# Legal Guide to Cooperative Conversions

A Business Owner's Legal Guide to Cooperative Conversion

Including Conversion Models, Case Studies and Sample Documents

*Created by:*

Janelle Orsi | William Lisa

Sushil Jacob

EAST BAY COMMUNITY LAW CENTER
GREEN-COLLAR COMMUNITIES CLINIC
Sustainable Economies Law Center

DISCLAIMER: The research that provided the basis for this publication was supported by funding under an award to the Metropolitan Transportation Commission (MTC) from the U.S. Department of Housing and Urban Development. The substance and findings of the work are dedicated to the public. The author and publisher are solely responsible for the accuracy of the statements and interpretations contained in this publication. Such interpretations do not necessarily reflect the views of the federal government or MTC. For a copy of the specific research findings and the methodology underlying that research, please go to http://www.theselc.org/cooperatives.

# TABLE OF CONTENTS

## The Purpose of this Guide

This Guide has been prepared as a publication under an award to the Metropolitan Transportation Commission, as part of a project to increase worker-ownership for low- to moderate-income workers. We aim to provide an overview of the legal steps involved for you, a selling owner, to convert your business to employee-ownership. We provide a few models of how to convert your business, the issues raised in valuing your business, and related financing, governance and employment law considerations. Finally, we close with a few case studies that illustrate the points we raised in the guide. We hope you find this guide useful and please submit any comments or feedback to us at communications@theselc.org.

## Important Disclaimers:

**The contents of this handbook should not be relied on as legal advice.** Some of this information could become outdated, and laws vary from place-to-place.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.

**This handbook was written by lawyers knowledgeable primarily about California law.** Although we tried to write in general terms that could be applicable across states, and although some legal matters are governed by federal tax law, anyone using this book should be aware of the necessity to research your own state's laws.

# Introduction to Employee-Owned Cooperatives

## The Benefits of the Cooperative Form

Cooperatives are member-owned and democratically controlled businesses that distribute profits based on an equitable patronage system.[1] Cooperative membership is typically restricted to suppliers, customers, workers, or some combination thereof.[2] In addition to ownership, control, and patronage-based profit sharing, most cooperatives adhere to the seven internationally-recognized cooperative principles: (1) voluntary membership, (2) democratic member control, (3) member economic participation, (4) autonomy and independence, (5) education, training and information, (6) cooperation among cooperatives, and (7) concern for the community.[3]

Currently worker cooperatives represent a relatively small portion of the annual $500 billion dollar U.S. cooperative sector,[4] and a similarly small portion of employee-owned businesses in the U.S.[5] Nonetheless a myriad of studies have demonstrated the distinct advantages that employee ownership presents when compared with the traditional investor-owned businesses,[6] and worker cooperatives often present significant long-term advantages when compared with other forms of employee ownership.[7] Considering the advantages of employee ownership, it is no surprise that the number of employee owned businesses have grown in recent years, both in the U.S. and abroad,[8] and cooperatives have performed particularly well when compared with other firms during the recent recession.[9]

Given the advantages of worker cooperatives compared with investor-owned and other employee-owned forms of business, the relative rarity of worker co-ops is surprising, and is often attributed to workers' lack of capital and expertise.[10] But in light of the rapidly changing nature of the economy, the growing interest in worker cooperatives, the constant growth of employee ownership, and the structural advantages presented by worker cooperatives, the worker cooperative sector is only likely to expand in coming years. Given this trend, business and legal professionals should become familiar with the cooperative structure, and legal rules that govern cooperative enterprise.

---

[1] *Think Outside the Boss*, at 1-2 East Bay Community Law Center and Sustainable Economies Law Center (5th ed. 2014) *available at* https://d3n8a8pro7vhmx.cloudfront.net/theselc/pages/146/attachments/original/1417036445/TOTB5_Manual_FINAL.pdf?1417036445.

[2] *See* Peter Molk, *The Puzzling Lack of Cooperatives*, 88:899 Tulane L.J. 899, 901 (2014).

[3] Sushil Jacob, *Representing Worker Cooperatives in the 21st Century*, California Law Practitioner, Winter 2014 at 26-27.

[4] *See* Molk, *supra* note 2 at 917.

[5] Jaques Kaswan, *Projecting the Long-Term Consequences of ESOP Vs. Co-op Conversion of a Firm on Employee Benefits and Company Cash* at 1 (Democratic Bus. Ass'n of N. Cal. ed. 1992).

[6] *See e.g. Key Studies on Employee Ownership and Corporate Performance*, nceo.org, http://www.nceo.org/articles/studies-employee-ownership-corporate-performance (last visited March 20, 2015).

[7] *See id.* at 11-16 (arguing that for low-growth employee-owned firms, Co-op members should experience increasingly higher benefits when compared with ESOP members, while in high-growth firms ESOP members experience higher benefits during the initial years, followed by a reversal where Co-op members experience higher benefits for the duration of the business' life).

[8] *See e.g. Delivering Responsible Capitalism - The Growth of Employee Ownership*, Forbes Opinion (September 25, 2014, 7:32 AM) http://www.forbes.com/sites/jonathanrefoy/2014/09/25/delivering-responsible-capitalism-the-growth-of-employee-ownership/.

[9] *See* Bruno Roelants et al., *The Resilience of the Cooperative Model* (CECOP-CICOPA Europe, June 2012) *available at* http://cecop.coop/IMG/pdf/report_cecop_2012_en_web.pdf.

[10] Jacob *supra* note 3 at 27.

## The Legal Definition and Structure of Cooperatives

The legal definition of cooperative may vary based upon state or federal law. For instance, a cooperative may refer to a particular type of legal entity - the Cooperative Corporation - whose legal requirements vary from state to state.[11] On the other hand, in some states cooperatives may operate under a number of legal forms, such as cooperative corporations, LLCs, nonprofit mutual benefits corporations, general corporations or general partnerships.[12] And for certain federal tax provisions, only C Corporations, including cooperative corporations, may be considered cooperatives.[13]

Although the legal definition of cooperative may vary, cooperatives generally share a common set of operational characteristics: (1) each member has substantially equal control and ownership; (2) members have a functional role in the business; (3) transfer of ownership interest is prohibited or limited; (4) there are strict limits to return on capital investments; (5) economic benefits pass to members on the basis of their patronage; (6) members are not liable for the cooperative's obligations; (7) businesses services are primarily used by the members.[14] Nonetheless, businesses that do not exhibit all of these features may still be considered cooperatives for federal tax purposes.[15]

### Voting and Governance

Unlike investor-owned businesses - in which major business decisions and board elections are made by shareholders with voting power in proportion with the number of shares they own - in cooperatives members exercise control of the enterprise on a one-member one-vote basis. Cooperatives generally have boards of directors that exercise and oversee corporate duties and owe the company fiduciary duties of care and loyalty. Most worker cooperatives utilize such a representative governance structure, in which a class of employee-members elect the board of directors. A minority of worker cooperatives are organized as *collectives*, in which all employee-members serve on the board, and all members vote on key decisions.[16]

### Patronage Distributions and Capital Distributions

Unlike traditional investor-owned firms, the primary purpose of cooperatives is to benefit their members as patrons, rather than to maximize profits for capital investors. As such, whenever a cooperative earns a surplus of net revenue, the cooperative can retain it as working capital or distribute it to the members on the basis of their patronage. In the worker cooperative context, a workers patronage is typically determined on the basis of the number of hours the member worked or on the basis of how much he or she earned in wages. A minority of cooperatives also choose to distribute their net earnings on the basis of capital contributions. Unlike capital distributions, however, patronage distributions are tax-deductible to the cooperative.[17]

---

[11] *Think Outside the Boss supra* note 1 at 3.
[12] *See* Jacob *supra* note 3 at 28.
[13] *See* 26 U.S.C. 1042.
[14] Jacob *supra* note 3 at 28.
[15] *See* 26 U.S.C. 1042 (c)(2)(E) (allowing some members to have greater ownership interests); *see also infra* p. 13.
[16] Jacob *supra* note 3 at 31.
[17] *Id.*

## Capital Structure, Capital Accounts

In order to facilitate the payment of patronage dividends, most cooperatives have a capital structure consisting of individual member capital accounts.[18] The member capital account system is similar to a partnership's capital structure. Unlike a partnership, however, rather than all of the surplus passing through to the cooperative members, cooperative corporations may retain their surplus in an unallocated capital account for general business and administrative use.[19] In addition to the unallocated capital account, which is subject to corporate tax rates, the cooperative can draw from the undistributed portion of member capital accounts as an internal source of financing. The unallocated capital account combined with member capital accounts comprises the book value of the company.[20]

## Types of Legal Entities

While worker cooperatives can operate under a number of different entities, worker cooperatives are most commonly organized as cooperative corporations and LLCs. The precise requirements for cooperative corporations may vary from state to state, but the cooperative corporation is often considered the entity that best incorporates the cooperative principles of democratic ownership and control.[21] That is because most cooperative statutes provide for direct worker participation in governance, and provide for distribution on the basis of member patronage. On the other hand, LLCs are also great vehicles for creating cooperative enterprise since they are quite flexible contract-based structures, and LLC members can easily ensure the cooperative principles are codified in the LLC Operating agreement. While both LLCs and cooperative corporations present great potential vehicles for cooperative enterprise, there are important differences between the two business forms. Because of the contractual basis for LLC operating structures, LLCs are more flexible when it comes to permitting variations in governance structure. They are also more flexible when it comes to member employment status, because members can be classified as employees or partners.

### Governance Structure

LLCs have incredibly flexible governance structures, which can present great options for small cooperatives, especially those that wish to operate informally in a collective fashion, since LLCs do not require a board of directors. A risk with LLCs is that, while the Operating Agreement can be crafted to include the cooperative principles of one-member one-vote, it can also be easy for future LLC members to change to a non-cooperative governance structure by simply amending the Operating Agreement. Cooperative corporations often do not present the same risk of future abandonment of the cooperative principles, since many cooperative statutes have democratic member participation as a permanent governance feature.

### Employment Status

In cooperative corporations the worker members are often presumed to be employees. Thus most businesses organized as cooperative corporations must ensure adherence to employment law, including payment of minimum wage, deduction of payroll taxes, provision of workers' compensation insurance and payment of overtime. The presumption that members are employees also means that all cooperative

---

[18] *Id.* at 33.
[19] *Id.*
[20] *Id.*
[21] *See Think Outside the Boss supra* note 1 at 14.

members should have legal authorization to work in the United States. By contrast, LLC members are generally not considered employees, but are treated as partners. This means that members of LLCs are often not required to be paid minimum wage, pay payroll tax, or have workers' compensation insurance. It also means that the LLC may provide a vehicle of cooperative ownership for workers that are precluded from becoming employees.

## Deciding to Convert into a Cooperative

While worker cooperatives may present economic advantages, the decision to form or convert an existing business into a cooperative typically involves additional concerns beyond competitive advantage. Cooperatives help keep money circulating locally, thus providing communities with a greater degree of economic autonomy, they afford members with greater job security, foster community and worker happiness, and are conducive to environmental responsibility, since they are so rooted in local communities.[22] Thus businesses that are trying to foster these values should consider the cooperative form. Business owners considering converting into a cooperative should also consider whether the business' workers are open and committed to cooperative principles and prepared to assume a more active role in business management.[23] Additionally they should assess whether the appropriate financial circumstances exist to enable conversion. In assessing whether and how to convert into a cooperative, professional assistance from legal, financial and accounting professionals can prove essential.

The next section covers the mechanics of conversion, highlighting four possible ways for you to sell your business to your employees and form an employee-owned cooperative.

[22] *See Id.* at 4.
[23] *See id.* at 7.

# The Mechanics of Cooperative Conversion

## Four Cooperative Conversion Types

As described later in this handbook, there are two primary ways to sell a business, each with pros and cons: An asset sale and an entity sale. In the former, a business sells all of its assets to another entity or person. In the latter, the owners/shareholders of the business sell their interests/shares to another entity or person.

In selling a business to workers to create a cooperative, there is an added layer of consideration around the mechanics of how the business will transform its financial, governance, and entity structure to that of a worker cooperative. In some cases, a new cooperative entity will be formed to acquire the assets or shares of the original business. In other cases, the original entity will simply restructure into a cooperative. Combining both layers of considerations, we have outlined four scenarios for how a cooperative conversion might play out:

### Type A: Convert the Original Entity

The **original entity converts to a cooperative** by filing amended and restated Articles of Incorporation and adopting amended Bylaws (or an amended Operating Agreement, in the case of an LLC). The original owners redeem some or all of their shares/interests in exchange for cash, promissory notes, and/or preferred shares. Workers become members of the cooperative, usually by contributing capital. In many ways, this may be the simplest way to complete a cooperative conversion, but it may not be ideal in all cases, as described below.

### Type B: Form a New Entity and Acquire the Business' Assets

**The workers form a new cooperative entity, and acquire assets of the original business.** This approach has the benefit of enabling workers to organize and operate as a cooperative, even before taking over the business. The new entity can act independently to raise money, negotiate with business owners, and begin practicing democratic governance.

### Type C: Form a New Entity that Buys the Original Entity, Merge the Two Entities

**The workers form a new cooperative entity and acquire the shares/interests held by former business owners, then merge the entities.** There are at least a couple scenarios where this might occur. One is where the sale of shares, as opposed to the sale of assets, offers a tax advantage to one of the parties. Another is where a shareholder of the original entity resists cooperative conversion and refuses to redeem his/her shares. In such a case, depending on the terms of the business' Bylaws or stock plan, sometimes the only way to legally force redemption is to do a "reorganization." Merging the entity with another entity generally counts as a reorganization under statutory definitions.

### Type D: Form a New Entity that Buys the Original Entity, Operate Both Entities

**The workers form a new cooperative entity and acquire the shares/interests held by former business owners, then continue to operate the business under the original non-cooperative entity.** There are at least a couple scenarios where this might take place. In multi-stage buy-outs, the worker cooperative entity can operate primarily as a shell that slowly acquires the interests of the owners of the primary business entity, until such time as it acquires a sufficient share of the interest and merges. In other cases, the operation of the business under the umbrella of a conventional corporation may be preferred by the lenders that finance the worker buyout. In this way, shares of the conventional corporation may be pledged as a security for the loans. In both cases, the two entities could eventually merge when the cooperative pays off its obligations to the sellers and lenders.

In a Type D conversion, although the business operates under a conventional corporation, the characteristics of a cooperative can be established by requiring that the cooperative entity appoint its own Board to act as the Board of the primary business entity, and that it allocate dividends on the basis of the cooperative members' patronage of the primary business. This scenario, however, would require careful review to determine whether the cooperative is eligible for taxation under Subchapter T of the tax code. While a Type D conversion may offer benefits to the sellers and lenders, the workers and cooperative may be ineligible for the pass-through tax status they would receive in a straightforward cooperative. In addition, in order to receive the benefits of the 1042 capital gains rollover, the owners need to sell their business interests to a qualifying worker cooperative. More research is needed, but it is possible that the workers would actually need to be employed by the cooperative entity, which would act as an employee leasing company for the primary business entity. If that is the case, this adds significantly to the administrative burden of the entities, particularly with regard to compliance with employment laws.

## Deciding Between an Asset Sale or Entity Sale[24]

Businesses can be sold, and their assets transferred, either through an asset sale or an entity sale. In an asset sale, the entity sells its tangible and intangible assets to the buyer, while the entity's owners retain equity in the entity. On the other hand, in an entity sale, the seller transfers his or her equity to the buyer, who acquires the entity with all of its assets. Where the business is a sole proprietorship, the sale by default will be a sale of assets, because there is no entity apart from the owner. Where the entity is a partnership, LLC or corporation, the buyer and seller will generally have some choice over how the business should be sold.

Whether a business sale should be structured as a sale of assets or as an entity sale depends on a number of factors, not the least important of which is what the buyer is willing to accept. Other crucial factors that will weigh on both buyer's and seller's choice will be (1) the existence of outstanding liabilities; and (2) the disparate tax effects that would result from the sale of assets when compared with the sale of the business entity. The tax implications are especially important where the seller's business is a C Corporation because a sale of assets might result in double taxation. Where the business is converting from an investor owned or closely held C Corporation to an employee owned business, the incentive to sell the business' equity to the employees is increased, because Section 1042 of the Tax Code provides significant tax benefits to qualifying companies that transfer equity into employees' hands.

