable or educational purposes," in which case the new activity may be permitted without amendment provided it furthers the exempt purpose.
- Review your tax-exemption application and determination letter from the IRS to see whether the new activity contradicts any requirements the IRS imposed in the determination letter.

If your Articles do not include the contemplated purpose, then:

- Amend the Articles of Incorporation to include the new purpose and business activity and send a copy of the amendment to the IRS and the California Franchise Tax Board.
- In the amendment, include a letter describing the new purpose and business activity and why the nonprofit organization considers them to be charitable and educational.
- In California, the nonprofit corporation must draft a Certificate of Amendment and submit it to the Secretary of State's office. Here is a sample Certificate with further detailed instructions:

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<http://www.sos.ca.gov/business/corp/pdf/amendments/corp-amdtnp.pdf>

For more information on nonprofits starting for-profit subsidiaries see these resources:

Different Entities Available for Formation of Cooperatives

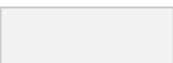
Most of this section has been written under the assumption that a nonprofit has formed a cooperative corporation. However, a nonprofit that incubates cooperatives may choose, for a variety of reasons, to form the cooperative as an LLC, partnership, or other entity. For more information on this, see the chapters on entity choice and employment law, “Forming Cooperatives of Foreign Nationals.”

Non-legal Considerations: Does your nonprofit have the capacity or experience to start a cooperative?

Hilary Abell, a non-profit management and cooperative development consultant, speaks about the “entrepreneurial culture” and long-term commitment required of the nonprofit organization itself, if it is going to find success in incubating worker cooperatives. As former executive director of WAGES, a non-profit that incubates worker-owned businesses for Latina women, Hilary has helped incubate successful co-ops in low-income communities and has advised non-profits that are exploring or involved in co-op development. In her view, one of the main non-legal considerations for nonprofits is the fit between the sponsoring nonprofit and the organizational capacities and culture needed to build a successful cooperative business. She states,

“While the competencies needed for community organizing or providing social services may be helpful in co-op incubation, the daily rhythm, underlying logic, and actual activities of incubating and operating a business are quite different. Experience has shown that the nonprofits that are most likely to succeed at social enterprises or co-op development are the ones that already have the entrepreneurial skills and business-like culture that are needed to make small businesses thrive, or that recognize that the culture and skills needed to run their other programs may be different from what they’ll need to incubate businesses. Some complex negotiations and cultural shifts are often necessary in order to integrate people with new skill sets and enable the staff or department responsible for the co-op project to do their job well.

It is also important for non-profits to realize that co-op development is a long-term commitment. If the sponsoring organization removes its technical assistance and organizing support prematurely, it can backfire both for the non-profit and for co-op members. A nonprofit should know in advance how many years of support it can provide to the new co-op and how it will secure the skilled staff and resources to fulfill this commitment. Because people put so much of their heart and soul into cooperatives, a developer does a disservice if it is too optimistic or idealistic in its assumptions about what is needed. As we know, about half of small businesses fail within five years due to lack of experience, planning or investment capital. In under-resourced



communities, small businesses may need even more support. The cooperative model can be more intensive and, when done well, can yield great rewards, but it is a complex undertaking.”

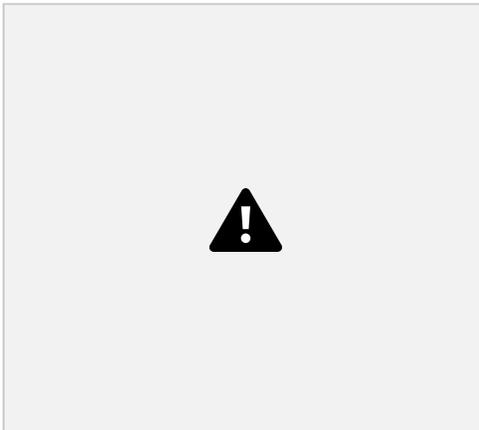
There are many non-legal considerations to take into account in incubating a worker owned cooperative. Nonprofit organizations may not have the staff with the requisite skills or experience necessary to start or manage a new business, especially one that is to be eventually owned and controlled by other people. Before embarking on such a project, you should consult with a social enterprise or nonprofit management consultant to determine whether your nonprofit has the capacity to take on a new venture.

If Your Nonprofit Wants To Start A Cooperative, Consult A Lawyer! The ability for nonprofits to contribute to the worker cooperative movement by creating new cooperatives is very promising. Nonprofits who are considering such a move should seek legal and tax advice from certified public accountants and attorneys who are familiar with nonprofits engaging in business ventures as well cooperative attorneys to properly structure the relationship. You can also reach out to the East Bay Community Law Center and Sustainable Economies Law Center as resources!

MANAGING YOUR COOPERATIVE BUSINESS

Governance refers to how the company is controlled and how decisions are made. Governance also includes how the company and its workers are held accountable both to their internal members and to external stakeholders. In a worker-owned, democratically governed business, the workers own the company's assets, but equally important, they control the company and business. If your cooperative is incorporated, it must comply with formal governance requirements as defined by statute, such as having a Board of Directors and Officers. If your cooperative is an LLC, governance can be more flexible and it may or may not have a Board of Managers. If you are an LLC, be careful. In an LLC that has no Board, each member has the legal power to bind the entire cooperative, unless expressly restricted in the Operating Agreement.

Governance Structure



(1) Board of Directors

If you choose to form your business as a California Cooperative Corporation, i.e., under the cooperative corporation statute, you must have a Board of Directors and Officers. The Board of Directors is a group of individuals who serve as the governing body of the cooperative. In most cases, the worker-members of a worker cooperative elect the Board of Directors. The Board of a cooperative has legal responsibilities to be loyal to the company, to act with care and honesty and to operate the company for the benefit of the membership. The Board generally

sets its company's goals and strategies and makes important decisions such as whether to borrow money, purchase capital assets and hire executive management. The role of the Board in day-to-day decisions depends on the size and complexity of the company. If there are few employees, the Board may be composed of all of the workers, frequently referred to as a Collective Board. In such cases, the Board functions as the policy-making body, deciding everything from whether to move to a larger location to the company's return policy. A Collective Board worker cooperative would not be required to hold an annual meeting of members. Under the cooperative corporation statute, the Board must have a minimum of three directors.

If the Board is a subgroup elected from the membership, its authority derives from election by the members. To prevent corrosive "us vs. them" scenarios, the Board should and sometimes must adopt measures to ensure its accountability to the workers such as: regular elections, distribution of meeting minutes, solicitation of worker input, appointment of worker-directors to special Board committees, etc.

(2) Officers



The California cooperative corporation statute requires that a cooperative have at least three officers: a president, a secretary and a chief financial officer. Unlike the Board, which has the ultimate governing authority over the cooperative, the officers are the executive agents who carry specific responsibilities within the cooperative. For example, a president is often empowered to sign documents on behalf of the cooperative. A secretary usually provides required notices to members and keeps meeting minutes. A financial officer manages finances and accounts, and often signs checks for the cooperative.

Officers may be executive managers with authority from the Board to implement company goals, or they may be figureheads who are deployed only to sign necessary documents for outside parties. The role of officers, like that of the Board, varies based on the size and complexity of the business and the company culture.

If the company is adopting a collective, nonhierarchical model, its workers may not choose to give its named officers executive authority, but they would need to decide how these officers will be represented to outside parties. For example, if a figurehead treasurer were to sign a contract on behalf of the cooperative without the authority to do so, this could lead to a lawsuit or be generally detrimental to the cooperative's future business relationships.

Regardless of the size of the company, the relationship of workers to the Board and to executive officers should be established at the outset and regularly reviewed and evaluated. Worker-owners might resent having the responsibilities of ownership if they do not feel they are able to make decisions that affect their workplace. If workers perceive the Board as not connected to their daily work lives, then there may not actually be democracy in the workplace.

Workplace Structure

The fact that workers are owners does not compel them to adopt any one particular workplace organizational model. A democratically-managed business might sometimes be organized along the traditional hierarchies found in American businesses. For example, the Board may hire executive managers who hire employee-owners who carry out board decisions under the managers' supervision.

Some worker cooperatives, by contrast, are characterized by minimal hierarchy, perhaps flat or nearly flat pay scales, job rotation, and individuals held accountable not to a single supervisor, but to the whole cooperative. Of course, hybrids of these two extremes are common. Each company needs to evaluate which model works for their particular business and industry.

A business founded on democratic workplace principles should spend extra time exploring how the ideals of democracy in the workplace will be manifested in the business organization. Be aware that many cooperatives evolve through different models as they grow in size and complexity. What worked when there were 5 members starting the business sometimes becomes unmanageable when there are 25 or more members, so flexibility is important. If the organization grows and becomes more complex, its internal mechanisms

for ensuring accountability of workers to the organization as a whole should expand as well. In a cooperative, members should pay special attention to those wearing multiple “hats” in the company, as these de facto leaders are often the first to expand their roles without authority from the membership.

