

EMPLOYEE COOPERATIVE AS A PLAN FOR BUSINESS SUCCESSION

Employee cooperatives – that is, cooperatives in which the company’s employees rather than its customers are the Patrons – are not often encountered in the business community. This may be because cooperatives are not widely understood, and, even if they were, a healthy, happy employee cooperative requires a certain set of circumstances and attitudes to thrive.

For a long time, state cooperative statutes have not been available to employee cooperatives (and many other types of cooperatives). Many of these statutes were originally enacted as enabling statutes to permit the organization of agricultural cooperatives. Enabling laws usually have a more limited purpose than a stand-alone corporation statute. Many cooperative statutes:

- A. acknowledge the corporate legitimacy of cooperatives, but only if formed by agricultural producers;
- B. specify a few unique cooperative characteristics such as member voting and structure of the board of directors, but very little about corporate organization and capital (stock) structure; and
- C. tie the cooperative statute with either the state’s general business corporation law or non-profit corporation law (or both, in some states) to provide other corporate law provisions such as those for merger, dissolution, capital stock, and shareholder rights. These enabling statutes are either too restrictive or too meager to be taken seriously as a real option or “choice of entity” when organizing or reorganizing a business for employee ownership in a cooperative.

Some states have updated their cooperative statute to a comprehensive corporation statute with appropriate cooperative terminology. These statutes are now available to be added to the “choice of entity” list for Owners who are seeking a plan for business succession by sale of the business to their employees. The Ohio Cooperative Law is one of the best of these updated cooperative statutes.

The Problem of Business Succession

Many small and medium size companies are the result of the enterprise, vision and lifetime work of one or a few individuals (the **Owners**). When an Owner grows older, he/she begins to have intimations of mortality and realize the need to plan for retirement and sale of the business.

If the Owner would like to see the company continue with his or her vision intact, or if the most logical and desirable market for the company is some or all of the Owner’s closest

business associates (the employees), the Owner may consider some form of employee acquisition of the company.

This inter-generational transfer may be within the Owner's family, in which case, the Owner may use traditional estate planning techniques. But many business Owners find that handing the business over to the next generation within the family is not an option. Even though the company's corporate culture may be like a "family", the next generation who will succeed the Owner may not be members of the Owner's family. In this case, the Owner and the Owner's heirs (or charitable beneficiaries, if the Owner has no children) will expect to extract full value upon transfer of the company. This means a sale/purchase agreement with a plan for the ongoing organization and capitalization of the company.

Choice of Entity for Business Succession

The Owner-seller and the employee-purchasers have a number of organizational choices to evaluate. Their choice of entity will be based on considerations of tax, financing, shared vision for business continuity, employee interest and unity, market value of the business, special requirements of the company's business, and other matters relevant to the transaction. One of these organizational options is an employee cooperative.

There are many reasons why an employee cooperative may be ruled out of consideration. A significant number of the employees may not be interested in owning the company or sharing in the enterprise risk of the company's business. The employees may have no interest in participating in the governance or management of the company. The employees may not have an agreed plan for management of the company, or they don't have a long term commitment to the company. However, if the employees are in agreement to make a collective acquisition of the company, a cooperative may be a more satisfying and unifying plan than a conventional corporate acquisition and ownership structure. Distribution of corporate profits to employees as patronage refunds may be more logical and tax-efficient than payment of dividends to shareholders. Employees who are Members of an employee cooperative are more likely to judge the relative value and obligations of company ownership in terms of their respective employment status and career rather than as a passive investor.

Understanding the Cooperative Model

Because employee cooperatives are not as well known as other kinds of employee-owned entities, the Owner and the employees must understand the distinguishing features of a cooperative and the economic essentials of "doing business on a cooperative basis."

Most cooperatives are not employee cooperatives. A typical cooperative is organized to "do business on a cooperative basis" with some or all of its customers (called **Patrons**). This means that the cooperative's business plan and motivation is to produce economic advantage for its Patrons and only secondarily for the Patrons as investors.

Every cooperative should have one or both of two functions:

- A. A marketing function in which the cooperative's primary purpose is to market the output of its Patrons; or
- B. A supply function in which the cooperative's primary purpose is to procure supplies, services or other inputs for its Patrons.