Unfortunately, tax and liability considerations often pit seller and buyer against one another. Typically, the seller would prefer to transfer equity, while the buyer would prefer to buy a pool of assets. Moreover, where both parties have agreed to an asset sale, the parties' interests often conflict as to how the sales price should be allocated across assets. In the cooperative context, these concerns will undoubtedly exist, but may be less pronounced, especially where the seller intends to stay on as a worker-owner, employee or consultant. For attorneys intending to represent the seller, the buyer, or both in a conversion project, please see [§ 41 of this guide], Legal Representation During Conversion.

### Outstanding Liabilities and Method of Sale Choice

---

[24] This section draws heavily from Fred S. Steingold, *Sell Your Business, The Step by Step Legal Guide*, 4/2-4/13 and 9/2-9/19 (Marcia Stewart and Jake Warner eds., 1st ed. 2004).

As a general rule, any outstanding liabilities will follow the business entity, but will not follow the business' assets. Thus where a buyer purchases a business entity, he or she will be stuck with the business' outstanding liabilities. On the other hand, in the vast majority of cases, if the buyer opts to purchase the business in an asset sale, he or she can buy them free and clear of outstanding liabilities. The only exception to the "free and clear rule" is a doctrine known as successor liability, which applies in the some states, but only in the manufacturing context. For these states, if the buyer purchases a manufacturing business through an asset sale, and continues engaging in substantially the same type of production, he or she may be held liable for tort claims stemming from the seller's manufactures. In any case, because outstanding liabilities and debts follow the business entity, where such liabilities exist, the buyer will likely be much less inclined to purchase the business through an entity sale.

## Tax Considerations in Method of Sale Choice

When a business owner decides to sell his or her business he or she must carefully consider the various tax rates that might apply, for the applicable tax rates will have significant bearing on what transactional structure the seller should seek, and might even affect the final sales price and business valuation. The potentially applicable tax rates include (1) ordinary income tax rates, which max out at 39.6%; (2) corporate income tax rates, which range from 15% to 35%; (3) long-term capital gains tax, which range from 0-15%; and (4) the real estate recapture tax rate of 25% for all non-accelerated depreciation.

What tax rates apply will depend upon a number of factors including the ultimate form of the transaction (i.e. whether the sale is an entity or asset sale), the terms of sale, whether the value of the business' capital assets has been written off, what entities are involved, the business' income, and the seller's present and future personal income, among others.

## Noncapital Assets, Capital Assets and Capital Losses

### Noncapital Assets

Noncapital assets consist of any asset that the IRS does not categorize as a capital asset.[25] Noncapital assets include: inventory, promissory notes given to the business, accounts receivable and real estate or other depreciable trade or business property held for less than a year. Proceeds from the sale of noncapital assets are treated as ordinary income or loss.

### Capital Assets

Capital assets include equipment, real estate, good will and some intellectual property. Some capital assets, known as Section 1231 assets, can be depreciated. These typically consist of business real estate, furniture, fixtures and equipment held by the business for over a year, and intangible property that can be amortized under Section 197.

When a business acquires a Section 1231 capital asset it is permitted to depreciate, or "write off," the value of the asset over the period of its anticipated useful life, by allocating the asset's depreciation as an expense on the company balance sheet, in accordance with the General Accepted Accounting Principles.[26] If the business opts to depreciate the asset using a straight-line method, it will allocate the same dollar amount of depreciation as an expense each year of the asset's anticipated useful life.[27] The business may also use some accelerated method of depreciation, in which a greater portion of the asset's

---

[25] *IRS Publication 544*, *available at* http://taxmap.ntis.gov/taxmap/pubs/p544-012.htm#TXMP6d1fb63b
[26] *See* 7: Property, Plant, and Equipment, 2002 WL 31118534
[27] Jerry J. Weygandt et al., *Basic Accounting* 430 (Christopher DeJohn and Brian Kamins eds. 8th ed. 2007).

value is written off in the early years of its anticipated useful life.[28] Intangible personal property outlined in Section 197 has a minimum authorized useful life of 15 years.[29] Other properties may be depreciated in 3, 5, 7, 10, 20 or 25 years, as set forth in the tax code.[30]
Whichever method is used, at the end of the asset's anticipated useful life, its entire value will have been written off, and its book value will be zero. Of course, this does not actually mean that the asset is without value, so long as it can be sold for some price.

Where a capital asset is sold that has been held for over a year, and is not eligible for depreciation, or has not been depreciated, all proceeds resulting from its sale will be taxed at the long-term capital gains rate - typically 15%.

### Capital Losses

Where the sale of capital assets leads to net capital losses, sellers may subtract the loss from their ordinary income for up to $3000 a year ($1500 if married and filing separately) until the capital loss is used up.

## Depreciation Recapture

Capital assets that have been depreciated, and are sold for an amount that exceeds their book value are subject to deprecation recapture taxation. Depreciation recapture taxation enables the IRS to tax the full value of capital assets whose book value has been depreciated below the sales price.  Recapture taxation is thus inapplicable in sales of capital assets that (1) cannot be depreciated, (2) have been held for less than a year by the current owner, or (3) have been sold for an amount equal to or less than the asset's book value.

Where some portion of a capital asset has been depreciated and the asset is sold for more than its book value, it is subject to a recapture tax on the amount of the sales proceeds, exceeding the book value. With the exception of real estate, where a Section 1231 asset is sold, any sales proceeds that exceed its book value will be taxed at the ordinary income rate. For real estate, any accelerated depreciation must be recaptured at ordinary income rates, while non-accelerated depreciation is taxed at a 25% capital gain rate.

## Effects of Entity Form

### Pass- Through and Taxable Entities

Whether or not the business being sold is some type of pass-through entity - such as a sole proprietorship, a partnership, an LLC that has not elected to be taxed as a C Corporation, or an S corporation - can greatly affect the amount of the sale proceeds that will be taken from the proceeds resulting from an asset sale. Whether or not the business has been organized as a pass-through entity will thus influence the sellers' willingness and/or motivation to agree to sell the business as a collection of assets.

A pass-through entity is one that does not pay income tax. Rather, the tax burden is passed through to the shareholders or interest holders, who are taxed on the portion of the business income they receive at

---

[28] *Id*. at 432.
[29] *See* 26 U.S.C. § 197 (a) ("The amount of such deduction shall be determined by amortizing the adjusted basis (for purposes of determining gain) of such intangible ratably over the 15-year period beginning with the month in which such intangible was acquired").
[30] *See IRS Publication 946*, 32 - 33, *available at http://www.irs.gov/pub/irs-pdf/p946.pdf*.

the applicable personal income tax rate. Because of this structure, when a business organized as a pass-through entity sells its assets, the amount of proceeds attributable to each interest or shareholder will be subtracted from the sales price, paid to that interest or shareholder, and taxed at his or her personal income tax rate.

Where the business is not a pass-through entity, i.e. an LLC or Corporation that has elected C tax status, the proceeds resulting from an asset sale will be subject to double taxation. This is so because non-pass-through entities are subject to direct taxation on their income stream at the applicable corporate income tax rate. And, if the business is profitable, and distributes some portion of its profits to shareholders or interest holders, the shareholder or interest holder pays additional taxes at the dividends tax rate, usually 15%.

This form of double taxation may benefit businesses, if the corporation distributes all annual profits as employee compensation, or if it invests back into the business and takes advantage of favorable retained earnings tax rates for earnings under $100,000. On the other hand, where a corporate taxed entity engages in the sale of capital assets, it is subject to the same double taxation, but without the corresponding benefits. Proceeds from the sale will be taxed first as corporate income at the applicable corporate income tax rate, then the owners will be taxed for the share of proceeds distributed to them individually, at the dividends tax rate.

### Sole Proprietorships and Single Member LLC's

Where the business entity is a sole-proprietorship or single member LLC, the business will be sold as a collection of assets, and proceeds from the sale will be treated as the seller's personal income. However this does not mean that all of the sale's proceeds will be taxed at the personal income rate. For some assets, the seller will pay long-term capital gains tax (if those assets have been held for over a year), while for others the seller will pay the ordinary income rate. Thus, the seller of a sole proprietorship or single member LLC will pay long-term capital gains tax rates - most often 15% - for gains stemming from the sale of inventory and equipment held for over a year, for which no depreciation has been taken. On the other hand, on equipment for which a depreciation has been taken, the recapture rule applies. In such an instance, where the asset is sold for a price that exceeds the asset's depreciated value all gains above the depreciated value will be recaptured and treated as ordinary income.

### Partnership and Multi Member LLCs

#### Entity Sale

In the sale of a partnership or LLC, each partner or member's ownership interest that has been held for more than one year is treated as a capital asset. As such, the portion of sales proceeds that a partner is due, based upon his or her interest, is generally subject only to the long-term capital gains rate, typically 15%. On the other hand, if the partner held his or her interest for less than one year, it will be taxed at the ordinary income rate.

#### Asset Sale

Where a partnership or Multi Member LLC is sold in an asset sale, the entity itself will not be taxed. The portion of the proceeds due each partner or member, based upon his or her interest, will pass-through and be subject to either the long term capital gains tax rate, or to the applicable income tax rate, depending on how the sale price is allocated among the different classes of assets. [*See* §4].

### Corporations

#### Entity Sale

The sale of corporate equity is treated as the sale of a capital asset. Thus, in an entity sale, where the equity holder owned the stock for over a year, proceeds from the sale are taxed at the long-term capital gains tax rate. Where the shareholder held the equity for less than a year, on the other hand, proceeds are taxed at the applicable individual income tax rate.

Where the sale of a corporate entity results in a net loss for the seller, the loss will be treated as a capital loss, an ordinary loss, or both. An ordinary loss is a loss that directly lowers one's taxable income. Thus, if the seller of a business suffered a net loss of $75,000 and earned $100,000 the same year, an ordinary loss would reduce the seller's taxable income to $25,000. This would have the corresponding benefit of reducing the seller's overall tax rate.

While most losses will be treated as capital losses, Section 1244 of the Tax Code enables certain small business shareholders to treat the first $50,000, or the first $100,000 if filing jointly with a spouse, as an ordinary loss. To treat loss as ordinary (1) the seller must have been the first purchaser of the stock; (2) the stock must have first been issued by a small business corporation in exchange for cash or other property, excluding securities or stock; (3) the stock must have been issued to the seller as an individual; (4) no more than half of the corporation's gross receipts from the past five years may have come from passive income; (5) the total amount the corporation received for all Section 1244 stock may not have exceed $1 million; (6) the corporation must be a U.S. Company.[31]

Where the six conditions required for proper designation as Section 1244 stock are not present, the seller's losses will be treated as a capital loss. In such an instance, the seller may only subtract $3000 a year, or $1500 if married and filing separately, from his or her ordinary income, until the capital loss is used up.

<u>Asset Sale</u>
While both S and C corporations are subject to the same types of taxation if sold as entities, where a business organized as a corporation is sold in an asset sale, whether it is an S or C corporation can have a big difference on the tax rate that will be applied to proceeds of the sale.

### S Corporations

Because an S Corporation is a pass-through entity, selling an S corporation through an asset sale will not result in double taxation at the federal level. Rather, each shareholder will pay taxes on his or her share of the proceeds at the long-term capital gains rate and/or the applicable individual income tax rate, depending on how the sales price is allocated.

Nonetheless, S Corporations may be subject to additional taxation that other pass-through entities are not. Thus some states will tax the entity itself on the proceeds resulting from an asset sale, leading to double taxation at the state level. Additionally, if the S corporation has been converted from a C corporation within the past decade, it might be subject to a "built-in gains tax," which is computed at the highest corporate rate of 39%.

An S corporation that converted from a C corporation within the last ten years, and which held assets whose fair-market value exceeded their tax basis, would be subject to built-in gains tax of 39% for those assets.

[31] 26 U.S.C. 1244.

## C Corporations

Because C Corporations are not pass-through entities, proceeds from the sale of assets held by a C corporation will generally be subject to double taxation: the proceeds will first be taxed at the long term capital gain, depreciation, or corporate income tax rate, depending upon how the sales price is allocated. If most of the corporation's assets are noncapital assets, they will be taxed as ordinary income, and any proceeds distributed to shareholders will be taxed at the dividends tax rate, typically 15%. Thus, where a business organized as a C Corporation is sold in an asset sale, the shareholders could potentially receive less than half of the proceeds earmarked for them if the assets are noncapital assets.

## Section 1042

As discussed above, when a business is organized as a C Corporation the seller would do better to sell the business by transferring equity to the buyer, rather than transferring the corporation's assets. Structuring the sale of the business as an equity sale as opposed to an asset sale will enable the seller to avoid double taxation. The incentive for structuring the sale of a C Corporation as an entity sale is all the more pronounced when the business is being sold to its employees, because Section 1042 of the tax code enables business owners to reduce the amount of taxable proceeds resulting from the sale of equity to employees.

Section 1042 enables some business owners that sell their company to employees to defer capital gains taxation, and potentially avoid it altogether. In order to qualify for Section 1042 deferral the seller must (1) have owned the stock for more than three years prior to transfer; (2) have transferred at least 30% of the company's overall equity, and at least 30% of each class of outstanding stock, to his or her employees; and (3) issue a written statement to the IRS consenting to certain tax rates and requirements.[32] Two or more shareholders can combine their sales in order to meet the 30% requirement, so long as the sales are part of a "single, integrated transaction."[33] Moreover, the 30% requirement may be met over a series of multiple transactions - but only the transaction that facilitates employee ownership of 30% or more of the company will qualify for Section 1042 treatment.[34] After the initial 30% threshold is reached, all subsequent transfers to the ESOP or eligible worker cooperative will qualify for Section 1042 treatment.

In addition to the seller requirements, Section 1042 is only applicable where (1) the selling business is a C Corporation at the time of the sale (although some businesses other than C Corporations may be able to take advantage of Section 1042 by converting to C Corporations), (2) the equity is transferred to an ESOP or an "eligible worker-owned cooperative," and (3) the seller reinvests the proceeds of the sale in "qualified replacement property."

The seller has a 15-month period within which he or she can reinvest the proceeds or the equivalent amount in qualifying property: a three-month period before the sale, and a twelve-month period afterwards.[35] After rolling over the proceeds or their equivalent, if the seller chooses to hold the replacement property until death, he or she can avoid taxation on the proceeds from the 1042 sale

---

[32] *See* 26 U.S.C. § 1042

[33] Scott Rodrick, *An Introduction to* ESOPs, Kindle Edition, Location 274, (Nat'l Cent. for Emp. Ownership, 14th ed. 2014).

[34] Corey Rosen and Scott Rodrick, *Understanding ESOPs*, Kindle Edition, Location 364 (Nat'l Cent. for Emp. Ownership, 2014).

[35] *ESOP Tax Incentives and Contribution Limits*, nceo.org, http://www.nceo.org/articles/esop-tax-incentives-contribution-limits (last visited March 20, 2015).

altogether.[36] Nor will the seller be taxed if he or she gifts the qualified replacement property,[37] or if he or she transfers the property to a living trust[38] or a grantor retained annuity trust.[39]

### Eligible Worker Cooperative

In order to qualify for Section 1042 tax deferral, the selling business owner must transfer his or her equity to an ESOP or an eligible worker cooperative. There is currently no administrative decision or guidance on the precise definition of an eligible worker cooperative beyond the text of Section 1042 itself. Section 1042 provides that to qualify as a worker coop, part I of Subchapter T must apply to the organization, a majority of the voting stock must be owned by the members, a majority of the members must be employees, and a majority of the Board must be elected by the members on a 1 person 1 vote basis.

In addition to these requirements, S. 1042 (c)(2)(E) provides that "[t]he term 'eligible worker-owned cooperative' means any organization . . . a majority of the allocated earnings and losses of which are allocated to members on the basis of patronage, capital contributions, or some combination thereof." While this provision expressly requires that most allocated earnings or losses be allocated on the basis of patronage or capital contribution, it does not require that most of the company's earnings be allocated. Because the express terms of S. 1042 do not give any guidance as to how non-allocated earnings or losses should be distributed, there is nothing within the provision that would suggest that a majority of the company's non-voting stock must be owned by employees. This is important, as it provides owners with the option of financing the sale of their business to their employees, while retaining a majority ownership until the committee pays off the first seller-financed installment. For an example of such a transaction, see the Select Machine case study below.

### Qualified Replacement Property

In order to take advantage of Section 1042, a qualifying seller must reinvest, or rollover, the proceeds from the sale or an equivalent amount into qualifying replacement property.[40] Qualified replacement property includes stocks, bonds, notes and securities of operating corporations, incorporated in the U.S.[41] Preferred shares may also qualify as replacement property, but only if convertible into common stock at a reasonable price.[42]

### 1042 for Entities Other than C Corporations

While a business must be a C Corporation to qualify for Section 1042, some businesses may be able to take advantage of Section 1042 by converting into C Corporations.