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Members vs. Nonmembers Within The Company

Having employees who are not members of the cooperative has positive and negative consequences. Non-member employees can provide an effective temporary workforce for a seasonal business that cannot maintain a year-round level of employment. Non-member employees can also help a company manage volatile revenue swings. This is because, unlike a traditional company, a worker-owned company cannot dispense with unneeded members when the market changes or the business experiences a setback.

However, non-member employees can become a second-class employee group. This can change the dynamics of the democratic workplace. Members then become like bosses to the non-member employees, creating divisions between workers. In order to avoid these divisions and encourage democracy in the workplace, California law requires that 51% of a worker cooperative’s workers be members or candidates.

It is essential that owners clarify the role of non-member employees. If there is a company program for moving employees to member status, it should be presented clearly and made available to all. Narrowing the gap between members and non-members in their relative access to decision making and profit-sharing may be critical for workplace unity and democracy.

Helpful Tip:

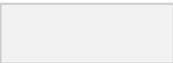
The bylaws or operating agreement of the cooperative are very important because they provide the answers to these and other important governance questions.
(See Appendix for sample bylaws)

External Governance Issues

If the business was organized under the auspices of a parent non-profit or with the aid of outside investors, it may need to include these outside entities in the internal governance of the cooperative. Co-op founders will need to establish the level of participation of a parent non-profit on the Board of Directors. For instance, how many seats on the Board will be allocated to outside entities? If the participation of the parent non-profit requires a separate membership class, how will that entity share in the risk of the enterprise? If outside investors are involved, will they have some decision-making power related to the protection of their investment? Will these outside investors have more direct representation on the Board? This topic will be discussed in more detail in the section on

“Nonprofit Incubators.”

When the cooperative engages with business partners, will this engagement occur under the authority of the Board, or will individuals with management-level roles transact directly with third parties? The members may identify specific contracts that require Board approval and those that may be concluded directly by individual workers.



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If a community member or customer has an issue with the company, will their concerns be addressed by the Board or by an individual worker? What sorts of issues warrant resolution by one mechanism or another?

The bylaws or operating agreement of the cooperative are very important because they provide the answers to these and other important governance questions.

Cooperative Principles and Cooperative Governance

The “one-member, one-vote” principle of cooperatives provides only the starting point for decision-making in a cooperative. Consider these more advanced issues: (1) When will a decision be final: when the board approves by majority, by a 2/3 vote, by consensus, by a vote of directors present, or by all directors? (2) Should some decisions require a higher approval level than others? (3) The Board will not make every decision. If incorporated under a specific cooperative statute, which decisions does the law reserve only to members instead of to the Board? What decisions can be made by the members? By work teams? By individual supervisors? (4) Can the members appeal a decision of the Board? What kinds of decisions are eligible to be appealed?

The cooperative principles include concern for the community in which the cooperative operates, but how will this play out in practice? Will members of the community be invited onto the Board of Directors? How will the company monitor its social, economic, and environmental impacts on the community?

Internal Governance Controls

The company should adopt measures to hold directors accountable to each other and to the Board as a whole. Directors can be evaluated for meeting attendance, participation, and knowledge of issues affecting the business. If an individual director or executive officer acts according to her own beliefs on what is best for the cooperative, but not in accordance with the deliberated decision of the Board, how does the Board reclaim its own authority?

What mechanism does the cooperative have for members to exercise control over decisions affecting their workplace? Regular Board elections can help make directors accountable, but there often needs to be more than that. Managers need to be directly accountable to the worker-owners, inviting participation from workers prior to making a decision, explaining their decisions, and providing means for review and evaluation by workers. If there are loose structures or no structures of command and control, leaders will arise spontaneously. Most cooperatives want to encourage this process. However, without

formal structures, these leaders may operate without accountability and in a way that impairs democracy in the workplace.

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<p style="text-align: center;"><u>Useful Resources:</u></p> <p style="text-align: center;">Additional tools on governance can be found at: Worker Coop Toolbox- US Federation of Worker Cooperatives: http://www.cccd.coop/files/worker_coop_toolbox.pdf California Governance Resources: http://www.lawforchange.org/NewsBot.asp?MODE=VIEW&ID=3678</p>

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COOPERATIVES AND EMPLOYMENT LAW

Old-Fashioned Jobs: Working FOR Others

Employment laws have been created mostly to balance the relationship between “master” and “servant.” Employment laws recognize that employees are vulnerable because they are dependent on and work under the control of employers. Employment laws give certain rights to employees, like the right to minimum wage, to reasonable work hours, to a safe and healthy workplace, to protection from discrimination, to compensation for workplace injuries, and so on.

Versus...

workers are left unprotected by a loophole.
The safe thing is to assume that everyone
working for a

Cooperatives: Working WITH Others Now

how do employment laws apply when you form a cooperative to work *with* others, rather than *for* others? You might think employment laws no longer apply, but, actually, they often do! Employment laws are designed to cover as many people as possible, so that no

Question:

If you form a cooperative and work for it, are you an employee of the cooperative?

Umm, maybe. It's complicated. But it's very important to consider.

cooperative is an employee, and then work backward from there to see if you can find any exceptions.

What Does It Mean To Have Employees?

Having employees comes with a list of obligations and requirements, including:

- Paying minimum wage and overtime;
- Complying with standards for hours and working conditions;
- Payment of payroll taxes and other withholdings;
- Maintaining workers compensation insurance;
- Complying with occupational safety and health laws;
- Verifying employees' eligibility to work in the U.S.;
- Posting of certain kinds of notices and posters related to employees' rights; and • Adhering to certain recordkeeping requirements.

However, if someone is not an employee, most of these requirements do not apply.

Who Is NOT an Employee?

There are four primary legal categories of workers that are not considered employees; here are some basic explanations of each:

A. **Volunteers** = People who do work for charitable, religious, or humanitarian benefit.

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B. **Interns** = People who do work for their own educational or therapeutic benefit.

C. **Independent Contractors** = People who do work for others in an independent manner.

D. **Partners** = People who work together as relative equals for their own and mutual benefit.

A. Who Can Be Considered a VOLUNTEER?

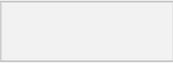
As a general rule, you **CANNOT volunteer for a for-profit business** unless you can be

classified under one of the other three categories below (interns, independent contractor, or partners). But as a general rule, you **CAN volunteer for nonprofit organizations** that are engaged in charitable, religious, or humanitarian purposes. Most cooperatives will not meet the definition of “charitable, religious, or humanitarian,” unless they are nonprofit organizations that are tax exempt under 501(c)(3) or 501(c)(4). Most childcare cooperatives are 501(c)(3) nonprofits. Here are some extra rules and exceptions to the rules:

1. **You MIGHT be able to volunteer for a for-profit business if it has a defined and separate charitable project:** Let’s say you have a cooperative café and once per month it opens up to the public and serves only free food to people in need. This is a grey area, but this may be a situation where members of the public could volunteer. If the café has regular employees however, those employees probably could not volunteer because the work is too similar to the work they normally do as employees.
2. **You MIGHT NOT be able to volunteer for a nonprofit if it is operating a commercial enterprise serving the general public.** This is also a grey area, because many high profile nonprofits, such as Girl Scouts, allow volunteers to sell things to the public. But the rule stated by the Supreme Court and California law is: People cannot volunteer for “ordinary commercial activities,” even if those activities are operated by and for the benefit of charities and religious organizations.²⁸
3. **“Paying” volunteers with food or other valuable perks might mean they are employees:** The rule expressed by the Department of Labor and in the Fair Labor Standards Act (FLSA) is that people are allowed to volunteer so long as it is “without promise, expectation, or receipt of compensation for the services rendered, although

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²⁸ *Tony & Susan Alamo Foundation v. Sec’y of Labor*, 471 U.S. 290, 302 (1985). See also California Division of Labor Standards Enforcement Opinion Letter dated October 27, 1988, *available at* <http://www.dir.ca.gov/dlse/opinions/1988-10-27.pdf>, which states: “[W]hen religious, charitable, or nonprofit organizations operate commercial enterprises which serve the general public, such as restaurants or thrift stores, or when they contract to provide personal services to businesses, such enterprises are subject to the Industrial Welfare Commission Orders and volunteers may not be utilized.”