Many cooperatives perform both functions. A common example of a dual function cooperative are the hundreds of grain marketing and farm supply cooperatives throughout the Midwest.

An employee cooperative turns this cooperative concept "outside in" by viewing the employees as the Patrons with whom the company does business on a cooperative basis. In this case, the company business plan and motivation is to produce economic advantage for the employees as contributors to the collective economic output (production) of the company, and secondarily for the employees as investors. Employee investment in the cooperative becomes a means to gain access to company profits on the basis of the relative value of the employee's work and skill input to the company's enterprise. An employee cooperative is a marketing cooperative. It markets its employees' skills and work.

Cooperative Principles

The defining features of a cooperative are described in cooperative principles that provide a consistent logic of corporate economics and governance. We begin with first principles – the idea of **operation at cost** and **Patron** – from which other cooperative principles follow.

- A. **Patron** is a person with whom the cooperative makes a contract to provide goods or services or to market the person's output on a cooperative basis (i.e., collectively with the goods and services requirements or output of other Patrons). Part of this contract is that the cooperative will return to the Patron any profits (referred to as Net Margins in the context of a cooperative) attributable to these transactions. In an employee cooperative, the employee is the Patron and the cooperative markets the employee's work in the course of the cooperative's business enterprise. By marshalling the collective efforts of a group of employees, the cooperative's business enterprise should create greater value for the individual employee's work. This additional value is measured in the cooperative's Net Margins. Other corporations aggregate employees to create a more valuable work effort. In the case of an employee cooperative, the employee-Patrons are entitled to this additional value in the form of an allocation of the Net Margins to the Patrons in proportion to their work inputs. By contrast, other business organizations typically distribute these profits to shareholders on the basis of their invested capital. In a cooperative, the Patron takes precedence over the shareholder in the claim to corporate profits.
- B. **Operation at Cost** is a central theme of the Patron contract and operating on a cooperative basis. A cooperative transacts business with or for its Patrons at cost. This means that, if a cooperative realizes a profit from its business transactions with or for its Patrons, that profit belongs and will be allocated to the Patrons in

proportion to the volume or value of each Patron's business transactions. The net result of this **Patronage Refund** is that the original price of the business transaction (the employee's wage or salary) is adjusted to the actual cost by addition of the Patronage Refund. The resulting combination of wage/salary and Patronage Refund should, in the economic logic of a cooperative, reduce company profit to \$0. This result indicates that the company has done business (marketing employee skills and labor) at cost with respect to the Patrons and their respective work inputs. **This does not mean that the company intends to operate without profit.** It means that a cooperative earns its Net Margins on behalf of its Patrons. A natural corollary of this cooperative principle is that capital investment interests in the cooperative are subordinated (but not ignored or dismissed) to the interests of the employee Patrons.

Three other cooperative principles logically flow from the notion of operation at cost:

- C. **Limited Return on Equity Capital.** Cooperatives usually limit the amount of dividends they pay on capital stock and other equity interests. Cooperatives do not normally issue capital stock or other equity interests that appreciate (or decline) in value in connection with the company's retained earnings (or losses) or perceived market value. Instead, most of a cooperative's equity capital is accumulated by retention and reinvestment of part of the amount that is allocated to the Patrons as Patronage Refunds.
- D. **Democratic Control of the Cooperative by its Members.** This often, but not always, means voting on a one member, one vote basis rather than on the basis of invested capital or share ownership.¹
- E. **Member Ownership.** A company whose profits and control are devoted to its Patrons may not be attractive to other investors. Therefore, the Members and other Patrons should furnish most of the equity capital for the business. Member-Patron access to profits and control of a cooperative are supported by corresponding Member-Patron ownership and investment.² An employee Member-Patron in an employee cooperative would tend to view her or his investment in the cooperative as the purchase of a Patron's share of the

¹ Another commonly used cooperative voting scheme is "patronage-weighted" voting, meaning that the Member Patrons have individual voting power in the same proportion as their Patronage Refund is determined – that is, the Member's volume or value of patronage transactions. Some cooperatives employ other voting arrangements including voting on the basis of equity ownership, but nearly all restrict voting to Members only. The IRS has issued some very restrictive private letter rulings on the subject of "democratic control" as a necessary part of "doing business on a cooperative basis" under subchapter T of the Internal Revenue Code. The author advises that voting on the basis of equity ownership and nonmember voting should be avoided or strictly limited in an employee cooperative because these voting schemes may create problems for the cooperative under applicable securities law, state cooperative statutes, or subchapter T of the Code. State cooperative statutes usually address the issue of voting control of a cooperative. The Ohio Cooperative Law (O.R.C. §1729.17) is flexible in this respect.