#### S Corporations

S Corporations may simply revoke the S Corp election and elect C-status, enabling shareholders selling to an ESOP or qualifying coop to take advantage of the 1042 tax deferral.[43] Moreover, five years after

---

[36] *Id.*
[37] 26 U.S.C. 1042
[38] I.R.S. P.L.R. 9141046 (Oct. 11, 1991)
[39] I.R.S. P.L.R. 200709012 (Mar. 2, 2007) ("Provided that the Taxpayer is treated as the owner of the QRP held in the GRAT under sections 671 and 675 at the time of the transfer, the transfer of QRP to the grantor retained annuity trust does not constitute a disposition of the QRP under section 1042(e)");
[40] *Id.*
[41] Rodrick *supra note* 33, Location 269.
[42] 26 U.S.C. 409 (l)(3).
[43] *See* Rosen *supra* note 34 at Location 565.

the sale, the corporation can reelect S status. Whether converting to a C Corp is advantageous will likely depend upon whether the selling shareholders have a high "basis" in their shares.[44] If the selling shareholders have a high basis in the S Corp stock, there is typically not a great advantage to revoking the S Corp election and taking the 1042 deferral.

Computing an S Corp shareholder's basis is a technical process that varies based upon how the shareholder acquired the stock, and requires knowledge of multiple provisions of the tax code and access to a wide swath of company records.[45] Generally speaking however, a shareholder's basis is his or her initial capital contribution, plus or minus the flow through amounts from the S corporation.[46] If the shareholder acquired his or shares by forming the corporation, the initial capital contribution is the sum of cash and the adjusted tax basis of property contributed to the formation of the corporation. If the shareholder acquired the stock through purchase, the initial capital contribution is generally the cost of acquiring the stock. Different rules apply for stock that was gifted, inherited, or converted from a C Corp.[47] After determining the S Corp shareholder's initial contribution, the shareholder's basis is increased by his or her share of the business' income, and correspondingly decreased by his or her share of the loss.[48]

Because of the complexity of determining a shareholder's basis in stock of an S Corp, and because of the importance of other tax considerations, S Corps considering converting to C Corps in order to take advantage of S. 1042's tax deferment should work closely with an accountant or other tax professional.

Partnerships and Other Ownership Interests
Outside of the corporate context, the IRS may count the holding period of a seller's non-corporate ownership interests towards the 1042 three-year requirement once the ownership interest has been converted into corporate stock. While there is nothing directly in the code that supports this proposition, prominent organizations endorse it,[49] and an IRS private letter ruling lends some support as well.[50] However, sellers should be cautious, since the private letter ruling dealt with an LLC that had elected to be taxed as a C corporation from the outset, and private letter rulings are not precedential.

## Allocating the Purchase Price in an Asset Sale

### The IRS Categories of Allocation

When a business is sold by asset sale, the parties must allocate the sales price across seven categories provided by the IRS. The manner in which the sales price is allocated can significantly affect what tax rate will apply. The seven categories include: (I) cash and cash like assets; (II) securities, including share

[44] Rodrick *supra note* 33, Location 595.
[45] *See S Corporation Stock and Debt Basis*, irs.gov, http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/S-Corporation-Stock-and-Debt-Basis (last visited March 24, 2015); *see also* Meredith A. Menden, *The Basics of S Corporation Stock Basis*, Journal Of Accountancy (December 31, 2011) http://www.journalofaccountancy.com/issues/2012/jan/20114319.htm.
[46] *Id.*
[47] *See* Menden *supra* note 45.
[48] *See S Corporation Stock and Debt Basis, supra* note 45.
[49] Rodrick *supra* note 33, at Location 292 ("if a seller received the stock as a gift or acquired it in a tax-free exchange (e.g. a partnership interest converted to stock when the partnership incorporated) the three year holding period includes the prior holding period of the donor of the partnership interest").
[50] P.L.R. 200827018 (July 4, 2008) (ruling that the time period that sellers had held ownership interest in an LLC partnership that had elected C Corporation tax status and subsequently converted into a C corporation would be counted towards S. 1042's three-year requirement).

certificates, government securities, readily marketable stock or securities, and foreign currency; (III) accounts receivables and debt instruments; (IV) inventory; (V) other tangible property, including land and buildings, furniture, equipment and fixtures (improvements permanently attached to buildings); (VI) and other intangible property, which includes covenants not to compete, intellectual property, customer or client lists and licenses or permits granted by the government; and (VII) goodwill and going concern value.[51]

### Conflicting Interests

Generally speaking, the seller will retain class I and II assets. Because the buyer typically does not purchase these assets, none of the sales price will be allocated to classes I and II. Additionally, because of the risks associated with collecting on accounts receivable, the seller often retains all class III assets as well; although the seller might incentivize the purchase of accounts receivable by selling them at a discount. In either case, there is not typically a strong preference to maximize or minimize the value allocated to class III assets on either the buyer's or seller's part.

Most of the conflict between buyer and seller pertains to asset classes IV - VII. As will be explained, the seller would like to minimize the amount of the sales price that would be allocated towards noncapital and depreciable tangible capital assets, while maximizing the allocation towards real estate and intangible capital assets. On the other hand, it will typically be in the buyers' best interest to minimize the amount of the sales price allocated towards real estate and intangible capital assets, while maximizing the amount of the sales price allocated towards depreciable tangible capital assets and non-capital assets.

#### Seller's Interests Explained

The reasons underlying the seller's preferences have been briefly alluded to above. For the seller, any allocation towards noncapital goods will be taxed at his or her ordinary income rate. Additionally, any allocation towards depreciated tangible assets will be subject to recapture taxation at the applicable personal income tax rate, and thus will increase the seller's exposure to tax liability. Because much of the common depreciable capital assets that a business is likely to possess can be written off in under 7 years, many of these assets are likely to be substantially or fully depreciated. Consequently, a substantial portion of the sales price allocated towards those assets could be taxed at the seller's ordinary income tax rate. If the seller is a C corporation, or an entity that has elected to be taxed as a C Corporation, that means the applicable corporate tax rate. If the seller is a pass-through entity, the proceeds would be taxed at the applicable personal income tax rate of the interest or shareholders.

On the other hand, by allocating the maximum amount towards non-depreciable capital assets held for over a year, the seller can ensure that the proceeds are taxed at the long-term capital gains tax rate. And while "goodwill and going concern value," and other intangible assets listed in Section 179 can be depreciated, they cannot be fully depreciated for at least 15 years. Thus there is greater likelihood that the asset will not be substantially depreciated. If the amount allocated towards these assets does not exceed the book value, the proceeds will only be taxed at the long-term capital gains rate. Lastly, by maximizing the amount allocated towards real estate, the seller can ensure that that portion of the

[51] *IRS Publication 544, available at* http://www.irs.gov/publications/p544/ch02.html#en_US_2014_publink100072483

proceeds is taxed at the real estate recapture rate of 25%, which often falls below the applicable ordinary or corporate income tax rate.

Buyer's Interest Explained

The buyer's interests are most often served by a markedly different allocation of proceeds. For one thing, the buyer receives no proceeds from the sale, and thus does not directly bear the tax burden of the sale. For another thing, while the seller is more likely to minimize his or her tax burden by allocating a greater portion of the proceeds to those assets that have a longer timeline of depreciation, the buyer is directly benefited by allocating a greater portion of the proceeds towards capital assets with a shorter depreciation timeline. This is so because the buyer will be able to use the amount of proceeds allocated towards the assets as their future taxable basis, and will be able to fully write off the value of the asset in the allowed amount of time. Where the allowed timeline for depreciation is shorter, the buyer can quickly reduce his or her tax burden going forward. While inventory is not a depreciable capital asset, it is a short-term asset that can be written off quickly, thus decreasing the buyer's tax burden in the near future.

# Valuing the Business and Determining a Sales Price[52]

## Overview of Factors Affecting Business Valuation

There is no singular gold standard on business valuation. Nonetheless, there are many commonly used methods, metrics, and market factors that a seller should consider in valuing his or her business. Some factors that will affect the price of the sale include the seller's personal needs, and the terms of sale. Additionally, in the cooperative conversion context, both the terms of sale and sales price will be affected by the need for worker-owners to receive wages immediately after the sale.

In addition, a seller's personal needs may significantly impact the sales price. For instance, the seller's desire to quickly complete the transaction and sever a future relationship may diminish the business' value. By contrast, where the seller is seeking to stay on as a consultant, an employee, or a worker-owner, the business' value will likely be greater, since the worker-owners will be able to draw from the seller's experience in running the business.

In addition to the seller's personal needs, the terms of sale can have a significant impact on the sale price of the business. Most sales of businesses are seller financed - meaning the buyer pays the seller in installments over time. As such, the precise terms of sale, including the interest rate, repayment period and amount paid down, can have a significant effect on the final sales price. Typically, to account for the additional risk associated with longer-term financing, and for the disparity between the present and future value of money, the longer the timeline for repayment, the higher the purchase price of the business.

Last, in the cooperative conversion context, because most worker-owners will be relying on the business for their primary source of income, the sale price and terms of payment must result in cash flow to cover operating expenses, seller related financing, and salaries. The need for these cash flows can affect both the overall business valuation and the final terms of sale.

## Appraisal and Valuation Approaches

There are three basic approaches to business valuation used by professionals: income based valuation, asset based valuation and market based valuation.[53] While the final sales price agreed upon between the buyer and seller may not correspond precisely with the number resulting from any of these approaches, each of the approaches can provide the parties with useful benchmarks, and thus provide a reference point for buyer and seller during the negotiation process.

### Income Valuation Methods

Income valuation provides a useful, but imperfect approach to affixing a value to a company. The utility of this approach in the employee-owned company context is questionable, since it assumes that the buyer is looking at purchasing the business merely as a source of investment income. Nonetheless, it can provide sellers seeking to convert their business to employee-ownership with a reasonable benchmark of valuation used by many businesses. Conversely the buyer can use this as a way to reduce the value of the business—i.e. if they know the seller has a much lower expected rate of return (i.e. below 10%). This may be a good method for employee committees to use in their negotiations with the seller.

---

[52] This section draws heavily from Steingold *supra* note 24 at 5/2 - 5/7.
[53] *See* Shannon Pratt and Alina V. Niculita, *The Lawyer's Business Valuation Handbook* 24 (American Bar Association 2d ed. 2010).

There are two basic approaches to income valuation: the discounted cash flow or discounting method, and the capitalization method.[54] The primary difference between the two methods is that the discounting method considers the return on investment over the life of the investment, whereas the capitalization method focuses on average returns within a single time period.

### Discounted Cash Flow Method

Using the discounting method, an appraiser would determine what income the investor could expect over the life of the investment, and then discount each increment of the stream of income back to present value at a discounted rate of return, or discount rate.[55]

The main benefit of using the discounting method is that it accounts for the time value of money. This could potentially be beneficial for a buyer's committee that is weighing the possibility of purchasing the business and wishes to determine whether the purchase of the business would make economic sense. Although, as previously indicated, income valuation approaches are likely less applicable in the cooperative conversion context. This may be particularly true of the discounting method, since the potential life of each cooperative member's investment period might diverge significantly, based upon the number of years he or she would remain employed at the firm.

### Capitalization Method

The capitalization approach is expressed by the formula: Business Value x Desired Rate of Return[56] = Expected Annual Profits. To use this method of valuation, the seller must first identify a target annual rate of return that he or she expects would be attractive to an investment-oriented buyer, typically between 10% and 20%. The seller must then identify, with reasonable accuracy, the business's profits for the next few years. After determining the annual profit, the seller divides this number by the desired rate of return. The resulting value would be the business' sale price.

For example, a Seller who reasonably anticipates that an investment-oriented buyer would want a 20% annual return, and reasonably anticipates that the average annual profit over the next few years will be $50,000, would divide $50,000 by .2, for a business valuation of $250,000.

### Market Methods

<u>Guideline Public Company Method</u>

The guideline public company method seeks to find public companies engaged in similar business as the private company being sold in order to find a potential free-market value of the equity. Using this method an appraiser or qualified seller would calculate valuation multiples from financial data of comparable public companies and apply the multiplier to the appropriate data from his or her company.[57]

This method is a bit more complicated than the other market methods and will likely require the assistance of a business appraiser. Furthermore, it is probably not applicable to most small companies, and should be limited to companies with annual revenues exceeding $5 million.[58] Nonetheless, it can

---

[54] *Id.* at 25.
[55] *Id.*
[56] This is also known as the capitalization rate.
[57] *Id.*
[58] Paul R. Hyde, *When to Use the Guideline Public Company Method*, Business Appraisal Practice, Spring - Summer 2004, at 5.

provide useful information for sellers, buyers' committees and their attorneys in assessing the potential value of the company. If a seller is interested in learning more about this method of valuation, Shannon Pratt's *The Market Approach to Valuing Business* is a great resource.

Sale of Comparable Businesses Method[59]
Ideally, a seller will look to market data on the sale of similar businesses to inform the ultimate sale price. This data, however, is not abundant and requires significant investment in time, and perhaps money, to obtain. Nonetheless, acquiring such data can be a great resource in providing the buyer with a reasonable estimate for what the business is worth. Resources for data on the sale of comparable businesses include trade publications, business brokers, Internet sources such as www.bvmarketdata.com's BizComp Service, and personal networks. Professionals, such as brokers and appraisers, can greatly assist in obtaining data on the sale of comparable businesses.

Industry Formulas and Standards
Certain formulas have gained credence in particular industries, but these should be treated only as rough approximations of business value, since they may be too broad to deal with particular factors affecting the seller's individual business. Common industry specific formulas include Sales or Earnings Formulas, which use some multiplier times gross sales or net earnings to identify a value, and Units Formulas, which use some multiplier times the number of customer contracts in place, or the number of machines in operation.

### Asset Based Methods[60]

Another basis of valuation is totally up the resale value of the business' tangible assets, and the value of intangible assets, such as leases, business name, intellectual property and customer lists. A company's asset based value should not be confused with its book value, which is an accounting term, and which may reflect depreciation on assets, thus not reflecting the true collective value of the company's assets. [61] Asset valuation will be affected by outstanding or potential liabilities, unless the seller agrees to assume sole responsibility for those liabilities.

## Working with Professionals

While it is advisable for sellers to independently assess the value of their business, they are strongly encouraged and may find it necessary to seek professional assistance, which can greatly contribute to identifying a price range. Accountants can help organize and evaluate a business' financial data, apply a pricing formula, and help present the pricing information in a compelling format. Brokers can help by tracking down information about sales of comparable businesses, and tailoring the information to current market conditions in the business' community. Appraisers can assist with company valuation, and are typically astute at assigning accurate value to tangible property. Additionally, a good appraiser might be able to identify business shortcomings and suggest ways to increase the business' value.

While professionals can greatly contribute to the valuation process, sellers must be mindful of the potential shortfalls and limitations of professional assistance, and make sure that the professional they

[59] This method is also often referred to as the guideline transaction method. *See* Pratt, *supra* note 53, at 25.
[60] This method is also known as the Adjusted Net Value Asset Method, and is one of two asset-based approaches. The other approach is known as the excess earnings method, and is really a hybrid of both the asset based approach and the capitalization income approach. *See id*. at 27.
[61] *See id.* at 11.

have identified has experience and a reputation of honesty. For instance, sellers should exercise caution when working with brokers, who are often paid on a commission basis. The seller should be clear about what they are seeking - market data on comparable business sales. Moreover, when working with brokers, sellers should be leery of initial "free" appraisals that assign a very high value to the business, as this is often a ploy to lure the seller into working with the broker who may charge a lot, only to ultimately assign a more realistic value. When working with appraisers, sellers should be mindful that most businesses' value exceeds the value of tangible assets, and accordingly should try to find an appraiser experienced in valuing nontangible factors such as favorable leases and goodwill. Bankers or real estate brokers might be able to help identify an appraiser with a good reputation. The American Society of Appraisers may be able to as well.

## Documents Required in a Cooperative Conversion

The documents required to convert a business to a cooperative are described below, although they will vary greatly depending on the form of business and the chosen process of conversion. Regardless of the process, there will likely be one large document that commits the parties to moving forward, outlining the entire conversion process in detail (we call this the "Conversion Agreement" below). Then, to fully execute the conversion, there will usually be a variety of smaller documents to create or convert any necessary entities, deed over real property, give parties necessary authority, and make the conversion official at closing. For Island Employee Cooperative, the time between executing the larger agreement (the "Stock Purchase Agreement") and the closing of the sale (which required simultaneous execution of multiple documents) took approximately 6 months.