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a volunteer can be paid expenses, reasonable benefits, or a nominal fee to perform such services.”²⁹ So you can give your volunteers a little something, but not a lot.³⁰

B. Who Can Be Considered an INTERN?

For-profit businesses can have unpaid interns, so as long as the arrangement in which the intern is working meets the criteria for a valid internship. In California and in most jurisdictions, the following criteria are considered in determining who is an intern (also known as trainee or student):

- “The training, even though it includes actual operation of the employer’s facilities, is similar to that which would be given in a vocational school;
- The training is for the benefit of the trainees or students;
- The trainees or students do not displace regular employees, but work under their close observation;
- The employer derives no immediate advantage from the activities of trainees or students, and on occasion the employer’s operations may be actually impeded;
- The trainees or students are not necessarily entitled to a job at the conclusion of the training period; and
- The employer and the trainees or students understand that the trainees or students are not entitled to wages for the time spent in training.”³¹

The Importance of Being Unhelpful:

Most businesses struggle especially with the fourth criteria in the internship test, which is the requirement that “the employer derives no immediate advantage from the activities of trainees or students, and on occasion the employer’s operations may be actually impeded.” Some businesses do seek interns for the sole purpose of providing an educational experience, but let’s be real: Most employers hope that interns will also be helpful to the enterprise, and the framing of this law makes that hard. It’s difficult to know where courts will draw the line, and we are left to wonder: can’t an intern be just a little bit helpful? Fortunately, one case decided by the 9th Circuit Court of Appeals seems to indicate that intern can be helpful, as long as the intern is the true beneficiary in the relationship.³² Note,

²⁹ See Department of Labor Opinion Letter, “Volunteer emergency crew as separate and independent agency under section 3(e)(4)(A),” FLSA 2008-13, December 18, 2008, and FLSA, which notes that volunteers may receive “nominal fees” and “reasonable benefits” (29 U.S.C. § 203(e)(4)(A)).

³⁰ If you want to know more about what kinds of benefits you can provide volunteers, see *Hoste v. Shanty Creek Management, Inc.*, 592 N.E.2d 360 (Mich. 1999), and Department of Labor Opinion Letter, “Nonexempt employees who volunteer as coaches/advisors and nominal fees under section 3(e)(4)(A),” FLSA 2005-51 (November 10, 2005).

³¹ From Department of Labor Non-Administrator Letter, “Internship program and employment relationship under FLSA” FLSA2004-5NA, dated May 17, 2004. See also the April 7, 2010 Opinion Letter from the California Department of Labor Standards Enforcement, available at <http://www.dir.ca.gov/dlse/opinions/2010-04-07.pdf>.

³² See *Williams v. Strickland*, 87 F.3d 1064 (9th Cir. 1996), where the Ninth Circuit looked at a case involving a man that volunteered for a long time for a Salvation Army store, primarily for the purpose of his rehabilitation. Even though he participated in and benefited a business activity, and even though he may have

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however, that this remains a grey area, and if your cooperative would like to have interns, it’s best to focus primarily on teaching them.

How to Have an Intern

Given the limitations on how interns can work in enterprises, here are some

who is an employee versus who is an independent contractor:

- The hiring party's right to control the manner and means by which the product is accomplished;
- The skill required;
- The source of the instrumentalities and tools;
- The location of the work;
- The duration of the relationship between the parties;
- Whether the hiring party has the right to assign additional projects to the hired party;
- The extent of the hired party's discretion over when and how long to work;
- The method of payment;
- The hired party's role in hiring and paying assistants;
- Whether the work is part of the regular business of the hiring party;
- Whether the hiring party is in business;
- The provision of employee benefits; and
- The tax treatment of the hired party.

If a group of independent home bread bakers form a cooperative to jointly market their breads and to collectively purchase ingredients, a court would likely find that the bread bakers are not employees of their cooperative, so long as the bakers work in their own homes, use their own appliances, hire their own assistants, set their own hours, decide on the manner in which the bake, and have the freedom to sell bread elsewhere.

However, if an autocratic manager or board of the cooperative began to exert more control over each baker, the relationship might change. If the cooperative dictates how much each baker must produce, sets specifications for ingredients, and fixes prices on the breads of all bakers, and if one manager has the power to hire and fire bakers, this could potentially be ruled to be an employment relationship. This was essentially the outcome of the Supreme Court's 1961 ruling in *Goldberg v. Whitaker House Cooperative, Inc.*,³⁴ where 200 home-based clothing manufacturers (primarily women engaged in knitting and embroidery) joined a cooperative and sold clothing items to the cooperative. The Court determined that an employment relationship existed, due to the level of control the cooperative had over each member's work (dictating design, order size, timing, payment, and other terms of work).

The moral to the story is that if multiple independent entrepreneurs, such as health care practitioners, gardeners, or food artisans, come together to form a producer, marketing, or purchasing cooperative, it's very important to look at the various factors listed above to determine whether the relationship is more like an independent contractor relationship or an

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³³ *Community for Creative Non-Violence v. Reid*, 490 U.S. 730, 751-752 (1989).

³⁴ *Goldberg v. Whitaker House Cooperative, Inc.*, 366 U.S. 28 (1961).

employer/employee relationship. If it's the latter, then congratulations, you may have created

a worker cooperative! However, see the next section to learn more about when workers in a worker cooperative need to be treated as employees.

D. Who Can Be Considered a PARTNER?

Employment law does not apply when there is truly no master/servant relationship. It is widely accepted that if you start a sole proprietorship and work for yourself, you are not your own employee. Now how does that apply when two people own, manage, and work for their own business in partnership with one another? How about when 100 people own, manage, and work for their own business? And does it matter what kind of business entity it is – a partnership, LLC, cooperative corporation, or other corporation?

Let's start with the question of what is a master/servant relationship. Strong precedent was created in answer to the question when the U.S. Supreme Court decided the case of *Clackamas Gastroenterology Associates, P.C. v. Wells* in 2003.³⁵ There, the Court was asked to decide whether the Americans with Disabilities Act applies to working shareholders of a small professional corporation. The Court then adopted the following guidelines for determining when a master-servant relationship exists:

- Whether the organization can hire or fire the individual or set the rules and regulations of the individual's work;
- Whether and, if so, to what extent the organization supervises the individual's work;
- Whether the individual reports to someone higher in the organization;
- Whether, and if so to what extent, the individual is able to influence the organization;
- Whether the parties intended that the individual be an employee, as expressed in written agreements or contracts;
- Whether the individual shares in the profits, losses, and liabilities of the organization.

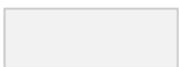
Note that not every court or labor law agency will apply the same test, and there are many tests that have been developed to determine who is a partner to an enterprise. Another case that summarized the factors courts consider is *Simpson v. Ernst & Young*, decided by the 6th Circuit in 1996.³⁶ The court named the following factors as relevant to the determination:

- The right and duty to participate in management;
- The right and duty to act as an agent of other partners;
- Exposure to liability;
- The fiduciary relationship among partners;
- Use of the term “co-owners” to indicate each partner's ‘power of ultimate control’;
- Participation in profits and losses;
- Investment in the firm;

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³⁵ *Clackamas Gastroenterology Associates, PC v. Wells*, 538 U.S. 440 (2003).

³⁶ *Simpson v. Ernst & Young* 100 F.3d 436, 443-444 (6th Cir. 1996).



- Partial ownership of firm assets;
- Voting rights;
- The aggrieved individual's ability to control and operate the business; • The extent to which the aggrieved individual's compensation was calculated as a percentage of the firm's profits;
- The extent of that individual's employment security; and
- Other similar indicia of ownership.

Does it make a difference if you form a partnership, LLC, or cooperative corporation?

In some jurisdictions and under some statutes, courts have leaned heavily toward the assumption that shareholders of corporations are employees when they work for the corporation they co-own.³⁷ One of the additions to the California Cooperative Corporation Law made in 2016 was the statement that cooperative corporations who elect to be organized as a worker cooperative “does not create a presumption that workers are employees of the corporation for any purposes.” However, this language has not been tested in a court of law. As a result, it is safest to work from the traditional assumption that shareholders of corporations are employee when they work for the corporation they co-own. This assumption has caused stress for California worker cooperatives, which are generally formed as cooperative corporations. If there is an assumption of an employer/employee relationship from the moment of incorporation, this means that cooperatives must have enough start-up capital to pay members minimum wage, obtain workers compensation, and so on. The Catch-22 is that most workers cooperatives have great difficulty raising start-up capital, due to the reluctance of banks to loan or of individuals to invest. This means that most worker cooperatives must bootstrap their business, and work for little or no pay in the beginning, like most partners in a start-up business do. Some worker “cooperatives” choose to act as partnerships or limited liability companies (LLCs)³⁸ in order to avoid application of employment law to members.