² There is an often-stated adage in business that the golden rule of American capitalism is "he who has the gold, makes the rules." This is as logical in a cooperative as it is in any other form of business because the rights of ownership are combined with, and not in opposition to, the responsibility of ownership. Contrary to the assumption of some, the cooperative business model is entirely consistent with American capitalism.

company's profits rather than as a passive investment upon which a return on capital is expected.

- F. Finally, a word about **Members** and **Patrons** of a cooperative. Patrons are described above. "Members" is a term of cooperative governance. The Members normally exercise most or all of the voting control of a cooperative. Some people use Member and Patron interchangeably because Members and Patrons are often the same group – but not always. The Members of a cooperative should be considered the cooperative's voting polity and the Patrons, including the Members, are the persons with whom the cooperative has contracted to distribute a Patronage Refund.

With this understanding of a cooperative, the Owner and employees can compare an employee cooperative with a conventional investor-oriented company for purposes of an employee buyout.

Workplace and Corporate Culture Considerations

An Owner's sale to employees in a conventional corporation would likely have less impact on the workplace and corporate culture of the company than a sale to an employee cooperative. Change in the employees' involvement in corporate decision making and ownership may be hardly noticeable. Some or all of the employees may become shareholders, but a shareholder's role in company operations is usually passive – limited to participating in elections of directors to the board of directors. Because the board of a conventional corporation has particular fiduciary obligations to the shareholders as such, the company's business would presumably be conducted to maximize the value of the stock. This may be similar to the Owner's own goals prior to sale of the company. Therefore, a sale to employees in a conventional corporation may result in little change in the business and the employees' workplace; at least in the near term. If the goal of the transaction is to sell only a minority interest in the company, sale to employees in a conventional corporation is preferable.

In contrast, sale of stock to an employee cooperative will likely result in significant changes in the workplace.

Selection of an employee cooperative business model can be enormously satisfying in certain situations, but it is not appropriate for every business application.

There are normally some opposing interests between employees and management in a company. An employee cooperative must overcome this and the understandable reluctance of employees to assume responsibility for investment in, and management of, their employer. An employee cooperative may be an appropriate business model in situations where the employees:

- A. recognize their common interest in working together to sustain the business and, therefore, their jobs and careers;
- B. believe they will create and gain greater value (however they define "value") from their work in a collectively owned and managed workplace;

- C. want to acquire the full value of their work in the form of a share of the business's profits, as opposed to an expectation of appreciation or other monetary return on invested capital; and
- D. are willing to subordinate some of their individual prerogatives as an owner to collective decision-making with fellow employee owners. This does not mean that the workplace would be managed by an endless series of Member votes, but it does mean that the employees will collectively determine how they will be managed and, more importantly, determine the relative value of each employee's work for purposes of dividing business profits at the end of the year.³

Obviously, a business with high employee turnover or a low level of employee loyalty to the business is not a good candidate for an employee cooperative. On a less philosophical level, a business in which the employees are unwilling to make significant capital investment or financial commitment to invest in the business is also not a good candidate for an employee cooperative.

A primary focus in the sale of a company to employees in a conventional corporation is stock value. The value of the company's stock is not only the measure of the sale price of the Owner's stock, but also the ongoing measure of employee ownership and benefits. By contrast, a primary focus of the employee's interest in an employee cooperative is a share of the company's annual profits and control of the company's management. In an employee cooperative, share acquisition is a means to achieve these goals.

An employee cooperative is no more expensive to establish and maintain than an employee-owned conventional corporation, but the cooperative may initially incur some additional expenses for specialized legal counsel and training of the company's accountant. Most professional advisors, employees and management are not familiar with cooperative governance, taxation and accounting.