### A Rough Timeline and Summary of Documents

Here, we have grouped the required documents into three primary steps. Note that, in the first two steps, there will be two categories of documents: 1) Agreements between workers and owners, and 2) Agreements between workers.

### Step 1 - Letter of Intent + Employee MOU – the "Ok, Let's Do This" Documents

One or two relatively informal and loosely-binding documents can be used to launch the conversion process. Even before getting to this point, both the owners and the workers will have likely done a great deal of exploration and assessment of the viability of conversion. Having concluded that they should go forward, a Letter of Intent signed by participating employees and owners, can lay a rough road map of the process, and a Memorandum of Understanding (MOU) signed by participating employees can describe how employees will work together in negotiating the buy-out.

#### The Letter of Intent

The first roadmap document, which we'll call "Letter of Intent," outlines the terms and process that the parties are contemplating and states that each party will make a good faith effort to iron out the details in a more firmly binding and detailed agreement. This Letter of Intent might be between one and four pages and could consist of simple bullet points. Although it is a short document and not intended to be strictly binding, it would preferably give each party an obligation to go forward with the process and make a reasonable effort to carry it out. This helps each party feel secure to commit time, money, and effort to larger steps, such as forming an entity, applying for financing, and so on. At this point, the owners might make an exclusivity agreement – agreeing to negotiate exclusively with workers and not seek or entertain other offers to buy the business. The parties might also want to agree not to disclose the details of the negotiations, if any of the business information is sensitive. Each worker may sign the Letter of Intent as an individual party, or, if the workers have an MOU and have appointed a Steering Committee, it may be signed by one or more individuals designated to represent the workers as a group. The owners' business entity (if any) should be a party to the agreement, and owners (as individuals) should likely also be parties, to the extent that individual owner consent will be necessary to complete the conversion.

#### Memorandum of Understanding (MOU) among Workers

The participating employees should all be on the same page about how to move forward, and they might want to form a "Steering Committee" to lead the cooperative conversion process on behalf of the employees. To officially appoint this committee to act on behalf of workers, the workers may want to execute an MOU, signed by all involved workers, describing their purpose, any commitments of time or money employees will pledge, powers granted to the Steering Committee, and how the workers will make decisions as a group. This could be a short and informal document, or, alternatively, it could mirror the Bylaws that the cooperative may eventually adopt, which has the benefit of giving the workers practice in operating as a cooperative and understanding Bylaws.

## Step 2 – The Conversion Agreement + Cooperative Governance Documents – the "Here is Exactly What Everyone is Going to Do" Documents

When everyone is in agreement and ready to fully bind themselves to the conversion process, the owners and workers will likely execute a lengthy contract that we will call the "Conversion Agreement." Additionally, if a new cooperative entity is to be formed, employees should execute Articles of Incorporation, Bylaws, and any other formation and governance documents for the cooperative. All of these documents are pivotal to the conversion process, and we strongly recommend that parties consult with a lawyer to make sure that the terms are fair, in compliance with the law, and that no important terms are omitted.

### The Conversion Agreement

The Conversion Agreement is a detailed and formal document that binds all parties to complete various steps in order to eventually finalize the conversion. This document would contain the sale price, list of assets being transferred, information and assurances on which all parties are relying (representations and warranties), promises by each party to do or not do things (covenants), and various contingencies (conditions) that allow each party to back out of the deal if certain requirements are not met, such as confirming the necessary financing. This document would describe all other documents that must be properly executed to complete the conversion. Much like the purchase and sale agreement used in selling a house, there may be a variety of due diligence tasks and intermediate steps between the execution of the agreement and the closing of the sale. The Conversion Agreement might also be a called Buy/Sell Agreement, Sales Agreement, Purchase Agreement, Stock Purchase Agreement, or something similar. It will likely run between 5 and 40 pages, and include multiple attachments that represent samples of other documents to be executed before or at closing. Since this document will have many similarities to a buy-sell agreement used when selling any business, many samples of such a document are available.

Although the Conversion Agreement will contain many terms not described here, below are a couple terms worth describing in greater detail:

1. **Non-Compete Agreement and Non-Solicitation Agreement:** Non-Compete Agreements and Non-Solicitation Agreements are often used in the sale of a business, since the selling owner(s) are well positioned to create a business that directly competes with or poaches employees from the sold business. A Non-Compete Agreement can specify a period of years and a geographical area in which the selling owners(s) are prohibited from starting a specified type of business. The Non-Solicitation Agreement can also state that the seller may not solicit or hire any of the cooperative's employees to work for the seller.
2. **Consulting Agreement with Selling Owners:** The knowledge and expertise of the selling owner(s) can greatly benefit a business, particularly in the months or first few years after transition to worker ownership. The Conversion Agreement could specify that the selling owner will provide ongoing advice and consulting services to the business. For example, the Island Employee Cooperative contracted with the prior owners to provide full-time consultation for a period of four weeks following the sale, and 500 hours per year for the subsequent two years.

### Cooperative Formation and Governance Documents

**If the workers plan to form a separate cooperative entity**, then they will form the entity by executing and filing Articles of Incorporation and adopting Bylaws. If the cooperative chooses to form as an LLC, the workers would instead file Articles of Organization and adopt an Operating Agreement. If the cooperative will use a name that is substantially similar to the original business name, the original business may need to write a letter to the Secretary of State giving permission to the cooperative to file Articles using the name. The execution and filing of these documents would preferably take place prior to the execution of the Conversion Agreement, so that the new cooperative entity can be a party to the Conversion Agreement.

At formation, the Articles of Incorporation can specify that the Steering Committee will serve as the Cooperative's first Board of Directors, and the Board may then adopt a resolution to adopt the Bylaws and admit members. To legally admit members, the Cooperative might also need to prepare a document providing certain disclosures to members, as is required in California. Membership certificates are generally not legally required, but could be used to give workers a more formal acknowledgment of their new ownership interest. The Cooperative need not receive capital contributions from members at this point, since doing so might first require some work to ensure that the Cooperative complies with securities laws, but the Bylaws may provide for a capital contribution required at a later date.

Since the decision to execute the Conversion Agreement is a major decision of the sort that cooperative members (as opposed to directors) are generally required to make, the Cooperative should then schedule a members meeting to officially vote on any resolutions necessary to validly execute the Conversion Agreement. All resolutions and meeting minutes should be kept with the Cooperative's official records, and the initial resolutions and minutes may be provided to the business owners to give assurances that the Cooperative had the power to become bound to the Conversion Agreement.

**If the workers do not plan to form a new entity,** the Conversion Agreement should include an attachment representing the Amended Articles and Bylaws that would eventually be executed when conversion is complete. This is so that workers are fully informed of the nature of the entity that they will soon own, govern, and rely on for the livelihoods. This also provides assurances to the owners that they are indeed selling their business to a worker cooperative, and not to a group of workers who might turn around and sell the business to the highest bidder.

## Step 3 – Executory Documents – the "Now Everything is Final and Official" Documents

To make the conversion final and official, a variety of documents will likely need to be executed. An escrow service may be used to facilitate the final execution of documents and transfer of funds, and many of the documents will be signed at a single closing meeting. One or more of the documents may be completed after closing, in situations where parties agree to take a specified action within a reasonable period of time after closing (such as changing trademark registration). Some of the documents needed before or at closing may include:

1. **Redemption Agreements:** Where the Conversion Agreement does not provide for the automatic relinquishing of owners' interest in the company upon the occurrence of certain conditions, the owners may sign a document at this point to officially relinquish their interests in the business.
2. **Promissory Notes:** The cooperative will likely execute promissory notes representing the cooperative's debt to the prior owners and/or to other lenders. A very basic sample promissory note is provided in the back of this handbook, though institutional lenders will often use their

own form. If individual workers are receiving loans to finance their buy-in, workers will also need to execute promissory notes individually.

3. **Loan Agreements:** Because promissory notes are generally short documents that simply describe the terms of promised payment, some lenders may require the cooperative to sign an ancillary Loan Agreement to provide for other obligations of the cooperative or lender. For example, the lender may require that the cooperative receive technical assistance from a specified provider, in order to ensure the financial viability of the cooperative.
4. **Inter-Creditor Agreement:** In cases where multiple lenders collaborate to support a conversion, it may be necessary for the lenders to execute an inter-creditor agreement, committing each lender to provide financing and specifying the priority of repayment and the assets securing each loan. An Inter-Creditor Agreement was used in the conversion of the Island Employee Cooperative, as described in the case study later in this handbook.
5. **Share Certificates:** The cooperative may prepare certificates evidencing the issuance of preferred shares, if any.
6. **Governing Documents:** Where original business entity simply changes its structure, the new Articles and Bylaws may be officially adopted at closing.
7. **Leases, Lease Assignments, or Deeds:** For businesses with a physical location, it will be necessary to execute documents ensuring that the cooperative has secure land tenure. This could involve the transfer of land by deed, the assignment of a lease (usually requiring the landlord's permission), or the execution of a new lease if the prior business owner will retain ownership of the location and lease it to the cooperative. In cases where the original business entity simply converts to a new structure or new type of entity, it may not be necessary to execute any documents to transfer land title, since the land doesn't change hands. However, since there may be a name change to add the word "Cooperative," it would be a good idea to amend any deeds or leases to ensure that the owner/lessee name is up-to-date. Lastly, if ownership changes hands and there are other tenants at the location, the tenants should be notified of the change of ownership.
8. **Assignment of Contracts, Bank Accounts, and Insurance Policies:** Since businesses tend to be parties to multiple contracts, including insurance policies, it may be necessary to obtain agreement from the other contract parties and insurance companies to assign the contracts and policies over to the new entity, if the cooperative is operating under a new entity. In addition, bank accounts will need to be closed, assigned, and/or renamed. Documents evidencing these assignments, contracts, policies, and accounts should be provided at closing, although some may, by necessity, need to be completed after the closing.
9. **Transfer or Licensing of Intellectual Property Rights and Trademarks:** It cases where the individual business owners personally own the rights to any intellectual property rights or trademarks associated with the business, it will be necessary to transfer those rights to or license them to the cooperative. This may be done in the Conversion Agreement, itself, if the individual owner is a separate named party, or it may be done in an ancillary agreement. In the case of registered trademarks, copyrights, and patents, the registration will need to be changed.
10. **Consulting Contracts with Third Parties:** While the Conversion Agreement may commit the prior owners to ongoing consulting with the cooperative, the Conversion Agreement may also require that the cooperative enter into separate contracts with other technical assistance

providers. For example, the lenders that supported the conversion of the Island Employee Cooperative required that the cooperative enter into technical assistance and professional service contracts with three agencies, in order to receive support in grocery management, marketing, merchandising, business planning, cooperative governance and operations, and accounting.

11. **Letters and Resolutions Affirming Authority:** Prior to closing, it is wise for the parties to collect documents that verify that all parties to the Conversion Agreement have the full legal authority to bind the entities and complete conversion. That way, it is unlikely that someone would later challenge the validity of the conversion on the basis that the parties did not have the necessary authority. For example, the attorney for the original business entity may write an opinion letter stating that the owners have made a valid decision to convert the business and that no laws or obligations to third parties prevent them from doing so. In addition, the cooperative can provide copies of Board resolutions and Member resolutions, signed by the Secretary, verifying that the cooperative has made legally binding decisions to commit to the conversion.
12. **Tax Clearance Letters:** The business should provide evidence that it has filed all tax returns and paid all taxes. This evidence may take the form of a letter from an accountant or from the local, state, and/or federal taxing authority.
13. **Bill of Sale:** In the case of an asset sale, a bill of sale – or multiple bills of sale – will officially transfer ownership of certain assets, such as intellectual property, client lists, inventory, equipment, files, records, and so on.
14. **Securities Offering and Registration Documents and/or No Action Letter:** In some cases, when the cooperative receives capital contributions or loans from cooperative members, the cooperative may need to take additional steps to ensure that the receipt of capital from members complies with securities laws. See the financing chapter of this handbook for additional details on when securities law will be relevant, and what paperwork may be required.
15. **Final Valuation of Inventory:** For businesses that maintain inventory, the value of the inventory can fluctuate on a day-to-day basis. The final value of the inventory will need to be determined as close to the date of final sale as possible, causing the business sale price to shift slightly.
16. **Deeds of Trust:** If any loans will be secured by real estate, it may be necessary to file (or "record") a Deed of Trust along with local property records, to ensure that the lender's right to the property is protected in the event of a default on the loan, and to make prospective purchasers aware of the security interest.
17. **Resignation of Officers and Directors:** Except in the case of an asset sale, the officers and directors of the original entity will need to submit their resignation. This is because the relinquishing of their ownership interests will generally not automatically result in removing them from governance and administrative roles.

## Step 4 – A Few Final Formalities

After closing, the parties may have a handful of additional papers to prepare and file, particularly for tasks that cannot be completed until after closing. Tasks that may occur after closing might include changes to contracts with third parties, changes to bank accounts, changes to trademark registration, and any other action that is both contingent on successful closing and on third party action. Generally, the Conversion Agreement or other contracts executed at closing will bind the parties to completing these additional tasks as quickly as possible.

Additionally, the cooperative may need to file a Statement of Information or a similar document with the Secretary of State to provide an updated list of directors and officers. If it plans to do business under a name that is different than the entity's legal name, it will usually need to file a Fictitious Business Name ("Doing Business As") Statement.

In the case of an asset sale from one entity to the new cooperative, it is possible that the original entity will then want to dissolve, which requires a handful of formalities to wind up the business, file certificates of dissolution, final tax returns, and so on.

# Financing Cooperative Conversion

## Legal Considerations Related to Financing Cooperative Conversion

In order to purchase the business they work for, workers generally need to aggregate capital from multiple sources, which might include:

- Themselves – in the form of member buy-in, loans, and preferred shares,
- Loans from economic development nonprofits, community development financial institutions (CDFIs), or governmental agencies,
- Loans from community banks and credit unions,
- Loans from friends and family,
- Loans from prior owners of the business,
- Grants and donations,
- Micro-loans from the public, raised through crowdfunding and/or a direct public offering, and
- Non-voting "preferred" shares with a fix return sold to investors.

Each type of financing can be customized with terms to fit the unique needs of the cooperative and the funder, and some of those terms and options are discussed below. In addition, each type of financing may come with legal considerations related to securities and tax, also discussed below.

## General Considerations in Financing a Cooperative Conversion

Financing a cooperative is different in a few ways from financing a conventional business. In a conventional business, the provision of capital often comes hand-in-hand with a share of control of the business and the potential to maximize profits from the investment. Worker cooperatives, by definition, put control in the hands of workers and they distribute earnings primarily on the basis of the value and quantity of the workers' labor.

As such, the individuals and entities that finance cooperatives generally do so with the expectation of receiving a fixed return that is generally set at not much more than market rate or prevailing rates of return. Financing sourced from mission-driven organizations or government funds may even come at below-market rates, in recognition of the powerful social and economic benefits that worker cooperatives bring to communities.

### Rewarding Cooperative Founders

The patronage-based distribution of earnings in a worker cooperative generally need to be adapted in order to reward the workers who took risks in founding the cooperative and who stuck with the business during lean years. Often, in the years following cooperative conversion, the cooperative may need to commit a substantial portion of its earnings toward making payments on the loans or preferred shares that financed the transaction. This will reduce the cooperative's net income available for distribution as patronage dividends, meaning that workers who took the risk to convert the business to a cooperative will receive fewer financial rewards than workers who join in years after the loans are paid off.

As a result, it is good practice to offer addition financial incentives to the workers who take part in the conversion and work to pay down the loans. Some cooperatives do this by allowing the members' capital contributions to accumulate interest. However, in cooperatives where the workers provide very little in the way of monetary capital contributions, they still "capitalize" the business with their labor. As such, some cooperatives pay a "bonus" later on, directly based on the estimate of what workers *would have* made had the financing payments been distributed more evenly over a longer period.

### Multi-Stage Buy-Outs

Depending on the size and value of the business, it may be difficult to obtain all financing necessary to purchase the business in a single transaction. In such cases, some cooperatives complete the buy-out in multiple stages, as Select Machine did (see the Select Machine Case Study later in this handbook). The cooperative or individual workers could receive loans to complete a partial buy-out, and, after paying down those loans, obtain more financing in one or more additional stages to complete the buy-out. In order for the owner to take advantage of the 1042 rollover, at least 30% of the business must become owned by the workers through a qualifying cooperative after the initial transaction.