The simple fact of incorporation, in the eyes of some courts and agencies, is enough to establish a presumption that the shareholder is separate from the entity, and therefore cannot be considered a partner. California attorney Neil A. Helfman has written about this in his 1992 article “The Application of Labor Laws to Workers’ Cooperatives.”³⁹ Mr. Helfman writes:

“As the law presently stands, it looks at form over function. The fact of incorporation may have more bearing upon the determination of an employment relationship, than the actual relationship between the parties. A worker in an incorporated cooperative who has managerial authority, for example, may be considered an employee just because the business is

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³⁷ For an examination of this issue, see McGinley, Ann C. “Functionality or Formalism - Partners and Shareholders as Employees under the Anti-Discrimination Laws” 57 S.M.U. L. Rev. 3 (2004). ³⁸ Note that, for employment law purposes, LLCs and partnerships are generally treated the same. ³⁹ <http://sfp.ucdavis.edu/cooperatives/reports/LaborLawWorkerCoops.pdf>.

incorporated; while a junior partner of a thousand-partner accounting firm, who is under the control of others, is not. The rationale for this distinction is not entirely clear; one explanation is that in the former, worker members are providing services to an entity. For example, in the Matter of Construction Survey Cooperative (Case No. T-62-3) (1962)) before the California Unemployment Insurance Appeals Board, members of a workers' cooperative were held not to be employees. In that case, member workers received compensation on the basis of their contributed labor. By common consent, the activities of the cooperative were directed by a manager, although ultimate authority for managerial decisions rested with the membership. The appeals board found the workers to be principals of the cooperative, and held that under California law that it was incompatible for them to be employees of their own organization. When presented to the Employment Development Department, EDD representatives took the position that if the entity were incorporated, workers should be considered employees even if no other facts had changed.”⁴⁰

The good news is that the U.S. Supreme Court, in the *Clackamas* case, has since rejected the de facto assumption that the formation of a corporation should determine employment status.⁴¹ The *Clackamas* Court’s rejection of the presumption acts as powerful precedent, which may even serve to relieve California worker cooperatives of the automatic presumption of employment relationships, at least for the purpose of *some* employment laws (see more below).

Note also that other courts have found that a “partnership” relationship exists even when the entity is a corporation.⁴² The court in *Godoy v. Rest. Opportunity Ctr. of New York, Inc.* also held that the members of a worker-owned cooperative were “partners,” in spite of the fact that they were working under a corporation.⁴³ Many courts may ultimately consider the incorporation status of an entity as relevant, but only as one factor among many in determining whether an employment relationship exists.

The lesson here is: If you are planning to form and work for a cooperative corporation in California, tread very carefully in determining whether you are an employee, and talk to a lawyer.

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⁴⁰ As a source of this info, Mr. Helfman cites: Interview at California Employment Development Department (E.D.D.), November4, 1991, with David Johnson (Senior Tax Counsel), Terry Savage (Section Chief Auditor and attorney), and Noreen Vincent (tax auditor).

⁴¹ See *Clackamas Gastroenterology Associates, PC v. Wells*, 538 U.S. 440, 443 (2003), where the Court rejected the Ninth Circuit’s reliance on a Second Circuit decision that held that “the use of any corporation, including a professional corporation, ‘precludes any examination designed to determine whether the entity is in fact a partnership.’ 271 F. 3d 903, 905 (2001) (quoting *Hyland v. New Haven Radiology Associates, P. C.*, 794 F. 2d 793, 798 (CA2 1986)). It saw ‘no reason to permit a professional corporation to secure the “best of both possible worlds” by allowing it both to assert its corporate status in order to reap the tax and civil liability advantages and to argue that it is like a partnership in order to avoid liability for unlawful employment discrimination.”

271 F. 3d, at 905.

⁴² See *EEOC v. Dowd & Dowd, Ltd.*, 736 F.2d 1177 (7th Cir. 1984).

⁴³ *Godoy v. Rest. Opportunity Ctr. of New York, Inc.*, 615 F. Supp. 2d 186, 195 (S.D.N.Y. 2009).

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Think'Outside'the'Boss:'How'to'Create'A'Worker-Owned'Business

How much control must each cooperative member have in order to be considered a “partner” under employment law?

If all members of a small worker cooperative serve on the Board of Directors and take part in a collective decision-making process, then arguably each member could be considered a “partner” for the purpose of some employment laws. But where do courts draw the line? How much control do the workers need to have in order to be considered partners?

One case that examined the question of who is a “bona fide partner” is *Wheeler v. Hurdman*, decided by the 10th Circuit.⁴⁴ In that case, the court actually de-emphasized the need for each partner to have a significant amount of control, noting that the practical needs of the business may result in partners giving up a certain amount of control over the day-to-day, and abdicating such control to managers, teams, or committees. The court essentially recognized the following practical reality: Any time a group of people voluntarily works together, each individual gives up a certain amount of control to the group or to members of the group.

In another case, *Fountain v. Metcalf, Zima & Co.*, the court focused on certain voting rights as the indicator of control, and not on the actual realities of management in the firm. There the court ignored the argument that a managing partner was running the firm autocratically, and focused instead on the fact that the plaintiff partner “had a right to vote his thirty-one percent ownership on member/shareholders' amendments to the agreement, on admission of new member/shareholders, on termination of relationship with member/shareholders, on draws, and on distribution of profits and income.”⁴⁵

In contrast to *Wheeler* and *Fountain*, however, other courts have focused heavily on the issue of control, and found that factor to be a deal-breaker. For example, the court in *Caruso v. Peat, Marwick, Mitchell & Co.*⁴⁶ examined the employment status of a partner in a 1350-member accounting firm, and the court looked at three primary factors:

- (1) the extent of ability to control and operate the business
- (2) the extent to which compensation is calculated as a percentage of the firm's profits
- (3) the extent of employment security

On the question of “ability to control and operate the business” in the *Caruso* case, it was significant that the firm was “managed by a board of directors separated from plaintiff by six levels of hierarchy” and that the plaintiff tended to seek approval of management-level partners in decisions about his own work. The court held that the plaintiff was, indeed, an employee.

The Court in *Clackamas* also focused heavily on the question of control and common

law definitions of the master-servant relationship. The Court wrote:

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⁴⁴ *Wheeler v. Hurdman*, 825 F. 2d 257, 276, (10th Cir. 1987).

⁴⁵ *Fountain v. Metcalf, Zima & Co.*, PA, 925 F. 2d 1398, 1401 (11th Cir. 1991).

⁴⁶ *Caruso v. Peat, Marwick, Mitchell & Co.*, 664 F. Supp. 144, 149-150 (S.D.N.Y 1987).

56.....*For informational purposes only, not to be relied on as legal advice.*
Think'Outside'the'Boss:'How'to'Create'A'Worker-Owned'Business

“A court should examine ‘whether shareholder-directors operate independently and manage the business or instead are subject to the firm's control.’ [...] ‘[i]f the shareholder-directors operate independently and manage the business, they are proprietors and not employees; if they are subject to the firm's control, they are employees.’⁴⁷”

Another case that examined this issue specifically in application to a worker cooperative was *Wirtz v. Construction Survey Cooperative*, decided by a federal district court in Connecticut in 1964.⁴⁸ In that case, the court emphasized numerous elements in support of a finding that the cooperative members were not employees.⁴⁹ Even though two members of the cooperative exercised management over the others:

“It is true [that two members] exerted some measure of leadership over the [other members]. But the Court finds this was due to their longer experience, more extensive knowledge, and driving interest rather than due to positions of control or power. What little guidance they supplied was by consent not authority.”⁵⁰

The lesson with all these cases is: there is no clear set of rules to determine when members of a worker cooperative are employees. Some of the cases described above indicate that, even with somewhat hierarchical management structures, working co-owners of a business may still avoid classification as employees. However, if you want to argue that members of your worker cooperative are not employees, then the safest thing to do is to:

- (1) Have all members serve on the Board of Directors.
- (2) Make decisions by a consensus process or with supermajority voting; this arguably gives each member a strong voice in each decision.

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⁴⁷ *Clackamas Gastroenterology Associates, PC v. Wells*, 538 US 440, 448 (2003), quoting the EEOC's Amicus brief in the case.

⁴⁸ *Wirtz v. Construction Survey Cooperative*, 235 F.Supp. 621 (D. Conn. 1964).

⁴⁹ See *Wirtz* at 624, where the court described: “The members of the Cooperative constitute a small, closely knit partnership of intelligent technicians, working together as a unit to improve their economic lot as a unit.

(1) Obtain Workers' Compensation

Employers in California are required to get workers' compensation insurance, even if they only have one employee. When a worker suffers an injury, illness or death because of work, worker's compensation insurance can provide medical care, temporary disability benefits, permanent disability benefits, supplemental job displacement benefits or vocational rehabilitation and death benefits

58.....*For informational purposes only, not to be relied on as legal advice.*
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More info: See the California Department of Industrial Relations website for a more detailed explanation of worker's compensation insurance and links to relevant forms. (www.dir.ca.gov/dwc/employer.htm)

You can find a worker's compensation fact sheet for employers at the link below. (www.dir.ca.gov/dwc/FactSheets/Employer_FactSheet.pdf)

How to Get Coverage: You can get coverage through an agent or broker from a private insurer. Insurance Brokers & Agents of the West can help you select a broker (visit: www.ibawest.com). You can also get insurance through the State Compensation Insurance Fund (State Fund), a division of the California Department of Industrial Relations (visit: <http://www.statefundca.com>).

Cost: The cost of workers' compensation will depend on a number of things, such as how many employees you have and the type of work they are doing. Prices differ depending on the insurance broker, so you should shop around. Generally, workers' compensation can run between 10 to 20 percent of the wages you pay your employees.