Tax Considerations For an Employee Cooperative.

An employee cooperative brings immediate tax advantage. A cooperative is a subchapter C corporation for federal income tax purposes, but the calculation and distribution of its income and some other tax benefits should qualify for special cooperative tax treatment under subchapter T of the Internal Revenue Code.⁴ Under subchapter T of the Internal Revenue Code, an employee cooperative may exclude substantially all of its profits (Net Margins) from its taxable income for federal income tax purposes to the extent that it allocates and distributes these

³ Most cooperatives operate under forms of management and management organizational charts that resemble those of non-cooperative businesses. After all, management and operation of an employee cooperative's business must be just as disciplined and competent in order to be profitable. This means that some employee or employees will be the "boss" and others will follow their direction. The chief distinction of management in an employee cooperative is that management is hired or appointed by a Member-elected board of directors and the business is operated to benefit the Members as Patrons rather than as shareholders. Of course, the imperatives of business competition apply equally to cooperatives and non-cooperatives.

⁴ 26 USC §§ 1381 - 1388

Net Margins on a patronage basis to its employee Patrons within 8-1/2 months after the end of the cooperative's tax year.⁵

Subchapter T prescribes several procedural requirements for this exclusion⁶ (the IRS has characterized the exclusion as a deduction), the most important of which is that the Patron agree to include her or his Patronage Refund in their gross income for federal income tax purposes. The result of this is that the cooperative's income is taxed only once in its journey from the cooperative's business operations to the Patron. This single tax treatment is similar to the pass-through of income in a subchapter S corporation or a limited liability company and is consistent with the cooperative principle of operation at cost. Subchapter T and other tax Code provisions also permit similar allocation and pass-through of most tax credits and losses. An employee cooperative is not a tax exempt entity, but single tax treatment of its income is an important defining feature.

A subchapter T employee cooperative is unlike a subchapter S corporation and other true pass-through entities in important respects. For example:

- A. the terms and conditions of a Patronage Refund to a Patron depend on the wording of a private contract between cooperative and Patron (usually found in the cooperative's Bylaws) rather than an automatic and complete flow-through as provided in the Internal Revenue Code for pass-through entities. The deductible Patronage Refund (called a patronage dividend in subchapter T of the Code) is based on a narrower set of requirements for source and distribution of income. A Patronage Refund must consist only of the Net Margins attributable to the patronage transactions of the Patron to whom the Patronage Refund is allocated. The aggregate Patronage Refunds may be less than all of the cooperative's profits;
- B. if the cooperative makes a tax deductible allocation and distribution of Patronage Refunds, this tax deduction is available to the cooperative for the tax year in which the Net Margins are earned. However, the Patron need not report this amount until the Patron's tax year in which notice of the Patronage Refund is received.⁷ Since a cooperative may allocate and distribute Patronage Refunds up to 8-1/2 months after the end of its tax year, there is typically a one tax year delay between the time a cooperative earns a Net Margin and the Patronage Refund is reported as income by the Patron. The cooperative/Patron contract acts as a sort of control valve on the flow of income from the business to the employee. This can permit the income earned by the cooperative in one tax year to be reported for the first time as taxable income (by the Patron) in a subsequent tax year when it is distributed to the Patron.

⁵ 26 USC § 1382(b) and 26 USC § 1388(a)

⁶ 26 USC § 1388(c)

⁷ 26 USC § 1385(a)

Capitalizing a Cooperative

Like most businesses, a cooperative's primary source of equity capital is accumulation of its own earnings. Recalling the cooperative principle of Member investment and ownership of the cooperative, an employee cooperative is not likely to distribute the full amount of its Patronage Refunds in cash. The cooperative/Patron contract usually grants authority to the cooperative to retain some or all of each Patronage Refund for reinvestment by the Patron in the cooperative. Thus, the Patron receives the income, and her or his ownership interest in the cooperative is increased according to the amount of the Patronage Refund that is retained and reinvested.⁸ Subchapter T of the Code provides that the cooperative must distribute at least 20% of the Patronage Refund in cash in order to exclude the Patronage Refund from its taxable income.⁹ As a practical matter, the Member-Patrons usually expect and require that the cooperative distribute at least enough cash to cover the Patrons' tax liability for the Patronage Refund.