Since this means that the business would become a cooperative that is only partially owned by the workers, it brings up interesting questions related to both governance and allocation of earnings, since the concept of a worker cooperative, by definition, requires control by and distribution of earnings to the workers. This issue is further discussed in the Governance section of this handbook. In the case of Select Machine, it meant that the sellers had to give up substantial control despite retaining a majority shareholder interest after the initial transaction. In other cooperative conversions, it's possible to create a second entity that is fully owned and controlled by the workers, and which slowly buys shares from primary business owners over time. This scenario is not ideal, but it is an option where the sellers are unwilling to finance the complete buy-out with a promissory note.

### Legal Limitations on the Form of Financing

The form of financing has implications for the cooperative's eligibility for Subchapter T taxation, and may have implications under the state's cooperative statute. To be eligible for pass-through taxation under Subchapter T, a cooperative must distribute its earnings based on patronage. Earnings sourced from non-members or which are not distributed based on patronage are subject to taxation at the entity level – creating double taxation for that income. If a cooperative creates a class of preferred shares that pay out fixed dividends, both the cooperative and the shareholder will pay tax on that income. In addition, some cooperative statutes explicitly limit the size of the return that can be distributed each year based on capital contributions. In California, for example, this limit is 15%. Thus, any financing provided to a cooperative should be limited in its rate of return.

## Considerations Related to Different Sources of Financing

### Worker-Sourced Financing

The workers, themselves, are often a key source of capital for a cooperative conversion. One modern-day version of the Rochdale principles for the operation of cooperatives states that "Members contribute equitably to, and democratically control, the capital of their co-operative." This means, first of all, that each member has "skin in the game," which creates a greater sense of ownership and responsibility for the cooperative. As the principle also expresses, in an ideal cooperative, each member would contribute equally to the capital.

However, in practice, in industries such as food service, where employees generally receive fairly low wages, it is quite likely that workers will not have any savings that could be used to finance a buy-out. In addition, the economic status of cooperative members could vary widely. Some could have access to a substantial amount of capital to contribute, while others could have little to none. As such, it is common for cooperatives to make arrangements for unequal contributions. Note that, regardless of the amount of capital contributed by each member, everyone should have the equal voting power inherent in the democratic principles of cooperatives.

In general, it's important for the workers to contribute at least *some* capital, in order for the cooperative to become eligible for other sources of capital. When analyzing the creditworthiness of a business, lenders like to see that the owners of the business have invested their own money in the business first, before seeking outside funding.

With regard to worker-sourced financing, the cooperative will need to determine:

- **How much an ownership share will cost?** We have seen worker cooperatives set member share prices at anywhere from $10 to $15,000. The cost will depend on a number of factors, including members' ability to pay, the need for capital, access to other financing, and the value of membership.
- **Will there be one or multiple classes of shares?** As described below, some cooperatives create a category of preferred shares to incentivize both members and non-members to contribute additional capital.
- **Will the cooperative pay interest on member shares?** Most cooperatives that we know of do not pay interest on member shares, which enables the cooperative to distribute earnings primarily on the basis of patronage. However, to give some members incentives to contribute more capital, a cooperative could offer to pay a small amount of interest on amounts contributed.
- **May cooperative members contribute unequally?** If so, how can the cooperative prevent tensions from arising from the fact that some members have more money at risk than others? Should the cooperative make a plan to pay members back in order to equalize financing?
- **If a share is expensive, can the worker purchase it over time or find personal financing?** Although somewhat rare, there may be sources of loans to help individual cooperative members finance the purchase of their membership share.
- **Can the contribution be made through a regular withholding of wages or through the withholding of patronage dividends?** It is very common for cooperatives to receive at least some portion of a worker's capital contribution through the regular withholding of wages. Note that the amount withheld from the paycheck is still taxable income, because the member is receiving something of value in exchange for his or her labor. Generally, withholding of wages for this purpose requires the written and informed consent of the employee. Alternatively, if the cooperative foresees that it will make patronage dividends in the near future, it can allow a member to finance buy-in through an agreement to have the cooperative withhold a portion of that patronage dividend until the buy-in amount is paid in full.
- **May a member receive a membership share in exchange for goods or services?** Some cooperatives allow members to "pay for" their membership share in exchange for agreed upon good or services. The value of the membership share may be taxable income to the member, so it is important to consider whether a member would be prepared to pay taxes on the value of that share. Note, also, that provision of services in order to purchase a membership share may create an employment relationship. See the chapter on employment law for more details.
- **May members lend money to the cooperative, and at what interest rate?** Generally, if a member loans money to the cooperative, that loan pays interest and has priority for repayment over the member shares. For a cooperative member, it may feel advantageous to provide capital in the form of a loan. For the cooperative and other members, however, it may create a burden

that would not be present if the same capital were provided in the form of a membership share.

- **May members purchase preferred shares?** As described below, preferred shares are generally structured to pay a fixed return, making them similar to loans. However, repayment of the preferred shares are generally subordinate to repayment of loans (though may or may not be subordinate to repayment of membership shares). In addition, preferred shares are generally recorded as equity on the books, rather than debt, which looks better to prospective lenders reviewing the books.
- **Does the share structure comply with securities law?** Securities laws are designed to protect people from fraudulent or overly risky investment schemes, and may apply when workers finance the development of their own cooperative. We summarize some securities law basics below. The decisions about the structure and size of member contributions may be influenced by securities law considerations, so please read on.

## Preferred Share Financing

Some cooperatives choose to have "preferred shareholders," meaning a class of investors who contribute a sum of money and, in exchange, get a fixed regular dividend with no (or very limited) governance rights attached. Cooperatives that issue preferred shares typically do so with terms that allow the cooperative to redeem the shares at face value at a later date.

A few key benefits of offering preferred shares, rather than promissory notes, are:

1) The preferred shares look like equity – rather than debt – on the cooperative's books, which looks better to lenders.
2) The redemption of the preferred shares is generally subordinate to any loans, which protects lenders.
3) If the cooperative goes bankrupt or closes due to losses, generally, preferred shares are not outstanding liabilities that the cooperative must pay.

Disadvantages of preferred shares over promissory notes:

1) A primary disadvantage of issuing preferred shares is that the earnings used to pay regular dividends are subject to double taxation, unlike loan interest payments, which are generally tax deductible business expenses.
2) A cooperative that distributes a substantial portion of its earnings as dividends on preferred shares may come under scrutiny of the IRS, with regard to its compliance with Subchapter T.

The *Real Pickles* Case Study included in this guide illustrates an example of successfully using preferred shares to finance a cooperative conversion.

## Seller Financing

In cooperative conversions, it is very common for the former owner to finance at least part of the buy-out. Often, a seller does this by accepting a promissory note that outlines the cooperative's promise to pay the seller over time. It can be a difficult balancing act to ensure that both the sellers and the workers are adequately protected in this scenario – to ensure that the sellers are paid over time and that the workers are not so burdened with debt that they can barely scrape by. Generally, the best scenario for everyone is to take additional steps to ensure that the business will continue to thrive, such as having the seller agree to provide ongoing technical assistance, gaining commitments from customers, ensuring that workers are adequately trained to manage the business, and so on.

To protect the seller, safeguards can also be built into the governance documents, such as supermajority voting requirements for decisions affecting the owner's proprietary interests, and other reserved rights to withhold consent for major corporate changes until the seller has been fully repaid. See the Governance section of this handbook to learn more about how a transitioning Owner might retain some amount of control during or even after the conversion. In addition, see the section below for a discussion of other safeguards to protect lenders.

### Tax Advantages to Seller Financing

When a business owner sells to workers in exchange for a promissory note, as opposed to receiving cash, it is possible that the seller can more easily defer and manage capital gains. In tax law, under the doctrine of cash equivalency, a promissory note may not be treated as equivalent to cash if it is not readily redeemable for cash. Since there is risk that the workers will not fully pay off the promissory note, it would therefore be unjust to fully tax the seller on the note as if it were cash. As such, this allows the seller to stretch payment of capital gains taxes over a longer period. This may be especially helpful to an owner (such as a sole proprietor) who is not readily eligible for the 1042 rollover. More research is needed to describe the tax consequences of seller financing here.

## Obtaining Loans

It can be difficult to convince any lender, especially a conventional commercial lender, to debt-finance 100% of a transaction. Lenders are reluctant to do this even for common transactions (like mortgages) and are even more reluctant to do this for more "exotic" transactions (like a cooperative buy-out). In such a situation, there are a handful of ways to "sweeten the deal" for a prospective lender:

- **Have a person, guaranty fund, or other organization guaranty the loan,** by signing an agreement to pay the loan obligations in the event that the borrower is unable to**.** A seller is often in a good position to guaranty a loan from a third party, since the majority of the loaned funds are presumably paid to the seller to begin with. Guaranty funds exist for this purpose, is there is potential that cooperative-focused loan guaranty funds could be develop to drive capital toward cooperative development.
- **Secure the loan with assets**, by pledging business inventory, equipment, real estate, stock, or other valuable assets.
- **Have the prior owner secure the loan with "replacement property" from the 1042 rollover.** In circumstances where a prior owner takes advantage of the 1042 capital gains tax deferral by rolling the gains over into "replacement property" in the form of stocks or other securities, the replacement property could be pledged to secure the loan.
- **Create two entities and pledge stock of one entity as a security.** In the case of the Island Employee Cooperative, two entities remained after the conversion – a cooperative and a conventional corporation, called Burnt Cove. The cooperative owned all stock of Burnt Cove, but also pledged some of that stock to secure the loans that the cooperative received. Administratively and for tax purposes, it may not be ideal to maintain two entities, but it was necessary in that case to satisfy the concerns of lenders.
- **Commit to obtaining technical assistance to ensure the business will be a success.** Island Employee Cooperative committed to contract with technical assistance providers for at least five years, to ensure that the businesses would thrive and be positioned to pay off the loans.
- **Give a lender priority for repayment.** In the event that the cooperative receives loans from multiples sources, one or more lenders may demand that its loan be in first position for

repayment. In this case, an Inter-Creditor agreement can be made between lenders to specify the priority and timeline for the repayment of each lender.

- **Give the lender the right to approve major decisions.** Although lenders are not given a vote in the Bylaws of a cooperative, a loan agreement may nevertheless specify that a cooperative must seek a lender's permission prior to making certain major decisions, such as expenditure over a certain dollar threshold, or any other decision that could substantially undermine the cooperative's ability to pay back the loan.

The conversion of the Island Employee Cooperative is particularly instructive with regard to the variety of safeguards that can be built into lending transactions, and with regard to the use of Inter-Creditor Agreements. See the Island Employee Cooperative Case Study in this handbook for more details.

Even if a cooperative cannot obtain loan financing at the time of conversion, it may be able to refinance the initial transaction and pay off the original lenders by receiving a bank loan later on. In general, it is a good idea to engage in conversation with financing institutions to understand what they look for when deciding to finance a worker cooperative. What does the financing institution need to see on the books of the cooperative? What risks is it concerned about and how can those be mitigated? What does it need to know and understand about cooperatives?

### Pre-Selling Goods and Services to Finance the Buy-Out or Guaranty the Financing

Increasingly, it may be possible for a business to find enthusiastic support among its customers for a worker buy-out. In some businesses, worker cooperative conversion may be the only option for keeping a business in a community. And in general, growing awareness of the benefits of cooperatives could motivate customers to go out of their way to support worker ownership. One way customers can provide such support is to pre-purchase goods and services from the business. For example, if 500 customers each buy $200 gift cards for a store or cafe, that would provide $100,000 in capital to support a worker buy-out. Of course, the $100,000 becomes a "liability" of another sort, payable in products or services, which may lower the cooperative's cash flow after the conversion. As such, any pre-selling arrangement should be reviewed to estimate the timeline for redemption of the gift cards and to ensure the overall financial viability of the arrangement for the cooperative. In addition, in any pre-selling arrangement where there is risk that the cooperative could not deliver on the gift certificates, it's important to ensure that the arrangement complies with securities laws, described below.

#### Crowdfunding

Obtaining small loans from or selling preferred shares to community members is an increasingly viable option for financing a worker cooperative conversion. Generally, securities laws prevent businesses from advertising investment opportunities to the public without first overcoming extensive regulatory hurdles. See the Securities Law section below for a discussion of new opportunities emerging from securities law reform and crowdfunding law. Within existing laws, some cooperatives have also done the regulatory work to offer investment opportunities to the public, including Real Pickles, described below.

### Securities Law Considerations

<u>Does the financing arrangement comply with securities law?</u>

Securities laws generally require that when a business offers an opportunity to invest in or lend to the business, it must register that offering by submitting detailed paperwork and disclosures to securities regulators and to the prospective lenders or investors. However, some types of securities are exempt from registration, as described below. When a cooperative receives financing from individuals, in particular, as opposed to institutional lenders, the arrangement should be reviewed to ensure that it complies with securities law.

What is a security?

You create a security when you ask people to put money into your business and you offer to return that money, and/or offer them a return or share of earnings. 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
- Offering interests in limited liability companies
- Offering a membership in a cooperative

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, or 2) Qualify for an exemption from registration. Registration can be an expensive, time-consuming process. If possible, a cooperative should try to find an exemption, which is simpler and less expensive.

Common Exemptions

The following bullets describe ways to raise capital with relatively few securities compliance hurdles. More extensive and federal level securities compliance rules are beyond the scope of this handbook, but the following pathways may offer significant capital raising opportunities. Additional information about securities laws may be found at www.CommunityEnterpriseLaw.org.

- **Offering Securities Only in Within Your State:** If the cooperative plans to offer securities only within the state where it does business, it will generally not need to register the securities with the federal Securities and Exchange Commission (SEC). This is called the federal "intra-state exemption." It will, however, need to register or find an exemption at the state level, so read on.

- **Capital Contributions by Managing Members:** If the worker-members will be participating substantially in the management of the business, the capital contributions or loans by those members are generally exempt from securities registration. However, be sure that you understand the details of securities laws in your state before drawing this conclusion.

- **Specific Cooperative Exemptions:** In some states, the purchase of a membership share in a cooperative is specifically exempted from the definition of security or from the requirement to register. For example, under California Corporations Code Section 25100(r), a California cooperative can raise up to $300 from each California member without registering the securities. Any person who purchases a security under this exemption becomes a member and must have voting rights in the cooperative. As noted above, if a cooperative member will be participating in the management of the business, the members' capital contributions may be exempt from registration, which means that the member can contribute more than $300 to the cooperative. It is primarily for non-managing cooperative members that you would need to use the 25100(r) or a similar exemption.

- **Donations:** When people give money without the expectation of receiving anything in return, securities regulations do not apply. Many entrepreneurs are use crowdfunding websites such as

Kickstarter.com and Indiegogo.com to raise money for enterprises. Note that many entrepreneurs using such sites provide non-monetary rewards to donors, which, in some cases *could* create securities.

- **Pre-Selling:** It has become increasingly popular to financing a business by selling products and services in advance, often in the form of discounted gift-certificates. Pre-selling products and services before a business starts can be considered a security, particularly in California and roughly 16 other states that apply the "risk capital test" in determining what a security is. The pre-sole products or services may be securities when there is risk that the buyer won't get the product or service they have purchased. However, if you're an *existing* business and you are raising capital to expand or improve the business, pre-selling products and services might not be considered a security, because there is much less risk that people will not be able to redeem their gift certificates. This means that pre-selling could be a viable – and legal – way to finance cooperative conversion, since the business is already in operation and may not have difficulty redeeming the certificates.
- **Financing from "Friends and Family:"** In some states, selling a security to someone with whom you have a preexisting relationship often does not require registration. In California, for example, the Limited Offering Exemption (California Corporations Code Section 25102(f)) offers a special exemption for private (not advertised to the public) securities offerings sold to no more than 35 people within the state, so long as the investors have a preexisting personal or business relationship with the principle owners of the business offering the security. The preexisting relationship would need to consist 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." The 25102(f) exemption also applies to securities sold to investors who have enough financial experience to protect their interests, or who have experienced professional financial advisors, whether or not there is a requisite preexisting relationship with the investor.
- **Financing from Wealthy Investors:** There are generally very few hurdles involved in selling securities to accredited investors, often defined as people 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.
- **Crowdfunding Exemptions:** At the time of writing this manual, we are still waiting for the Securities and Exchange Commission to release regulations governing the recently enacted federal crowdfunding exemption in the Jumpstart Our Business Startups (JOBS) Act, which would lower hurdles to publicizing opportunities to make small loans or equity investments in businesses. In the meantime, multiple states have adopted their own crowdfunding laws, and California is currently considering two bills – AB 577 and AB 722 – which would open many new doors to financing cooperatives with relatively low compliance hurdles.