Are worker cooperatives exempt from the requirement to carry workers compensation?

In some cases, worker cooperatives will be exempt from the requirement to carry workers compensation, even if they do consider their workers to be employees for some purposes. The California Labor Code requires that all employees be covered by workers' compensation insurance; however, Section 3351 provides (emphasis added):

"Employee" means every person in the service of an employer under any appointment or contract of hire or apprenticeship, express or implied, oral or written, whether lawfully or unlawfully employed, and includes:

[...] (c) All officers and members of boards of directors of quasi-public or private corporations while rendering actual service for the corporations for pay; provided that, where *the officers and directors of the private corporation are the sole shareholders thereof*, the corporation and the officers and directors shall come under the compensation provisions of this division only by election as

provided in subdivision (a) of Section 4151

[...] (f) All working members of a partnership or limited liability company receiving wages irrespective of profits from the partnership or limited liability company; provided that where the *working members of the partnership or limited liability company are general partners or managers*, the partnership or limited liability company and the partners or

managers shall come under the compensation provisions of this division only by election as provided in subdivision (a) of Section 4151.

Thus, in the case of a cooperative corporation, if the directors are the only members (meaning they are the only “shareholders”) of the cooperative, then they may not need to be covered by workers’ compensation. Most worker cooperatives that are managed

.....
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Think 'Outside the Boss': How to Create a Worker-Owned Business

collectively meet this requirement. However, if there are co-op members that do not serve on the Board of Directors, then it’s possible that workers’ compensation will be required for everyone; that might not make intuitive sense, but that is how the above law reads. Note that a worker cooperative that hires non-member employees will definitely need to carry workers compensation for those employees. Note also that a worker cooperative that choose to form as a partnership or LLC will also be exempt from carrying workers compensation if the working partners/members participate in management.

(2) Pay at least Minimum Wage

Wage laws require an employer to pay at least minimum wage, which is currently \$9.00 per hour in California, and may be higher in certain cities such as San Francisco, Berkeley and Oakland. The Fair Labor Standards Act (FLSA) is the main federal law that affects workers’ pay. California Labor Code 1171 is the main state law related to wage requirements.

(3) Comply With Overtime Laws

The law also requires an employer to pay a worker extra for overtime work and comply with other rules regarding work hours, unless the worker can be considered an “exempt” employee. Generally, employees are exempt from overtime rules if they engage in certain categories of work, such as managerial, administrative, or professional work. California overtime rules can be found in Labor Code Sections 500-558. More information about determining overtime requirements can be found at: <http://www.dir.ca.gov>.

Are worker cooperative members subject to overtime rules?

This is a grey area and courts and labor agencies have yet to provide clear enough guidance. It may be hard for worker cooperative members to argue that they are exempt

from overtime on the more typically invoked grounds that they are all managers or executives, since the law in such cases generally requires that the managers and executives be in a position to manage, direct, and supervise other people.

However, some leaders in the cooperative movement have argued quite persuasively that overtime rules should not apply to worker cooperatives, since such application would contradict the intent of the overtime laws. Here is cooperative advocate and attorney Tim Huet's explanation of this:

“Perhaps the clearest indication of the legislature’s intent in passing the Eight Hour-Day Restoration and Workplace Flexibility Act of 1999 is in the legislative findings underpinning the Act:

(c) Ending daily overtime would result in a substantial pay cut for California workers who currently receive daily overtime.

(d) Numerous studies have linked long work hours to increased rates of accident and injury.

60.....*For informational purposes only, not to be relied on as legal advice.*
Think'Outside'the'Boss:'How'to'Create'A'Worker-Owned'Business

(e) Family life suffers when either or both parents are kept away from home for an extended period of time on a daily basis.

“It is evident that the design of the overtime law is to discourage employers - through the financial disincentive of premium pay - from requiring employees to work extended hours, with the attendant hazards to body and family. The logic of the financial disincentive is sound as long as premised on the idea of an employer ordering an employee to work extended hours; the logic fails when a worker is responsible for her or his own scheduling since, under those conditions, premium pay becomes an *incentive* to work extended hours. If compulsory overtime is applied to members, I, as a member of a cooperative, would be giving myself a 50% pay increase by scheduling myself to work longer than eight hours. I would be giving myself a 100% raise by continuing to work beyond twelve hours. And I have no supervisor to tell me to go home. There would be powerful incentive to work longer hours, even at the risk of injury/accidents and at the cost to family life. *The effect would be the exact opposite of that intended by the legislature.*

“Moreover, the internal dissension caused by members voluntarily scheduling themselves for overtime, and thereby giving themselves sizeable pay raises outside the collective process, would result in the demise of our freedom to self-schedule – and would push us towards surrendering a measure of our democracy in favor of having supervisors to schedule and enforce work hours. While an employee arbitrarily scheduling himself for overtime might be soaking an adversarial employer, a cooperative member would be taking money from his co-members/co-owners. The legislature’s finding that “{e}nding daily overtime would result in a substantial pay cut for California workers who currently receive daily overtime” makes sense in the context of employer-employee relations; its logic does not carry in the cooperative

context where any financial surplus left after paying wages, benefits, etc. reverts to the members in the form of patronage. Indeed overtime premiums would reduce member income through increasing our workers compensation payments and other payroll-related costs.

“Clearly the intent of compulsory overtime pay is to “protect” otherwise defenseless employees from being required to work overtime by an employer who might wish to exploit them. Where workers have some other form of protection or need no protection, the government has refrained from intervening. The Act in question provides a mechanism by which workers under a collective bargaining agreement can “opt-out” of the overtime scheme provided, as long as some premium pay is provided. Under a collective bargaining agreement, the rate of premium pay could be nominal – perhaps even fractions of a penny (*see* DLSE memorandum of 12/23/99: “The amount by which the premium exceeds the regular rate is left to the parties to negotiate; we will recognize any rate higher than the regular rate as a premium.”). One can only conclude that the legislature was willing to rely on the power of the unions involved to protect their members and express their hours preferences. It stands to reason if a union with limited power is left to negotiate

.....
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Think'Outside'the'Boss:'How'to'Create'A'Worker-Owned'Business

premium pay that cooperative members, owners who hold ultimate power and need not negotiate with anyone, would be left to devise their own schedules and pay.”

(4) **Comply with Meal, Break, and Time Off Requirements**

Employers must comply with rules governing breaks and meal periods during the work day. Employers must provide non-exempt employees one day off per week, and provide a 30-minute meal break for any shift of 5 hours or more, and a 10 minute break for every 4 hours worked, with a few exceptions. For more info, see:

http://www.dir.ca.gov/dlse/FAQ_MealPeriods.htm

Are worker cooperative members exempt? For the same reason that some people argue that worker collective members should be exempt from overtime, they may also be exempt from meal, break, and time off requirements. Remember, this is a grey area, so the safest thing to do is to give people breaks.

(5) **Deduct Payroll Taxes and Other Withholding**

An employer is required to withhold money from each employee’s paycheck for federal and state income taxes, social security tax, Medicare tax, and unemployment tax. The California Employment Development Department provides state payroll tax services and information on their website here:

http://www.edd.ca.gov/Payroll_Taxes/default.htm

An employer can also withhold money from an employee’s paycheck for health, welfare, or pension contributions – but only with the employee’s consent. The State rules

on deductions can be viewed here:

http://www.dir.ca.gov/dlse/faq_deductions.htm

Worker cooperatives and withholding from patronage dividends: Note that, for worker cooperatives, the law remains somewhat unclear as to whether the cooperative must withhold from and pay payroll taxes on patronage dividends. See Gregory Wilson's article on this subject.⁵¹ The IRS has yet to issue clear guidance on this, and in the meantime, most worker cooperatives do not treat patronage dividends as employment income for the purpose of withholding.

(6) Provide Safe Working Conditions and Comply With Safety Standards The Occupational Safety and Health Act (OSHA) requires an employer to provide a safe workplace free from hazards that could likely cause serious physical harm to employees.

Employers **MUST** also:

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⁵¹ See "Taxation of Patronage Dividends from Worker Cooperatives: Are They Subject to Employment Tax?" By Attorney Gregory R. Wilson, *available at* [http://www.gwilson.com/documents/Article4\(PatronageDivTax\).pdf](http://www.gwilson.com/documents/Article4(PatronageDivTax).pdf).

62.....*For informational purposes only, not to be relied on as legal advice.*
Think'Outside'the'Boss:'How'to'Create'A'Worker-Owned'Business

- Inform employees about hazards through training, labels, alarms, color-coded systems, chemical information sheets and other methods.
- Keep accurate records of work-related injuries and illnesses.
- Perform tests in the workplace, such as air sampling required by some OSHA standards.
- Provide hearing exams or other medical tests required by OSHA standards. Post OSHA citations, injury and illness data, and the OSHA poster in the workplace where workers will see them.
- Notify OSHA within 8 hours of a workplace incident in which there is a death or when three or more workers go to a hospital.
- Not discriminate or retaliate against a worker for using their rights under this law.