Comparison With An ESOP

Cooperative Net Margins that are allocated, distributed and taxed under subchapter T of the Internal Revenue Code do not provide the long term tax deferral advantages of a tax exempt Employee Stock Ownership Plan (**ESOP**), but Patronage Refunds, to the extent paid in cash, are available to the employee for current use and disposal. Retained portions (equity interests) of Patronage Refunds may be redeemed without any subsequent tax events for the company or the employee. The distribution of income from an employee cooperative to its employee Patrons is certainly more tax-efficient than distribution of income to employee shareholders in a conventional corporation.

Selling the company to an employee cooperative has an advantage from the Owner's perspective: it may justify a control premium for the initial sale of stock in an installment sale plan, even if the initial sale conveys only a minority interest, because the majority of the board of directors of an employee cooperative will be elected by the employee Members on some basis other than share ownership. This would not normally be the case in the sale of a minority interest to an ESOP.

Another possible advantage of a sale to an employee cooperative (from the Owner's perspective) is that the Owner and other close relatives who cannot participate in an ESOP can be Members of an employee cooperative, under the same rules that pertain to other Members. They may participate in Patronage Refund allocations from the cooperative along with other employee Members.

ESOP's are subject to extensive ERISA regulation and reporting, which should include retention of various professional advisors such as a trustee, consultants and appraisers. The initial and annual cost to form and maintain an ESOP is considerably higher than the cost to form and maintain an employee cooperative.

⁸ This accumulation of profits in the company is probably how most business owners have accumulated the value of the stock they are selling.

⁹ 26 USC § 1388(c)(1)

Finally, ESOP's, which are employee retirement plans, have recently come under criticism and legislative scrutiny because of the lack of diversity in plan funding. Some recent and spectacular failures of businesses with heavy investment in ESOPs have put a rather fine point on this issue. Business failure can be very disappointing to employee-owners whether their stock is owned by the employees directly or in an ESOP, but the ESOP emphasis on stock value rather than on producing a stream of income distribution to employees (as in a cooperative) can make a difference in the degree of employee disappointment. Employee cooperative features of direct ownership of the employer's stock and annual distributions of corporate profits should make employees feel directly responsible for the welfare of the company.

Converting a Company to an Employee Cooperative.

When the Owner decides to sell the company to the employees in a cooperative, he/she begins by converting the company to an employee cooperative and then selling his or her stock to the company under a **Stock Redemption Agreement**. The company would, in turn, resell the redeemed stock to the employees in proportion to their respective interests as prospective Patrons. For practical as well as tax and legal reasons, a sale of the company to an employee cooperative is suitable only when the seller and buyer contemplate the sale of all or substantially all of the Owner's stock. It would rarely be advisable to sell only a minority interest in the company to an employee cooperative.

If the sale is done all at once, there may be significant financing problems. A single payment sale may also be a problem if the Owner is planning a gradual exit from the business. These situations can be dealt with through a multi-step or installment sale over a period of years.

However, if the Owner sells shares to the employee cooperative in several stages, the Owner may find the conversion of the company into an employee cooperative at the first installment worrisome, since control of the board will pass from the Owner to the Members of the cooperative when the company is first converted into a cooperative. One way to deal with a concern over loss of control is to include protections for the Owner's interests in the Stock Redemption Agreement and the cooperative's governing documents – for example, supermajority voting requirements and other reserved rights for the Owner to withhold consent for major corporate changes until the Owner's stock has been fully redeemed.

It makes sense for the cooperative's employee Members, the company and the Owner to arrange financing sufficient to fund the initial purchase and to make plans to finance or otherwise fund subsequent purchases. This will probably involve the Owner's consent to allow the company's assets to be pledged to secure corporate borrowing from a bank or other institutional lender. It should also include some personal investment and financial commitment by each employee Member of the cooperative. In exchange for this investment, each employee would receive equity interests and Membership rights in the cooperative.