- **DPO Crowdfunding:** In places where crowdfunding laws are not yet in effect, a Direct Public Offering (DPO) is one of the only viable methods to advertise and issue securities publicly. A DPO essentially requires that the securities offering be registered in and approved by the state where it is being offered. This generally requires a good amount of paperwork and the preparation of a substantial disclosure document for investors. Real Pickles is a cooperative that raised capital from local investors by doing a DPO of preferred shares. Real Pickles had to register the securities by filing a “prospectus” document with the state securities agency, then provide the document to prospective investors. The prospectus included detailed information about the business and the investment, a memorandum of understanding between the buyers and the sellers, the cooperative’s Articles of Organization and Bylaws, and Real Pickles’ financial documents.

When in Doubt, Seek a No-Action Letter.

During the conversion process, if you have doubts about whether your arrangement for the sale of cooperative memberships or other securities is exempt from registration, you can write to securities regulators and seek what is called a “No Action Letter.” This is what the Island Employee Cooperative did. The request described, in great detail, the businesses and the way in which it planned to issue shares and memberships to employees, and the request cited Maine law as a basis for arguing that the securities should be exempt from registration. The Maine Office of Securities wrote back (approximately four months later) with a statement indicating that it would not take action and not require the registration of the offering, so long as the shares sold to members are non-transferable and redeemable only by the cooperative (which is generally how most cooperative shares are structured).

# Governance During and After Cooperative Conversion

## Introduction

There are potentially infinite ways to design a company's governance, and a wide variety of ways to transition governance in the process of converting to a cooperative. There is an art to governance design, with many policies, practices, roles, and rules than can be arranged into place to produce a desired outcome. One desired outcome of cooperative conversion is to give power to workers. The transfer of power may or may not implicate an immediate change in the day to day life of a business, but it will create the conditions for the evolution of a company that, in the long run, focuses on the concerns of its employees.

### A Few Basic, But Powerful, Governance Rights

At their legal core, cooperatives are obligated to give members only a few basic governance rights, including:

- The right to an equal vote in the election of the Board,
- The right to request and vote in an action to remove Board members,
- The right to take part in at least one member meeting per year,
- The right of access to information about the cooperative, its members, its Board meetings, and finances, and
- The right to approve/disapprove dissolution, merger, and other major decisions.

When a company converts to cooperative, these are sometimes the primary new governance powers that the worker-owners will give themselves as members. These rights may not sound like they amount to much, but they are quite powerful, in that they give members the ability to alter the direction of a cooperative through Board elections, helping to keep cooperatives *ultimately* accountable to members. While these powers may sound simple enough to grasp, a new worker-owner may not be familiar with strategies and opportunities for exercising their rights, which calls attention to the need to train workers on how to exercise their new rights. In particular, companies that did not previously have a Board of Directors may need training to understand the potential roles of a Board. Democracy is powerful when people are informed and active participants in the democratic process, and educating new worker-owners about the process can bring more genuine democracy.

In some cooperatives, workers will choose to give themselves a much wider variety of opportunities and processes to shape the direction and day-to-day work of the cooperative. Whether it's through participation in committees, collective management structures, distributed governance, rotating management positions, consensus processes, or other strategies, workers may grow more intimate with the company's governance in the process of converting to a cooperative.

### The Transition to Workplace Democracy

In some cases, the cooperative buy-out may happen gradually and may involve multiple intermediate steps. The transition of governance may, likewise, be gradual, particularly in companies where workers must complete the buy-out over time and borrow money from multiple sources – including, quite possibly – the selling owners. Full worker control may be an ultimate goal, but the intermediate governance structures may take many forms.

## How Much Will Governance and Management Change?

When companies change ownership, whether or not to become a cooperative, the workers, customers, and a wide variety of stakeholders often worry about the changes to be brought by new owners. Sometimes new owners bring dramatic changes (even closing the business), and other times, the transition is made to feel as seamless as possible.

On one hand, *stability* is a highly valued quality of a business, and it offers a very good reason to continue core governance and operational structures during ownership transition. Such structures may be key to the company's success and profitability, and it's not necessarily wise to shake things up in the moment where many parties are taking a great financial risk. Employees, in particular, have their livelihoods at stake during a transition. As such, they may wish to retain the status quo in governance, even if they find management structures to be stifling.

On the other hand, new governance structures may be the primary incentive for workers to buy their employer's business, and worker control could unleash widespread innovation in a company. In many companies, workers tend to be an undiscovered treasure trove of information. They sense the needs and impact of a company's work and operations at nearly every level of the system, and their experiences and insights – if tapped – could perpetually refine a company's efficacy and performance. This potential has been acknowledged in business management texts for nearly a century, but top-down approaches to management have left decentralized governance models at the margins of the mainstream business world.

## Legal Governance Requirements

The entity a cooperative forms at the state level and the tax status it chooses at the federal level will dictate certain limits and possibilities for how the cooperative may operate. For example, corporations must have boards of directors, and must follow certain election and meeting notice procedures; business taxed as cooperatives under Subchapter T *must* have democratic voting.

### Laws Governing Cooperative Corporations

The statutes governing cooperative corporations generally function to create:

- Due process for the group, so that an individual doesn't have too much power over the group,
- Due process for an individual, so that the group doesn't have too much power over the individual,
- A Board of Directors with the ultimate legal duty to make decisions in the best interest of and to ensure proper operation of the company, and
- Fallback rules in case the group doesn't adopt clear rules.

The due process rules generally specify minimum standards for how often meetings are held, how certain major decisions are made, how members and directors must receive notice of meetings, how members and directors can be expelled, how often elections are held, and so on. These rules prevent a complete tyranny of structureless-ness where members have no idea how to voice their needs and concerns. Even in a cooperative that has failed to prepare or follow Bylaws, a member can refer to the cooperative corporation statute to understand his or her basic rights, and even petition a court or attorney general to force the cooperative to follow the due process rules.

### Laws Governing Cooperatives Taxed Under Subchapter T

To receive the benefit of pass-through taxation under Subchapter T of the Internal Revenue Code, a cooperative must adhere to the ways in which courts and the IRS have interpreted the requirement for democratic control by workers. In one case, *Puget Sound Plywood, Inc. v. Commissioner of Internal Revenue* (44 TC 305 - Tax Court 1965), the U.S. Tax Court described democratic control as follows:

> "Implementation of the [principle] relating to democratic control is effected by having the worker-members themselves periodically assemble in democratically conducted meetings at which each member has one vote and one vote only, and at which no proxy voting is permitted; and these workers there deal personally with all problems affecting the conduct of the cooperative."

### Laws Governing Partnerships and LLCs Operating as Cooperatives

A cooperative that chooses to structure as a partnership or LLC will be subject to very few mandatory rules regarding governance and due process. Partnerships and LLCs will, however, be subject to statutory fallback rules if their Operating Agreements do not give enough specificity about how decisions are made and how finances are managed. Such companies are generally free to adopt highly customized governance and financial structures, if the partners/members agree to such structures. This flexibility can be a good thing in some cases, especially for cooperatives that are thoughtful about how they design governance. In other cases, a company that fails to establish basic procedures for the democratic process could devolve into a tyranny of structureless-ness where some members have very little control and no ability to meaningfully exercise rights of control.

### The Critical Importance of Understanding and Adhering to Governance Documents

Beyond the basic governance rules applicable to cooperatives, regardless of chosen entity, there remains a good amount of flexibility in the details of the Bylaws and Operating Agreements. It is critically important that cooperatives adhere to rules they choose to adopt. Otherwise, actions can later be challenged and invalidated on the basis that they were taken without adherence to adopted procedures. It is very common for cooperatives to fall into habits of operating informally, without regard to the procedures they have adopted. Later, especially when there are disagreements, chaos can ensue as members seek to invalidate prior decisions.

The moral to this story is that members should become familiar with and practice their governance procedures with care. To facilitate this, it is very helpful to ensure that governance documents avoid legalese and are written in plain-English (and/or another primary language of workers). Additionally, in-person trainings and simulations for workers can greatly facilitate adherence to governance documents. Finally, it helps to designate one member or a committee of members responsible for regularly reviewing procedures to ensure that the cooperative is following its chosen roles. In some cooperatives, we have referred to this role as a "Cooperative Trustee," meaning someone with a duty to ensure that the democratic principles of the cooperative are being faithfully upheld.

## Some Basic Components of Governance

In most cases, conversion to a cooperative should involve learning and training about new ways to operate. Future cooperative members may wish to form a working group to examine questions of and possibilities for governance. When designing governance structures for a newly converted cooperative, here are some of the key considerations:

- **What are the governing bodies and what realms does each control?** Board of Directors? Advisory Board? Bicameral governance? Role of committees?
- **How are governing bodies elected or appointed?** Member-elected board? Board-appointed advisory council? Specific appointments by outside organizations (such as a nonprofit that has a right to appoint one board seat)? How long do people serve? If there are elections, what is the nomination process for candidates?
- **Who are the members?** If applicable, what are criteria for membership? Who can become a member and participate in governance? Are there different classes of members with different powers?
- **What is the division of power between the board and members?** What are the rights and responsibilities of directors? Of members? When can members invalidate board action?
- **What are avenues for member and stakeholder participation and influence?** How can members and stakeholders take part in suggesting or dictating new directions for the organization?
- **Can the functions of the organization be delegated into semi-autonomous committees?**
- **How are meetings held?** Who can participate in meetings? How often are meetings and how do people receive notice of them? Are meetings in person or virtual? How is the agenda set? How is the meeting facilitated? Are there rules of order?
- **How are proposals brought, considered, and adopted?** Who can bring a proposal, when, and about what? Is there a clear process for exploring the proposal? Is it adopted by a majority? Supermajority? Consensus? By Holacratic procedures?
- **Transparency and Communication?** How can the organization efficiently and clearly communicate governance structure, rights, responsibilities, and activities to members and stakeholders?
- **Central organizations and outside governance:** What could be the role of a centralized trust or federation of organizations that dictates some activities and decisions of the member organizations?

## Governance Transition Scenarios

This section offers a handful of scenarios and considerations for the transition of governance during cooperative conversion, although the transitions will play out in a wide variety of ways.

### 1. Simple Transition: Transfer Ownership / Retain Management

In companies where management and ownership are separate to begin with, it is possible that governance will not change very much upon conversion. In many companies, owners/shareholders hire managers and set the basic management structure, but may otherwise not involve themselves in the details of the business. Upon handing control to workers, a worker-elected board could very well choose to continue operating under the exact same management structure.

### 2. When Former Owner Becomes Worker Owner

In cooperative conversions where the original owners will become worker-owners alongside the employees, it will be critical to take steps to overcome what many people refer to as "founders' syndrome." It can be hard for an enterprise to break away from habits of relying on founders to take on certain responsibilities and make primary decisions. New worker-owners may be cautious about exercising their rights to influence the business, and the original owners may feel a stronger sense of entitlement to control of the business.

One strategy for overcoming founders' syndrome is to adopt highly structured meetings and decision-making processes that demonstrate to workers their ability to voice their concerns, bring proposals to the enterprise, and influence the direction of the business. For example, at the Sustainable Economies Law Center, a nonprofit that functions as a democratic workplace, the eight employees make decisions using a proposal process very similar to that of Holacracy (see www.holacracy.org for more information). This has helped the Center move away from reliance on its founders for direction, and enables any employee to bring and respond to a proposal. Proposals are brought and considered by asking employees for feedback in a series of circles, meaning that everyone is given a space to be heard. Meetings are carefully facilitated so that people cannot speak out of turn and interrupt one another.

Other strategies for overcoming founders syndrome include: 1) Rotation of roles and responsibilities, so that workers don't get pigeon-holed into a set of roles where they have very little power, 2) Equalization of pay so that everyone has a strong sense of ownership and a sense of equal status, and 3) Training workers on various aspects of running the business and on democratic processes.

Note that this can be difficult when the original owners retain a higher financial stake in the business, such as by holding a promissory note to be paid by the cooperative. A worker-owner that has more at risk than other worker-owners may have a greater sense of entitlement to influence decisions in order to protect the financial stake. As such, it can be a good idea for cooperatives to work toward equalization of the financial resources each member has at risk.

### 3. Transitioning to Collective Governance

We generally use the phrase "collective governance" to refer to a structure where all members participate in the management of the business. While many small worker cooperatives are managed collectively, it may be somewhat more difficult to transition a conventional business to collective governance than it would be to establish collective governance when starting a new business. It is hard to unravel management hierarchies that are already in place, and it requires a high degree of structure and process to break old habits. See the above paragraphs for tips on reducing hierarchies and creating more equal participation in governance.

Collective governance can be empowering to some workers, and overwhelming to others. Participating meaningfully in the management of the business requires a good deal of knowledge, time, and attention. As such, a cooperative that desires to transition to collective governance may choose to do so gradually over time.

### 4. Transitioning to Distributed Governance

Distributed governance can be achieved by breaking the functions of an enterprise into multiple semi-autonomous spheres of control. Doing so essentially creates multiple small collective governance circles within a larger organization, meaning that workers can exercise a great deal of influence over their immediate realm of work and responsibility, but do not necessarily need to participate in management of the company as a whole. This has been achieved in many large companies, some of which are profiled in the book *Reinventing Organizations*, by Frederick Laloux. Holacracy and Sociocracy are models for distributed governance, and have been adopted by large companies like Zappos, and recently by at least one worker cooperative, Three Stone Hearth in Berkeley, CA.

## When Departing Owners Maintain Some Control

Even when a business converts entirely to worker-ownership and former owners cease active involvement in the business, there are some situations where the former owners wish to retain a certain amount of power temporarily or indefinitely. One of the core cooperative principles is that cooperatives should be autonomous, meaning that they are independent of outside control. As such, giving temporary or ongoing control to former owners can be seen as undermining of the cooperative principles. At the same time, there are some valid reasons, described below, to allow some degree of control by former owners.

### Reasons Former Owners Might Retain Some Control

The two most common reasons that former owners wish to retain some degree of control are:

1) The owners helped finance the buyout, so they still have "skin in the game," even if it's in the form of a promissory note, and
2) The owners want the business to retain a certain social/environmental mission or continue to serve a certain group of stakeholders.

### Retaining Control to Protect Financial Stake

If a former owner wishes to retain some control in order to protect a financial stake, this brings up the big picture question: How much voice should we give to capital? Giving power to capital is almost antithetical to the concept of a worker cooperative, but giving people no means to protect their investment would prevent a flow of a capital to cooperative development. Thus, a balance generally needs to be struck.

To protect a former owners' financial stake, it is not uncommon for the cooperative's governing documents and/or loan agreements to give former owners the right to approve or veto any decision by the cooperative to:

- Make a major expenditure,
- Pay out dividends, bonuses, or patronage distributions,
- Raise wages by a certain percentage,
- Borrow money,
- Restructure,
- Expand the business, and/or
- Dissolve.

### Retaining Control to Protect Mission

Even when a former owner has no substantial financial stake left in the cooperative, the former owner may wish to retain control to ensure that the cooperative continues to serve a social or environmental mission, and/or to ensure that it remains a cooperative and does not sell out to a conventional business. This is especially comment when a former owner forgoes the potential for financial gain in converting the business to a cooperative.

To protect the former owners' vision, the cooperative's governing documents or another contract could give the former owner the ability to approve or veto any decision by the cooperative to:

- Change the mission or change certain socially responsible policies of the company,
- Convert or sell the company to a conventional business,
- Change the dissolution provisions of the business (which may require distribution of remaining assets to a nonprofit or another cooperative), and/or
- Change the formula by which profits are allocated or distributed.

The former owner could also retain a right of first refusal to buy the company back, at a specified price or using a specified appraisal method, in the event that the cooperative desires to sell the company.

### Specific Strategies for Giving Control to Former Owners

The list below offers specific strategies and legal documents wherein certain powers and rights can be allocated to former owners. Note that some cooperative entity statutes will not allow Bylaws to give power to non-members. In such a case, power can still be given through contract, such as through a loan agreement. Hybrid statutes and structures (cooperative LLCs) tend to afford a greater degree of flexibility in governance. This can be helpful, but also dangerous, since a company could call itself cooperative without actually adhering to the democratic principles of cooperatives.