OSHA's resources for small businesses:

<http://osha.gov/dcsp/smallbusiness/index.html>

Free consultations: OSHA also provides free consultations and advice to small businesses to help businesses comply with the OSHA regulations. You can call the toll free number, or you can call the local office to set up a consultation or get advice.
Cal/OSHA Consultation toll-free number 1-800-963-9424.

Posting notices: OSHA requires that you post a notice called "Job Safety and Health Protection" for employees to see. The notice is available for free online, or you can get

one from the nearest OSHA office. <http://www.osha.gov/Publications/osha3165.pdf>

Logging injuries: All businesses with 11 or more employees must keep a log of all workplace injuries and illnesses. This log must be available for employees to see, and any incident must remain on the log for at least 5 years.

(7) Allow Employees to Unionize

The National Labor Relations Act (NLRA) protects the rights of employees to organize unions and collectively bargain with employers.

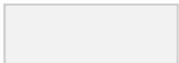
Does NLRA apply to members of worker cooperatives?

The NLRA protects employees, and whether this applies to members of worker cooperatives depends on the ways courts have interpreted the definition of “employee” under the NLRA. Whether members of a worker cooperative have a protected right to form or join unions is an interesting question, addressed in great depth by attorney Neil A. Helfman in his 1992 article “The Application of Labor Laws to Workers’ Cooperatives.”⁵²

(8) Comply With Additional Government Requirements

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⁵² Available at <http://sfp.ucdavis.edu/cooperatives/reports/LaborLawWorkerCoops.pdf>.



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Think'Outside'the'Boss:'How'to'Create'A'Worker-Owned'Business

Notices and records: Employers are also required to post notices related to employees’ rights, and to keep employee records according to the government’s requirements. You can view, download and print all the required employer postings here: <http://www.dir.ca.gov/wpnodb.html>

Register with the CA Employment Development Dept using this form: edd.ca.gov/pdf_pub_ctr/de1.pdf, or using this form for non-profit employers: http://www.edd.ca.gov/pdf_pub_ctr/de1np.pdf

(9) Verify Employee Eligibility to Work in the U.S.

Immigration laws require employers to complete the Form I-9, the Employment Eligibility Verification form to be sure that the employee can legally work in the United States. For more detailed information, and to see the forms, go to the U.S. Citizenship and Immigration Services (USCIS) website www.uscis.gov. On the right side of the page there is a section titled “Employment Verification,” you can click on the link below “Employment Verification” that says “I-9 Central” to get specific information on completing and filing the I-9 Form. Note that if the cooperative members are not considered employees, as described in above sections, then it is not necessary for the cooperative to complete an I-9 for them.

Who Enforces Employment Laws?

At the California state level, the Department of Industrial Relations, Division of Labor Standards Enforcement (DLSE) is the primary body that enforces wage and hour laws, child labor laws, etc. The Division of Occupational Health and Safety (Cal/OSHA) and the Division of Workers' Compensation (DWC) also play a role in enforcing employment related laws and regulations. The Department of Fair Housing and Employment protects employees from discrimination. In addition to the state-level agencies, agencies operate at the federal level to enforce similar laws. Although it is somewhat rare, employment law agencies may audit a business and fine it for violations. Most of the time, employment laws are enforced by workers that bring claims for back wages, health and safety violations, or some other complaint.

Cooperatives With Members Who Are Foreign Nationals

Various organizations are interested in creating cooperatives for undocumented people. "Undocumented people" refers to foreign nationals who are unauthorized to live and work in the United States. In official speak they are labeled "unauthorized aliens." This is a very complicated and unsettled area of law, but in short, while a worker-owned business may provide some benefits, business ownership will not resolve a person's legal status. However, foreign nationals are not prohibited from owning a business in the U.S.

There are currently 11 million unauthorized people living and working in the U.S. The Immigration and Nationality Act provides that anyone living in the United States without authorization is deportable. So clearly not everyone who is "deportable" is actually being deported. Despite this reality, a federal law, known as IRCA, or the Immigration Reform and Control Act of 1986, bans "hiring for employment" of "unauthorized aliens." This makes it very difficult for undocumented people to find and maintain work.

64.....*For informational purposes only, not to be relied on as legal advice.*
Think'Outside'the'Boss:'How'to'Create'A'Worker-Owned'Business

"Unauthorized aliens" are people who are not authorized to live or work in the U.S. Pursuant to IRCA, any business entity that would be considered to be "employing" unauthorized aliens would be violating federal law. However, IRCA does not ban foreign nationals from owning businesses outright. Thus, in setting up a business that is to be owned by unauthorized aliens, or foreign nationals, it is very important that organizations and workers prevent the owners from being characterized as employees of the business.

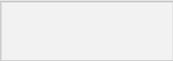
As discussed above, in California, the law sometimes assumes that members of cooperative corporations are employees. This would mean that a cooperative corporation composed of unauthorized aliens could be liable for violating IRCA. However, as also discussed above, managing members of LLCs or partnerships are generally not considered employees under California law.

Therefore, if you are structuring a worker-owned business composed of foreign nationals it is advisable not to choose the cooperative corporation statute to create your business. Further, if structured properly, members of LLCs will generally not be considered "employees" of the business, and thus within the narrow bounds of IRCA's prohibition of

hiring “unauthorized aliens.” However, care must be taken to structure the business such that the individual working members have control over the business. The *Clackamas* factors discussed above would most likely be used to determine whether an individual member of the LLC has enough control over her work and over the entity to not be classified as an employee.

Despite the fact that an LLC may not be in violation of IRCA does not mean that an individual member of the LLC is authorized to work in the U.S. Business ownership does not change a person’s unauthorized status, nor does it put an undocumented person on the path to citizenship. The client must still resolve his or her legal status. In sum, all we can comment on is that, in our opinion, owning the business as a partner (or member of an LLC) is not prohibited. However, please consult an attorney if you are considering creating such an entity. This is an untested legal theory and an unsettled area of law.

FOR MORE INFORMATION: SEE APPENDIX A: NEW EMPLOYER CHECKLIST

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Think 'Outside the Boss: How to Create a Worker-Owned Business

GETTING THE GREEN: FINANCING A WORKER CO-OPERATIVE

Part I: Bank Loans and Alternative Financing

Due to their unique ownership structure, worker-owned businesses typically have a difficult time financing their business ventures. This section of the manual seeks to provide tips to go about financing your worker-owned business. It is important to note that worker owned businesses come in multiple forms and have unique, and sometimes complex accounting, tax, and financing issues. This portion of the manual does not substitute for the advice of a qualified attorney, business advisor or financial advisor.

What is Capitalization?

Capitalization is the money that a business needs to start and continue running. It is

defined as the amount and source of money needed to start and operate a business.

Financing a Worker Cooperative, Generally:

One of the keys to success in starting a worker-owned business, or any business for that matter, is obtaining adequate financing. Traditionally, businesses look to three sources of capital: contributions from the founders of the business (internal equity), loans (debt), and outside investors (outside equity).

The initial source of funding for a worker-owned business is capital contributions provided by the founding members (e.g., each founding member contributes an amount as a membership share). Membership share is a term used to refer to the contribution required for a person to become a member of the cooperative. The initial funding provided by founding members is also known as equity capital. Equity capital reflects the member's ownership stake in the cooperative.

Equity capital is one of the measures by which financial institutions will gauge a business' potential for receiving loans. By contrast, debt financing is borrowing money that the business will have to pay back. The lender, such as a bank, does not receive an ownership share in the business. When analyzing the creditworthiness of a business, lenders like to see that the members of the business have invested their own money in the business first, before seeking outside funding. Lenders are also more comfortable giving loans if they feel that a business has its own resources to pay the loan back. Banks are not in business to lose money, so you need to convince them that lending to your worker-owned business is a worthwhile investment. Thus, in the eyes of banks and other lenders, the more equity capital the cooperative holds in the form of membership shares and other capital contributions, the better the investment.

Outside Equity: Issues Specific To Cooperative Corporations

Outside equity is more complicated for a worker-owned cooperative business than a traditional business. First, in California, cooperatives are not permitted to have "outside" or non-member investors. Thus these investors need to become members of the cooperative most likely as a separate class of "investor members" who have voting rights but do not participate in the cooperative's business activities. Second, cooperative businesses follow the

66.....*For informational purposes only, not to be relied on as legal advice.*
Think'Outside'the'Boss:'How'to'Create'A'Worker-Owned'Business

principle that voting rights are based on one's membership in the cooperative, not on one's investment of capital. This is different from a traditional capitalist enterprise in which ownership and voting are based on the number of shares an individual owns. In a cooperative, ownership and voting are based on your membership. Thus, no one member should have more votes than another.