Reorganization of the company requires new **Articles of Incorporation, Bylaws**, and a board of directors, the majority of whom should be elected by the employee Members. The Articles and Bylaws and the Members' **Membership Application and Subscription**

Agreements should specify Member voting rights, the Patrons' rights to allocation and distribution of Net Margins, and investment obligations of Members and Patrons.¹⁰

There are at least three threshold issues in selling the company to an employee cooperative that should be acknowledged and accepted by the Owner and the employees, each of which is a personal watershed for the Owner and the employees:

- A. Majority control of the company's board of directors will shift to the employee Members. This may enable the Owner to receive a control premium, or at least avoid a minority discount, for the initial sale in a multi-step sale transaction. The Owner may be a Member and serve on the board.
- B. Each employee-Member's pay and share of the cooperative's profits will depend on a determination of the relative value of the employee's work for the cooperative. The Owner previously made this determination. In an employee cooperative, employee peers (perhaps through the board or a special committee of Members) may take the place of the Owner on this subject. These management decisions may be delegated to a CEO or other management arrangement by agreement of the Owner and the employees. If the Owner is not yet ready to leave the company, the Owner may negotiate an agreement to continue as an employee and manage the company as part of the sale. This may be good for both the Owner and the other employees because it allows for a more natural transfer of management expertise from the Owner to qualified employee Members.
- C. The employees should agree that each of them will invest in the employee cooperative in proportion to their respective share of the profits either through direct capital contributions or by retention and reinvestment of a portion of their compensation or patronage refunds, or a combination of these.
- D. An employee cooperative allocates its Net Margins among employee Members on the basis of the relative value of their labor input rather than on the basis of their investment. There are some businesses in which the work is essentially the same for all jobs, but most businesses include a wide diversity of job skills and productivity that should be valued accordingly in order to be fair, and to make the pay scheme attractive to qualified employees. The measure of value might include salary or wage (market value), hours worked (volume), seniority (past labor input and accumulated wisdom), or skill, experience, education or especially valuable productivity (quality). These and other factors such as basic productivity and responsibility within the cooperative can be mixed and matched to a formula that the Members agree is a fair representation of the true value of their work.

¹⁰ It is possible to organize an employee cooperative under some states' general business corporation statutes, but a state cooperative statute is preferable because general business corporation statutes include many terms and provisions that are incompatible with "operating on a cooperative basis." Many state cooperative statutes are devoted solely to agricultural applications, or are antiquated and incomplete corporate statutes, or both. The Ohio Cooperative Law (Chapter 1729 of the Ohio Revised Code) is particularly adaptable to a wide variety of cooperatives, including employee cooperatives. The Ohio Cooperative Law provides for conversion of an ordinary corporation to a cooperative at ORC § 1729.42. The Wisconsin and Colorado cooperative statutes are others to consider.

Most of these factors are used to determine compensation in companies that are not cooperatives. However, a new formula for pay and Patronage Refunds could conflict with the company's existing pay scale, if that pay scale is the product of historical accident, office politics, or other important but non-economic considerations.

Looking Forward

In most cases, an employee cooperative will repay its buyout financing from future net income of the business. This may make significant claims on its cash flow and will likely force it to allocate and distribute some or all of its Patronage Refunds to employee Members in the form of equity interests (Capital Credits) in the cooperative, rather than as a cash payment, until the financing has been repaid. This reinvestment of the Members' share of business earnings and the corresponding deferral of cash payments will be a factor in the Members' own cash flow and financial planning. The employee Members will receive current income of the business, but most of it will be committed to investment in the employee cooperative. Patronage Refunds may not be immediately available as disposable income to the employee Members during the term of loan repayment and the resulting equity interests are exposed to the enterprise risk of the company's business.

The employee cooperative's plan of operation should take into consideration the interests of employees who are hired after the buyout. Membership, Patronage Refunds, equity redemption (before or at retirement) should be available to future employees. But new employees should be required to furnish their fair share of the employee cooperative's equity through personal investment in the cooperative in order to obtain these benefits. An employee cooperative is not required to have the suspense account or delayed allocations typically used with ESOPs, but it should establish similar accounting and allocation devices in its Bylaws or in policies and Member Subscription Agreements. The cooperative's income and equity allocation formulas should be structured to avoid allocating a disproportionate part of any unallocated surplus of the cooperative to new employees until they have furnished their fair share of the equity.

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