Rights and powers can be given to former owners by:

- **Granting rights in a contract**, such as a loan agreements, other financing contracts, or lease. These rights could require that the former owner be given notice whenever the cooperative takes a certain type of action or makes a certain kind of decisions, and the contracts could give the former owner the right to approve or veto certain decisions.
- **Giving the former owner one vote through retained membership,** and requiring that certain decisions be made unanimously or by a supermajority, which gives the owner's one vote significant power over those decisions.
- **Allowing one or more Board seats to be appointed by specific individuals or organizations.** This may not be allowed under some cooperative corporation statutes, but in California it is allowed under Corporations Code Section 12360(d).
- **Allowing the former owner to nominate candidates for the Board,** which would put the candidate on the ballot to be voted on by members. Many cooperative corporation statutes fail to address the procedure by which Board candidates should be nominated, which can leave space to give outside individuals the right to at least put someone on the ballot.
- **Having the former owner serve on the Board and on an "Empowered Committee" for a specified period of time after conversion.** An empowered committee generally must consist of a minimum number of directors and it generally holds the same power as the Board with regard to realms of control delegated to it by the Board, except with regard to a few major decisions.
- **Allowing the former owner to appoint all or part of the initial Board,** which will serve for a specified period of time, after which elections will be handed over to members.
- **Adopting Bylaws provisions that cannot be changed except if approved (or not actively vetoed) by specified individuals.** For example, the Bylaws provisions related to dissolution,

sale, and distribution of assets can be very important in preventing a cooperative from selling out to a conventional business. As such, the former owner may want to retain a right to veto any attempted changes to those provisions of the Bylaws. This may not be allowed under many cooperative corporation statutes, but it is allowed in California under Corporations Code Section 12331.

## Employment Law and Worker Cooperative Conversions

When converting a business to a worker-owned cooperative, it is possible that the conventional and legally-recognized employee-employer relationship could begin to blur as a result of the new distribution of ownership and control. It brings up the question: Will or should the worker-owners remain classified as employees? If so, do all employment-related regulations continue to apply?

Generally, having employees comes with a list of obligations and requirements for the employer, including:

1. Paying for overtime work;
2. Ensuring proper work hours and breaks;
3. Withholding and remitting payroll taxes and other withholdings;
4. Maintaining workers compensation insurance;
5. Complying with occupational safety and health laws;
6. Allowing employees to organize and join unions;
7. Verifying eligibility to work in the U.S.;
8. Adhering to standards and practices that protect employee benefit plans;
9. Posting notices and posters related to employee rights; and
10. Adhering to certain recordkeeping requirements.

If the employment relationship ceases to exist upon conversion to a worker cooperative, most or all of the above requirements will cease to apply. There are pros and cons to maintaining the employee status of the worker-owners. On one hand, the above requirements can be expensive, due to the administrative demands of compliance and due to the direct cost of workers compensation insurance and payroll services. A recently converted worker cooperative may show increased margins by avoiding the above requirements, or it may choose to invest the savings in other types of benefits and protections for the worker-owners.

On the other hand, the requirements listed above offer a substantial degree of protection to the worker-owners in cases where the tyranny of some worker-owners would result in exploitation of other workers-owners. If this is the case, however, it is arguable that an employment relationship *does* exist, and the cooperative could not have sidestepped employment law to begin with.

It is critically important to evaluate the question of employment status carefully. Failure to properly classify someone as an employee could result in an expensive lawsuit or fine when a labor department or worker decides to call out the actual employment relationship. Below, we provide some of the leading case law on determining the difference between a business owner/partner and an employee. Even with the detail provided below, we strongly suggest seeking the advice of an employment lawyer to ensure that workers are properly classified.

### When are Worker-Owners Employees?

It is widely accepted that if you start a sole proprietorship and work for yourself, you are not your own employee. How does that apply when three 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 is formed?

Employment laws exist primarily to balance the relationship between "master" and "servant," and generally do not apply when there is truly no master/servant relationship. In 2003, the U.S. Supreme Court, in *Clackamas Gastroenterology Associates, P.C. v. Wells*, was asked to decide whether the Americans with Disabilities Act applies to working shareholders of a small professional corporation. The outcome of the case turned on whether the shareholders were employees of the business. The Court summarized the following guidelines for determining when a master-servant relationship exists:

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

Note that not every court or labor department will apply the same test, and there are many tests that have been developed for determining 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. The court named the following factors as relevant to the determination:

1. The right and duty to participate in management;
2. The right and duty to act as an agent of other partners;
3. Exposure to liability;
4. The fiduciary relationship among partners;
5. Use of the term 'co-owners' to indicate each partner's 'power of ultimate control;
6. Participation in profits and losses;
7. Investment in the firm;
8. Partial ownership of firm assets;
9. Voting rights;
10. The aggrieved individual's ability to control and operate the business;
11. The extent to which the aggrieved individual's compensation was calculated as a percentage of the firm's profits;
12. The extent of that individual's employment security; and
13. Other similar indicia of ownership.

One thing that the above tests tell us is that if a worker cooperative chooses not to classify worker-owners as employees, it must give substantial management power to those worker-owners, and must adopt clear safeguards to prevent the devolution into a more hierarchical structure. It is also possible that the relationships could change over time, as management structure changes. Thus, it is even a good idea to conduct periodic "audits" to ensure that all workers are properly classified. Below, we provide additional guidance on determining how much control each worker-owner must have in order to be classified as a "partner," rather than employee.

### How much control must each cooperative member have in order to be considered a "partner" rather than an employee?

If all members of a small worker cooperative serve on the Board of Directors and take part in collective management processes, 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 in 1987. 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. What is important is that the individual gives this power voluntarily.

In another case, *Fountain v. Metcalf, Zima & Co.* (1991), the 11th Circuit 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."

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, in 1987, the U.S. District Court of the Southern District of New York in *Caruso v. Peat, Marwick, Mitchell & Co.* 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, and
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 that "[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."

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. In that case, the court emphasized numerous elements in support of a finding that the cooperative members were not employees, 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."*

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, supermajority voting, or another process that gives each member a strong voice in each decision.
3. Give each member a lot of control over his/her own work, or create many semi-autonomous departments or committees that control their own work, procedures, and hours.
4. Make it somewhat difficult to fire people, by requiring a vote of a large number of members.
5. If you put some people in a position to manage and supervise others, ensure that they can easily be moved out of their supervisory roles by a proposal brought to the cooperative by the people they supervise.

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

In some jurisdictions and under some statutes, courts have leaned toward the assumption that shareholders of corporations should be treated as employees when they work for the corporation they co-own. In other jurisdictions, the fact of incorporation is merely one factor, among many, that a court would consider in determining whether an employment relationship exists. Generally, corporations *are* required to treat their officers as employees for tax purposes. This does not, however, mean that a corporation must treat its officers as employees for the purpose of wage and hour law, workers compensation, and other realms of employment law.

Uncertainty about whether incorporation automatically creates an employment relationship has caused stress for some worker cooperatives, which are often formed as some type of Cooperative Corporation. As a result, some worker cooperatives have chosen instead to form as partnerships or limited liability companies (LLCs), entities where a court is less likely to find that managing partners and managing members are employees.

The U.S. Supreme Court, in the *Clackamas* case, and other courts have found that a "partnership," rather than employment, relationship exists even when the entity is a corporation. In 2009, 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. 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 a cooperative corporation, as opposed to a partnership or LLC, be extra attentive to the question of whether there is an employment relationship, and talk to a lawyer.

## Workers Compensation Insurance and Cooperative Conversion

In some cases of worker cooperative conversion, even if the worker-owners continue to treat themselves as employees, they may become exempt from certain legal requirements, such as the requirement to provide workers compensation insurance. For example, Section 3351 of the California Labor Code contains exceptions to the requirement that all employees be covered by workers' compensation insurance, such as "where the officers and directors of the private corporation are the sole shareholders thereof," or where the "working members of the partnership or limited liability company are general partners or managers,"

Thus, in the case of a cooperative corporation operating in California, 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 collectively meet this requirement. However, if there are cooperative members who do not serve on the Board of Directors, then it's possible that workers compensation will be required for everyone. 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 chooses to form as a partnership or LLC will also be exempt from carrying workers compensation if the working partners/members all participate in management.

At least one business that we know of converted to worker-ownership, brought all new worker-owners onto the Board, cancelled workers' compensation insurance for those worker-owners, and spent the savings on health benefits and long-term disability insurance.

## Could conversion affect union status of workers?

If employees take over ownership of the business they work for, they may still elect to form a union or remain part of a union, so long as a specific union's policy allows them to remain members. However, the worker-owners *might* lose their *protected right* to organize, meaning that if managers or a group of workers seeks to block organizing, the worker-owners may have no recourse. The National Labor Relations Act (NLRA) protects the right of employees to organize unions and collectively bargain with employers, and it prevents employers from intervening in and backlashing against such organizing.

Conversion of a business to a worker cooperative could move the worker-owners outside of the protection of the NLRA if the worker owners have an "effective voice" in the operation and policies of the business. In any cooperative where the worker-owners elect the Board and can serve on the Board (which is most worker cooperatives), it is quite possible that the NLRA would not protect the right of workers to organize. In addition, the worker-owners might not have a protected right to organize if there is a conflict of interest between the worker-owners and the non-owner workers of the business.

Whether members of a worker cooperative have a protected right to form or join unions is addressed in great depth by attorney Neil A. Helfman in his 1992 article "The Application of Labor Laws to Workers' Cooperatives," and by Deborah G. Olson in her 1982 article "Union Experiences with Worker Ownership: Legal and Practical Issues Raised by ESOPs, TRASOPs, Stock Purchases and

Cooperatives," Wisconsin Law Review.

The application of the NLRA to worker-owned businesses has also been examined in the following cases:

- *NLRB v. Union Furniture Company,* 67 NLRB 1307 (1946) (holding that employee-stockholders who chose the Board of Directors from amongst themselves had substantial control over corporate policy and divergent interests from non-proprietary employees).
- *Brookings Plywood Corp.*, 98 NLRB 794 (1952) (holding that employee-shareholders who could *collectively* influence company policy had sufficient control over corporate decision-making to fall outside of the protection of the NLRA).
- *Everett Plywood and Door Corp.*, 105 NLRB 17 (1953) (holding that employee-stockholders in a cooperative were protected by the NLRA).

# The Role of Lawyers in Cooperative Conversions

## The Need for Lawyers to Support Cooperative Conversions

While many conventional businesses operate and transact without much help from lawyers, cooperative conversions are perhaps uniquely in need of legal expertise and support. The reasons for this include:

- Cooperatives have unique governance, financial, and tax requirements that are not commonly understood by laypeople, banks, landlords, and other institutions and individuals vital to the business.
- Selling a business, under any circumstance, involves many steps, tax considerations, securities law considerations, and other technical details that are best handled by someone trained and experienced in handling such transactions.
- Business owners and employees have a lot at stake during a cooperative conversion, and each should receive independent advice.

Employees may be particularly vulnerable during the process of conversion, because they may be taking a risk with both their jobs and their personal assets. 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. By contrast, converting a business to a worker cooperative comes with fewer worker protections.

There will, for at least the next few years, likely be a gap between the demand for legal services and supply of lawyers competent to assist with cooperative conversions. There are simply very few lawyers in the U.S. with expertise on worker cooperatives. As such, this is also a call to action: Lawyers everywhere should learn about worker cooperatives and position themselves to be of service to the trend of cooperative conversions. Competence to advise on cooperative conversions entails basic knowledge of Subchapter T and Section 1042 of the tax code, of the processes and tax consequences of selling a business, of employment laws, of cooperative entity choices and structure, and of basic securities law.

In coming years, organizations like the Sustainable Economies Law Center and Democracy at Work Institute will likely begin to offer trainings for lawyers seeking to develop expertise in these areas. In the meantime, the U.S. Federation of Worker Cooperatives and the National Cooperative Business Association both maintain lists of professionals, including lawyers, accountants, and business strategists, able to assist cooperatives.

## Roles of Lawyers

Lawyers generally assist with a wide variety of questions and tasks in the process of cooperative conversion, including:

- Helping to choose and structure the business entity and laying out a roadmap to the conversion process,
- Drafting most or all documents described in the Documents section of this handbook,
- Filing paperwork with governmental agencies,
- Ensuring that the transactions, financing arrangements, and membership structure comply with securities laws,
- Ensuring that the cooperative governance and financial structure comply with Subchapter T of the Internal Revenue Code,
- Advising on the impact of the conversion on employment law,

- Reviewing the financial statements and records of the business to ensure that there are no concerning liabilities,
- Advising on the details of the proposed cooperative Bylaws and advising the workers on their rights with regard to finances, voting, and influencing decisions,
- Reviewing the conversion transactions and explaining the tax consequences for the entities and individuals, and
- Verifying that the business is current on all filings and payment of taxes.

In some cases, financial or tax advisors might be more suitable to advising parties on some components of the conversion, particularly in assessing the financial viability of conversion and personal tax consequences. Lawyers are not necessarily good with numbers and may not know how to spot issues on financial statements. A financial or tax advisor could actually sit down and do math with a client in order to play out different financial scenarios and outcomes. This process is important, as it may reveal situations where an individual or entity is taking on too much debt or failing to budget for the payment of certain taxes.

## Why Multiple Lawyers Will Likely Be Involved

A key question in the cooperative conversion process is: Which parties need their own lawyers? While it may be convenient and cost-saving to have just one lawyer involved in the conversion process, a single lawyer cannot effectively consider and protect everyone's interests simultaneously. Lawyers must follow professional ethical rules, which strongly urge, but do not absolutely mandate, that each party to a transaction be represented by independent counsel. This is to ensure that each party is fully advised of her rights, responsibilities, and risks when entering into a transaction, and that, when the interests of parties are in conflict, each party's attorney can advocate for an ideal outcome for her client. It is common for business partners to seek separate counsel when forming a business and negotiating the terms of the partnership or operating agreement. After formation, however, it is typical for only one lawyer to work with and represent the business entity. Thus, once the conversion is complete, it is likely that most lawyers will drop out of ongoing involvement, and the cooperative will work with one lawyer to assist with legal needs going forward.

Even when multiple lawyers are involved in the conversion, the process need not be adversarial and may be highly collaborative. All parties might discuss the conversion openly and come to a general agreement about the plan for and terms of the conversion. When it comes to drafting the key legal documents, it is common for one lawyer to take the lead and prepare drafts, which other lawyers review.

### In The Ideal Scenario: Everyone Would Get Independent Advice

During a worker cooperative conversion, *each worker*, *each selling owner*, and *each entity* is technically a separate party, and each might want to consider seeking independent advice on the financial and legal considerations, particularly when borrowing money, guarantying a loan, lending money, or contributing capital. A lawyer can help an individual or entity assess financial risks and goals, and make requests for changes to the legal documents in order to protect the client. In a perfect world, where lawyers would be affordable and where cooperative-specialized lawyers would be in abundant supply, the ideal scenario would be for every party – both individuals and entities – to get independent counsel.

If each employee does seek independent advice, it will ideally cost no more than $500. If legal services are more costly, it becomes decreasingly likely that an employee would seek independent counsel. As such, it will be important for lawyers to prepare themselves for advising a single employee on the legal implications of worker cooperative conversion, without creating undue cost for the employee. A lawyer could be prepared with a basic check-list of documents to review and matters to discuss with the client, in order to make the process quick and efficient.

### Second Best Option: Involve at Least Two Lawyers

In reality, since it may be hard for each party to seek out independent legal advice, the best affordable option may be for one lawyer to represent the owner or group of owners selling the business (or the business itself) and a second lawyer to advise workers as a group. The lawyer advising the workers as a group would likely require that everyone sign a waiver to acknowledge the potential for conflicts of interest, such as situations where one worker is taking greater risks than others. If one individual plans to put substantially more capital at risk than others, that particular individual may wish to seek separate counsel.

### For Simple Conversions: When One Lawyer Might Suffice

It has happened that businesses have converted to worker cooperatives with the help of only one lawyer representing the entity that is converted. When there is a shortage of affordable lawyers, this may be a viable option if the conversion does not require workers to take a significant financial risk, if the business has no debt or liabilities, and if the conversion does not affect the employment status of the new worker-owners. In such an arrangement, if there are very few risks for employees who become worker owners, it's conceivable that no harm would be done if only one lawyer is involved. Nevertheless, it is always advisable to have someone looking out for the interests of the workers, conducting due diligence to ensure that there are no hidden risks and liabilities.

## Legal Case Study: Island Employee Cooperative[62]

The Island Employee Cooperative ("IEC") was created after Vern and Sandra Seile, owners of a supermarket, grocery store, and pharmacy/variety store, merged and sold their businesses to their employees. The IEC conversion powerfully illustrates the importance of worker ownership as a succession plan for retiring business owners. The stores are located in remote locations in Maine, and, without the stores, local residents would have to travel 25 to 45 miles to obtain similar goods and services. At least one of the stores had been in operation for half a century, and the stores provided jobs for over 60 area residents. After a full year of listing the businesses for sale, the owners had received only one offer, which was too low. Since selling the businesses to an outside owner could have resulted in consolidation of the stores and reduction of jobs, selling the business to workers may have been the best option to enable the owners to retire while keeping the jobs and essential stores in the community.