This is a problem when a cooperative tries to attract capital investors, because such investors typically would like to have increased ownership and voting rights based on their capital investment. They may not be familiar with the concept of cooperative ownership and may not be interested in giving up the rights they would otherwise have in a conventional corporation.

Cooperative businesses have sought ways around these obstacles to raising capital by issuing memberships to a separate class of “investor members” who have limited voting rights. As of January 2016, worker cooperative corporations in California can have “community investors” whose voting rights are limited to protecting their investments through approving or denying the following: merger, sale of major assets, reorganization, or dissolution.⁵³ In addition, these shares can offer dividends, which may incentivize people to invest. However, dividend distributions (i.e., returns that are not based on patronage) from a California cooperative corporation are limited by statute (to 15% of the capital contribution per year). The IRS also disfavors excessive dividend distributions to non-participating investor members.

Small Business vs. Cooperative Business Funding

As discussed above, worker cooperatives face difficulty in getting outside investors. Thus, most worker cooperatives are debt financed, as opposed to outside-equity financed. We have found that cooperatively-run businesses have a difficult time obtaining private banking loans and investment capital, but it is by no means impossible.

Best Practices For Cooperatives Interested in Traditional Sources of Funding If you are interested securing a bank loan or other traditional financing options. The following outlines best practices when approaching a traditional lender, such as a bank or credit union. Potential challenges that a worker-owned cooperative in the start-up stage may face in accessing traditional loans include:

- **Requirement of a personal guarantee.** Lenders require borrowers to put up collateral to secure the loan in the event of default. If one member is unable or unwilling to pledge personal assets as collateral for a loan, lenders may require a third party guarantee.
- **Business Plan.** Lenders look for a very

Best Practices:

1. Preparation
2. Understand their Perspective
3. Pay Attention to Detail
4. Follow-up/ Keep at it!

specific

⁵³ See 'California' Corporations' Code' §§'12238(f), 12253(c).

..... *For informational purposes only, not to be relied on as legal advice.* 67
 Think'Outside'the'Boss:'How'to'Create'A'Worker-Owned'Business

business plan, a clear vision for the business, and an understanding of the cash conversion cycle. This is true of any business, regardless of whether it is worker owned or not.

- **Trend of profitability.** Traditional lending institutions often require two to three years of profitability before being eligible for a loan.
- **Size of the loans.** Historically, it is easier to get larger loans from traditional lenders. Sometimes worker-owned cooperatives, especially those not in manufacturing or another capital-intensive industry, don't need a large loan amount.

The goal of this section is not only to help you understand the difficulties that cooperatives face when approaching a lender, but more importantly, **prepare you to overcome**, to the best of your abilities, these challenges.

Best Practices:

(1) Preparation

Preparation is a key step in both business development and obtaining funding for your business. Very few people can simply walk into the bank without preparation and obtain a significant loan. To prepare before you meet with the bank, start by evaluating your financial situation and the financial situation of the other founding co-op members. You will want to collect documents from all founding members and evaluate personal income, credit scores, debts etc. You will then want to decide whether it is in the best interest of your cooperative to obtain funding individually (e.g., one member has outstanding credit and is willing to try and obtain a loan) or collectively (e.g., you all pool your resources and sign together for a loan). You can receive one free credit score per year at the government sponsored site www.annualcreditreport.com (but beware of credit report scams at other websites). You will want to bring all financial documents with you when speaking to bank loan officers. Be sure to cast a wide net; bringing more documents is better than bringing less. Do not neglect any information that is less favorable to you (e.g., a bad credit score or default on loans). You need to realistically consider the pros and cons of your financial situation, individually or as a group, and be prepared to discuss these pros and address the cons where necessary.

(2) Understanding Their Perspective

A bank is a business. They want to reduce their risk and increase their returns. It is important to understand that bankers, loan officers, or whomever you are dealing with at a financial institution have to follow institutionally determined standards. These standards are not all the same and some are less difficult to overcome than others. Ultimately, a financial institution will be interested in knowing how much money you want, what you plan on doing with it, and how you are going to pay the money back (on time!).

Research Project: Talk to other Cooperative Businesses!

Not all banking institutions make public the standards they use to assess loan

candidates; however, some do, and you may be able to find useful information from other co-ops in the community. Successful worker cooperatives may be willing to share which banks they do business with, and which to stay away from! As someone seeking a loan from a financial institution, you will be well served to realistically consider your business' assets, collectively and individually.

(3) Pay Attention to Detail

Details are key! Neglecting a negative financial history or failing to point out the strengths of your business are just two important details that might get skipped in the process of obtaining a loan. A financial institution should not have to search for necessary and persuasive information about you or the business. Present all the details of

If you find so that stands o creditor notin should be pro talking to your negative com adding your o file. "You hav in your crec explaining mis

your unique financial circumstances to the bank clearly. Also, being detailed and thorough will only make the process run more smoothly.

(4) Follow-Up/Be Creative/Keep At It!

Receiving financial assistance in the form of a loan is undoubtedly a difficult and time-consuming process; however, persistence is the key. Many small businesses face hurdles when they are just beginning. Do not let a few undesired events get in the way of your business's success. Be creative when preparing for and communicating with financial institutions and potential investors. Remember not to burn bridges and do not stop trying when one door closes.

Government Funding

There are also some decent government financing options, the most notable of which is the Small Business Administration (SBA) Loan.

- Most relevantly, the SBA offers the CDC/504 Loan Program
 - A Certified Development Company (CDC) is a private, nonprofit corporation, which is set up to contribute to economic development within its community. CDCs work with SBA and private sector lenders to provide financing to small businesses, which accomplishes the goal of community economic development.
 - **Must** be used for fixed-asset projects:
 - The purchase of land, including existing buildings;

⁵⁴The Entrepreneur Magazine: Small Business Advisor, 258 (1995).

- The purchase of improvements, including grading, street improvements, utilities, parking lots and landscaping;
 - The construction of new facilities or modernizing, renovating or converting existing facilities; and
 - The purchase of long-term machinery and equipment.
- **Cannot** be used for working capital or inventory, consolidating or repaying debt, or refinancing.
- There is also the California Small Business Loan Guarantee.
 - It allows a business to not only acquire a loan it could not otherwise obtain, but to establish a favorable credit history with a lender so that the business may obtain future financing on its own.
 - Eligible Applicants:
 - Any small business as defined by the SBA (typically businesses that employ 100 people or less).
 - Eligible Uses:
 - Proceeds must be used primarily in California and for any standard business purpose beneficial to the applicant's business, such as expansion into new facilities or purchase of new equipment.

Conclusion

Applying for a loan, for most businesses, is not easy. The process can be even more complicated for cooperative business because most banking and financial institutions either do not trust a business that is primarily debt-financed or do not understand the concept of cooperatively owned business, or both. Being aware of these challenges makes it possible to overcome them. In approaching a financial institution for a loan, members of a cooperative should follow the best practices outlined above. Remember that although a loan may not be a viable option at the outset of your business' development, over time your business assets will grow and loans may become a more viable option once your business develops. Despite the difficulties associated with obtaining a financial loan, keep at it and be creative!

Part II: Securities Law

How To Comply With Securities Law

Most financing and fundraising options you will pursue to raise investments for your business require compliance with securities laws. So, don't just ask for loans and investments! Make sure you follow the law. Even asking a potential investor for money can be considered a violation of securities law, unless you're just applying for a regular business loan from your bank as described above. This section of the manual does not substitute for consultation with a qualified lawyer in the field of securities law. **Securities law is highly complex and failure to comply with securities regulations may lead to civil and criminal sanctions.**

Consult an attorney before trying to raise money. This section of the manual will attempt to provide you with a basic overview of securities law as it relates to finding funding for your cooperative business.

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What Is A Security?

A security is a financial instrument representing ownership, a debt agreement, or the rights to ownership. Examples include stocks, bonds, derivatives, and many other types of financial assets.⁵⁵ You create a security when you ask people to put money into your business or venture, and you offer them a return. For example, a security could be:

- Selling stock in your business
- Asking people to lend money to your business
- Offering a share of your business's profits
- Interests in limited liability companies (LLCs)
- Pre-selling products or services that have not been developed yet (in California and other states)

It is important to know what is or is not a security because when you sell or even offer to sell a security, it needs to either: 1) be registered with the U.S. Securities and Exchange Commission and/or with the state agency where you want to raise money (in California, the agency is the Department of Business Oversight); or 2) qualify for an exemption from registration. Registration is an expensive, time-consuming process. If possible, your business should try to find an exemption, which is simpler and less expensive.

Ways To Raise Capital *Without Securities:*

(1) Donations

When people give money without the expectation of receiving anything in return, they are donating. Many entrepreneurs are using so-called crowdfunding websites such as Kickstarter.com and Indiegogo.com to raise money for various enterprises. Entrepreneurs that solicit donations often provide non-monetary rewards to donors. At what point might a reward be valuable enough that it could be seen as a financial return on investment? This issue has yet to be tested, but it is advisable to ensure that any rewards offered are valued at less than the amount donated.

Helpful Tip:

When raising money through donations, any reward to your donors should be small (i.e., less than the donation amount) and non-monetary. If the reward is high in value or money based, it could be seen as a financial return on an investment, also known as a security. In that case, you could be in violation of securities laws.

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⁵⁵ See <http://www.investopedia.com>.

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(2) Pre-Selling

If you're an existing business and want to expand your business, one possible way to raise funds is to pre-sell gift certificates. For example, you might sell a \$150 gift certificate that a customer can redeem at your business, but only charge \$100 for the gift certificate. Charging less than the value of the certificate gives the buyer an extra incentive to purchase the gift certificate. Note that pre-selling a product or service that has not yet been developed may be considered a security in California.

(3) Loans with Return of Principle Only

Return of principle only means giving back the money that the funder gave, and not offering a return on the investment. Not offering a return means that the business will not offer anything more than the original investment amount, such as an additional dividend, interest, or appreciation in value. It is important to note that in California, this is likely considered to be a security, so you should proceed with caution and consult with a lawyer if you choose to utilize this funding method.

(4) Product Discounts

Another way to raise capital for your business is to charge a membership fee and offer product discounts in exchange, as example of which is Costco. REI also provides an interesting model for product discounts funding. REI is a consumer cooperative that sells memberships to its customers. At the end of the year, REI members receive a "dividend" based on the amount spent at REI during the year. This "dividend" can then be used to shop at REI. REI takes the position that its memberships are not securities because what members are really buying is the right to receive discounts on the items they purchase – not at the time of purchase like at Costco, but at the end of the year in the form of a rebate check.

(5) Bartering

One unique and often forgotten way to gain needed resources is to avoid money altogether for certain goods or services your business needs. Bartering, or exchanging services or goods directly, is a means of obtaining resources. If you need to raise money to pay for something such as web design or compostable cups, consider whether you might be able to barter your goods or services to get what you need. This is not a traditional means utilized by businesses when financing their business; however, it can be utilized as an alternative way to obtain much needed resources for your business. However, you should note that bartering may be subject to taxation.⁵⁶

Ways to Raise Capital *With* Securities

Worker cooperatives are business entities that are (1) owned by their workers, (2) governed by their workers, and (3) operated for the benefit of their workers. Because worker

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⁵⁶ See SELC's resources on barter: <http://communitycurrencieslaw.org>

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cooperatives are owned and controlled by and for the people who work there, it is important to consider what kind of security you choose to offer. Specifically, be mindful when offering equity investments (as opposed to debt) to individuals who will not be working for the cooperative. Below are several methods for raising capital through securities offerings.

(1) **California Limited Offering Exemption (California Corporations Code Section 25102(f))**

California Corporations Code Section 25102(f) offers a special securities law exemption to certain kinds of private securities offerings, if they meet the following criteria:

First, you must be exempt from federal securities filing requirements:

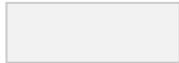
- Your company must be formed under California law (i.e., if you are a corporation you filed your articles of incorporation in California, etc.),
- You plan only to offer securities to California residents,
- Your contract with your investors includes that they will not resell the security to anyone outside the state for nine months, and
- Your business is very California-focused – here is a test for this:
 - You get at least 80% of your revenues from California
 - At least 80% of your assets are in California
 - You plan to use at least 80% of the money you raise within California

Then, you must meet the requirements for 25102f:

- You can sell your securities to up to 35 investors that are not wealthy as long as they meet one or more of the following criteria:
 - The investors have a preexisting personal or business relationship with you “consisting of personal or business contacts of a nature and duration such as would enable a reasonably prudent purchaser to be aware of the character, business acumen, and general business and financial circumstances of the person with whom such relationship exists.” These investors can be friends or family;
 - The investors have enough financial experience to protect their interests;
or
 - The investors have experienced professional financial advisors.
- You can sell an unlimited number of securities to officers and directors of the

company and accredited investors. Accredited investors are 1) people with \$1 million in net worth (excluding their home) or \$200,000 in annual income, or 2) entities with more than \$5 million in assets.

- Your securities offering cannot be advertised to the public.
- The investors must sign something saying that they are not investing for the purpose of reselling the securities to someone else.
- You have to file a simple form with the California Department of Business Oversight.



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(2) California Cooperative Equity Exemption

Under California Corporations Code Section 25100(r), a California cooperative can raise up to \$1,000 from each member without qualifying the securities. For example, a cooperative might set its initial capital contribution requirement at \$1,000. However, any person who purchases a security under this exemption becomes a member and must have voting rights in the cooperative. Worker cooperatives can offer shares of up to \$1,000 to community investors, who are technically members but whose voting power is limited to approval rights over mergers, sale of major assets, reorganization, or dissolution.⁵⁷ Also, you cannot use a “promoter” to sell these securities. As with the California Limited Offering Exemption above, you could use the federal intrastate offering exemption to satisfy the federal securities regulations.

Note that if a cooperative member will be participating in the management of the business, the members’ capital contributions are generally not considered a security, which means each member can contribute more than \$1,000 to the cooperative. It is primarily for non-managing cooperative members and community investors that you would need to use the 25100(r) exemption.

(3) Angel Investors and Venture Capital

Finding an angel investor or venture capitalist to invest in your business can be competitive and challenging. At the same time, angel and venture capital funds have helped to launch and grow many successful businesses.

(4) Crowdfunding

Crowdfunded investing occurs when many members of the general public invest small amounts of money in a business. Instead of relying on a small pool of wealthy “accredited” investors, crowdfunded investing allows a business to raise capital from its customers, neighbors, friends, family, and other community members, most of whom might be non-wealthy people who want to support your business. At the time of writing this manual, we are still waiting for the SEC to release final regulations governing the recently enacted federal crowdfunding exemption in the Jumpstart Our

Business Startups (JOBS) Act. In the meantime, a Direct Public Offering is one of the only viable methods to advertise and issue securities publicly to the crowd.

- **Direct Public Offering (DPO)** Registering a DPO is not simple and it may require assistance from a lawyer, but it's a nice option if you need to raise a lot of money and you want to offer shares of your business to local community members. A DPO is a securities offering that is registered at the state level and allows a business to publicly advertise investment opportunities to both accredited and non-accredited investors. Unlike an initial public offering (IPO), which requires an investment bank to underwrite the security, or the anticipated Crowdfunding exemption, which will require the online funding portal to be registered as an intermediary, a DPO allows an entity to sell securities directly to

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⁵⁷ See 'California' Corporations' Code' §§'12238(f), 12253(c).

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the public without a third party intermediary. Upon the state's approval of your DPO plan, you can begin offering securities directly to the public.

- **Crowdfunding Exemption (2012 JOBS Act)** In April 2012, President Obama signed the JOBS Act. Among other things, the JOBS Act includes a provision that would exempt certain small investments from securities registration requirements.⁵⁸ Although this new exemption is not specific to cooperatives, some cooperatives might consider using this exemption at some point, after considering related issues such as how crowdfunded investing might affect a cooperative's governance or control by its members. However, until the SEC releases final regulations governing the exemption, we know very little about how useful this exemption will be. A good resource for information on crowdfunding is Cutting Edge Capital:
<http://cuttingedgecapital.com/>.

(5) Socially Responsible Investing or Community Investment

Socially responsible investment organizations have grown rapidly over the past 30 years and continue to expand, even in the down economy. Many of them are located in the Bay Area.

- Working Solutions' Microloans for Start-Up Businesses offers loans of \$5,000 to \$50,000 to small businesses with significant experience in the same exact industry and with owner's equity injection into the business of at least 20% to 30% of the requested loan amount.
- Oakland Business Development Corporation Small Business Financing is affiliated with the City of Oakland and offers loans to small businesses of \$10,000 to \$250,000 at varying interest rates. They require personal guarantees on loans.
- RSF Social Finance is a private organization that offers food and agriculture specific programs that include grants and loans.

Quick Comparison: Traditional Sources of Financing Versus Alternative Financing⁵⁹

<p>Traditional Sources (Banks and Credit Unions)</p> <ul style="list-style-type: none"> • Greater funding • Potentially higher interest rates • May require 2 to 3 years of profitability • May require good credit, collateral, or equity 	<p>Alternative Financing (Micro Loans)</p> <ul style="list-style-type: none"> • Less funding • Potentially lower interest rates • May invest in startups • Credit, collateral, and equity requirements vary by lender
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⁵⁸ http://www.huffingtonpost.com/jenny-kassan/jobs-act_b_1405844.html.

⁵⁹ This quick comparison borrowed from Berkeley Law’s Community Food Enterprises Project Loan Handbook.

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Useful Resources:

Additional tools on financing your worker co-op can be found at:

- California Business Portal (Forms, fees, requirements)
- Small Business Administration (General guidance)
- Alameda County Small Business Development Center
- Alameda Community Development Agency