### Exploring Cooperative Conversion

The Cooperative Development Institute ("CDI") assisted the Seiles in exploring the benefits of and potential for conversion, after which the Seiles picked twelve of their most experienced employees to meet with a representative of CDI, Rob Brown. All of the handpicked employees had prior experience with cooperatives (such as the Stonington Lobster Fisherman Producer Cooperative) and had some passing familiarity with employee cooperatives. During the meeting, ten of the twelve employees volunteered to form a Steering Committee if, upon further deliberations with all of the employees, there was enough support to move forward with the conversion.

### Forming the Steering Committee

Rob Brown organized a meeting with all of the employees, more than sixty people. At this meeting, Brown gave a presentation about cooperatives, and afterwards took a written commitment of interest from employees. The document was a way for employees to express their interest in forming an employee cooperative and electing the aforementioned ten employees to form a Steering Committee to represent the employees during the conversion process. About 80% of the employees signed the commitment of interest and the Steering Committee was formed.

### Forming the Cooperative

Brown met with the Steering Committee on a weekly basis for a few months to teach them about cooperatives, sharing example Bylaws and other documents to help inform the Steering Committee about potential governance options for the cooperative. The employees formed a corporation and structured it as a cooperative, the majority of employees became members of the cooperative, and the members elected the Steering Committee to serve as the first Board of Directors. At the time of this writing, the cooperative has forty-five members, out of a total of sixty employees.

### Financing the Purchase and Structuring Agreements with Lenders

Coastal Enterprises, a community development financial institution (CDFI), helped the cooperative to convene multiple lenders and obtain the necessary financing to purchase the business. The cooperative obtained the following loans:

- $500,000 from Associated Grocers of New England
- $1,000,000 from Coastal Enterprises
- $800,000 from the Cooperative Fund of New England

[62] We are enormously grateful to IEC and to attorney Clifford Ginn for taking the time to explain the legal details to us.

- $3,300,000 from the selling owners, who took a $1,500,000 promissory note and a second $1,800,000 promissory note, with the intention that the National Cooperative Bank could later acquire the second note.

Each lender conditioned its loans on the provision of financing by the other lenders, meaning that they all went in together to help complete the conversion and to ensure that the businesses would continue to thrive. The lenders executed a detailed Inter-Creditor Agreement that defines the respective rights of the lenders in relation to each other, the priority of repayment for each loan, and which assets would be used to secure which loans. The purchase of the businesses came with purchase of real estate, which was used to secure the loans. The Associated Grocers loan had first priority to be secured by the stores' inventories, which, although fluctuating, were valued at over $930,000 at the time the businesses were sold. In addition, some of the loans were secured by corporate stock (explained below). The selling owners' $1.5 million note was subordinated to the other loans, and there was an additional provision that would require a holiday on loan payments for that particular loan in the event that cash flow of the cooperative falls below a certain level.

To further ensure that the loans were secure, the lenders conditioned financing on the following agreements from IEC:

- That IEC could not dispose of its assets, dissolve, or merge the business entities without lenders' consent.
- That capital expenses over $100,000 require pre-approval of the lenders.
- That distributions beyond normal wages and salary are not permitted without permission of lender, meaning that patronage dividends generally cannot be paid without permission of lenders.

In addition, to ensure the ongoing health of the businesses, the lenders required IEC to contract for long-term consulting services with the selling owners, Independent Retailers Shared Services Cooperative ("IRSSC"), CDI, and Specialized Accounting Services. IRSSC, a consulting organization with significant expertise in the retail grocery sector, trains managers, negotiates contracts with suppliers, performs marketing and merchandising, develops business plans, and trains worker-members to read financials.

### Worker Buy-In

The worker-members made approximately $300,000 in capital commitments, although a portion of that was not provided in cash, but was to come out of employee salary withholdings over time. The cooperative issued two classes of shares, one of which – Class B – is intended only for the roughly 45 employees who took the risk of becoming the founding members. Both Class A and B shares had a $1,000 buy-in, with one Class A and six Class B shares required for the founding members. The Class B shares were structured to accrue interest at a rate of 6% and either the cooperative or a member holding Class B shares could compel redemption after five years.

### The Purchase Agreement and Conversion Process

The entire process of conversion took 13 month to complete, with a purchase agreement having been signed in January, 2014 and sale closing in June, 2014. Both CDI and IRSSC provided substantial assistance to the employees, helping with the development of business plans, governance documents, purchase agreement, investment structure, and due diligence.

Before the purchase, two of the stores (both LLCs) were merged into the third (a corporation called Burnt Cove). All of the Burnt Cove Corporation's stock was then sold to IEC for $5.6 million by means of a Stock Purchase Agreement. Since the selling owners were able to benefit from the 1042 tax deferral, the cooperative was able to negotiate a lower purchase price than might have been paid by a conventional buyer.

The Burnt Cove Corporation continues to operate as a subsidiary of the cooperative, and has not merged with the cooperative, which makes the IEC case somewhat unique. It is a Type D conversion, per the typology we described earlier in this handbook. A primary reason that the entities did not merge is that the corporation's stock was pledged to secure some of the loans received by IEC, and a cooperative generally cannot pledge stock as a security interest without undermining the entity's cooperative legal structure. According to the IEC Bylaws, the corporation's Board of Directors must be the same individuals as the cooperative's Board, which is elected by cooperative members. When the loans are paid off, it is quite possible that the Burnt Cove Corporation could convert to a cooperative and then merge with IEC, or simply sell its assets to IEC. Further research is likely needed to assess the pros and cons of keeping a separate entity as a subsidiary of a worker cooperative, particularly with regard to the tax implications.

### Additional Steps and Documents Required in the IEC Conversion

The sale of any business – whether to a cooperative or conventional business entity – generally requires a good deal of paperwork and due diligence. To complete the transaction in the case of IEC, parties needed to transfer title of land and buildings, release each other from liability, notify other tenants of the change in ownership, re-assign insurance policies and other contracts, verify that all entities were up-to-date on necessary filings and taxes, properly take Board or Membership action to remove and appoint directors and officers, and execute documents to purchase business assets. In addition, the sellers agreed to not create a similar business (grocery, drug store, or hardware store) in the same county for 5 years, and that the sellers will not solicit any of the employees to work for them during that time.

## Legal Case Study: Select Machine

Select Machine is an Ohio-based firm that manufactures, sells, and distributes custom parts for demolition and construction equipment. It was founded in 1994 by Doug Beavers and Bill Sagaser. When Beavers and Sagaser began considering retirement in 2006, the company had 11 employees and sales of $2.5 million in 2006.[63] Beavers and Sagaser began seeking out buyers, and though several offers materialized, prospective buyers seemed primarily interested in getting their hands on Select Machine's client list. Beyond that, they would likely shut down the plant and cherry-pick through the equipment for use at facilities elsewhere. This spelled out layoffs for Select Machine's current employees. Beavers and Sagaser considered the employees of Select Machine – which is located in a rural, close-knit community – to be family. They did not want to see the plant closed and their friends out of work. As Sagaser put it, "[t]hese are our guys, our family, and we wanted them to keep on working."[64]

### Exploring Cooperative Conversion

In 2005, Beavers' and Sagaser's banker suggested they contact the Ohio Employee Ownership Center (OEOC) for guidance. OEOC is a non-profit organization that provides outreach, information, and technical assistance to employees and business owners interested in employee ownership. OEOC director, John Logue, knew that an Employee Stock Ownership Plan (ESOP), a standard exit strategy incorporating features of employee ownership, would be too expensive for a small operation like Select Machine.[65] Logue suggested that instead, Select Machine explore conversion to a worker cooperative as an exit strategy. OEOC mediated the conversion, helped fund a feasibility study, and financed part of the initial stock redemption.

### Selecting a Buyout Committee and Assessing Feasibility

The OEOC staff conducted several meetings with the owners, reviewed the company's financials, and toured the facility to get a better understanding of the business and to start charting out what the transaction would entail.[66] Beavers and Sagaser discussed the idea of converting to a worker-owned business with the employees, and were met with enthusiasm. OEOC then met with the employees to explain the basics of worker cooperatives and how such a conversion could be structured for Select Machine. The employees then voted to investigate the possibility of setting up a cooperative, and elected a "buyout committee" to undertake that task. Local accounting firm Brott Mardis conducted the feasibility assessment to estimate the value of the business and to determine if the sale was possible. The study was paid for by the Ohio Department of Job & Family Services' Prefeasibility Study Grant Program, administered by OEOC. The valuation exceeded the founders' predetermined selling price, but the owners stuck with their original sale price nevertheless.

---

[63] Barbara Taylor, *A Creative Way to Sell Your Business* N.Y. Times (October 29, 2010, 7:00 AM) http://boss.blogs.nytimes.com/2010/10/29/a-creative-way-to-sell-your-business/.

[64] Joan Raymond, *Unlikely Pioneers*, Bloomberg Businessweek, (March 19, 2006) http://www.businessweek.com/stories/2006-03-19/unlikely-pioneers.

[65] *Id.*

[66] John Logue, *The 1042 Roll-Over Cooperative in Practice: A case study of how Select Machine became a co-op* (Ohio Emp. Ownership Ctr. 2006) https://docs.google.com/viewer?url=http://american.coop/sites/default/files/1042rolloverco-opsmncasestudy.pdf&chrome=trues.

## Preparation of Offering Statement and Vote to Convert

At the completion of the feasibility study, Mark Stewart prepared an offering statement for the employees.[67] The prospective worker-owners then took time to review the offering statement, the feasibility study, the valuation, and the financial statements of the company. The employees then held a vote and agreed to set up an employee-owned cooperative.

## Deciding on Cooperative Financial and Patronage Structure

They then moved into deliberations about how to structure the cooperative, qualifications for membership, membership fees, and how to allocate patronage. They set the cooperative membership fee at $1,000. They developed a weighted patronage formula to use for allocating profits amongst the worker-owners. The formula assigns 50% of patronage to W-2 earnings (rewarding current market value of their skills), 25% to hours worked (rewarding diligence and equality), and 25% to seniority capped at 120 months (long-term contribution to the business). Until the debt is paid off, the worker-owners' patronage allocations will go to pay down the note used to acquire their stock.

## Financing the Buy-Out

To finance the deal, Logue and attorney Mark Stewart developed a multi-stage buy-out plan wherein the cooperative initially took out $324,000 in loans from a local bank and revolving loan fund, all personally guaranteed by Beavers and Sagaser, to finance the redemption of an initial 40% of Beavers' and Sagaser's stock. The monthly loan payment of $6,000 would come out of the company's cash flow.[68] Once the loans were repaid, Beavers and Sagaser would sell the remaining shares to the cooperative. They would then retire from the business. In the intervening period, they would train the other worker-owners to run the business successfully.

## Executing the Conversion and Partial Buy-Out

The sale and conversion happened simultaneously. Select Machine’s articles of incorporation were amended and restated to restructure the company into an employee cooperative. New Bylaws were drafted to replace the old Bylaws, reflecting the new cooperative structure. All of the nine employees at Select Machine (including the two owners) became worker-owners. The worker-owners elected a board of five comprised of the two selling owners and three new worker-owners. The new board then voted to authorize the redemption of 40% of Beavers' and Sagaser's stock, and to authorize the cooperative's borrowing of the money to fund it. From the initial conversation between Select Machine and OEOC to completion, the deal took six months.

## Ongoing Involvement of Original Owners

As noted above, Beavers and Sagaser became members of the cooperative as well. To do so, they each put up a portion of their unredeemed stock holdings as their membership stock (their portions being equivalent to the average membership stock the other members hold). Whereas the patronage allocations distributed to the other worker-owners goes toward paying down the debt used to purchase the worker-owners' stock, Beavers' and Sagaser's patronage allocations went directly into their capital accounts. After all, their membership stock is not debt-financed – as it came from their unredeemed stock holdings, they already own it. To be clear, however, while Beavers and Sagaser will build their capital accounts, they will not acquire additional stock in the process. Additionally, Beavers, Sagaser, and the cooperative executed an owners' employment agreement that provided Beavers and Sagaser with certain reserved rights as "protected shareholders" until their stock is fully redeemed.

---

[67] *Id.* at 3.
[68] Raymond *supra* note 64.

## Completing the Gradual Buy-Out

While the cooperative planned on purchasing the outstanding 60% of stock by 2010, the dismal economy led the workers to elect to delay the transaction. Due to a decrease in revenues, the company reduced its workforce on a voluntary basis in 2009. During the recession, the cooperative redeemed a 5% block and then a 10% block. As the economy began to recover in 2010, however, Select Machine, Inc. returned to pre-recession revenues, and the worker-owners resumed the process to complete the full acquisition. Finally, in 2011, the cooperative redeemed the remaining stock from the founders, financed by a loan from the founders themselves. Although the parties agreed from the outset to revalue the company for each stock redemption agreement, the company was revalued only for the final stock redemption. The cooperative continues to repay the loan from the founders.

The conversion, from the first discussion with OEOC to first stock redemption, took six months, and the stock redemptions took six years to complete.

**Acknowledgments:**

This summary was written by staff and interns of the Sustainable Economies Law Center and Green Collar Communities Clinic, based on an interview with Todd Brewster, 10-31-14, and from various secondary sources, including:

- http://dept.kent.edu/oeoc/oeoclibrary/1042_rollover_co-ops_MN_case_study.htm
- Roy Messing (2011). "Transitioning a Private Business to a Worker Cooperative: A Viable Community Development Tool." Grassroots Economic Organizing (GEO) Newsletter, Volume 2, Issue 8. http://geo.coop/node/637.
- Joan Raymond, "Unlikely Pioneers," Bloomberg Businessweek, March 19, 2006, http://www.businessweek.com/stories/2006-03-19/unlikely-pioneers.
- John Logue, "The 1042 Roll-Over Cooperative in Practice: A case study of how Select Machine became a co-op," Ohio Employee Ownership Center, 2006, http://american.coop/sites/default/files/1042rolloverco-opsmncasestudy.pdf
- Barbara Taylor, "A Creative Way to Sell Your Business," N.Y. Times, October 29, 2010, http://boss.blogs.nytimes.com/2010/10/29/a-creative-way-to-sell-your-business/

## Legal Case Study: Loconomics Conversion to a Freelancer-Owned Cooperative[69]

### Background

Loconomics is a company that some would place in the realm of the "sharing economy" or "peer economy." Along with Airbnb, Handy, Uber, and Task Rabbit, Loconomics is an online platform where people may offer their services to strangers who use the platform to book, pay for, and review the services. The service providers who use the platform include babysitters, dog walkers, house cleaners, massage therapists, psychotherapists, and handy people. They are also part of the "freelancer economy," which is made up on a growing number of people who operate independent businesses, do temporary work, moonlight, and generally work on an independent contractor basis. Organizations like the Freelancers Union have recently been calling attention to the need to create greater income security and better working conditions for this growing sector of society, which, by some estimates, currently encompasses more than one third of the workforce.

### A Freelancer-Owned Cooperative

Loconomics offers a solution to this need. In contrast companies like Airbnb and Uber, which take a large cut of freelancers' earnings and which operate primarily for the benefit of their shareholders, Loconomics is now what founder, Josh Danielson, describes as a "freelancer-owned cooperative," a company that is owned and democratically governed primarily by the freelance workers that benefit from the company's service. Some of the ways in which a freelancer-owned cooperative would likely differ from a conventionally-structured company in the sharing economy is that it is more likely to:

- Work to ensure predictable work for freelancer members,
- Keep fees low,
- Distribute dividends to freelancers,
- Offer benefits and supports services to the service providers,
- Bargain on behalf of freelancers (for insurance and other benefits),
- Create rules and culture that benefit freelancers and help maintain freelancer independence and mobility, and
- Empower freelancers to propose and carry out initiatives within the company.

### Loconomics as a Conventional Shareholder-Owned Corporation

Loconomics was previously a for-profit company structured as a California Benefit Corporation with eleven individuals holding stock and/or stock options. Each of these eleven shareholders contributed time, and – in some cases – money, to the founding of the company and the creation of the platform. In 2014, the platform was nearing completion and was already in use by a handful of service providers. Josh Danielson approached the Sustainable Economies Law Center (SELC) to seek legal assistance with converting the company to a cooperative.

### Documents Required in the Conversion

SELC assisted by helping to prepare:

- A letter to the shareholders to explain the thinking behind and process of cooperative conversion,
- A Stock Redemption Agreement (attached as a sample),

[69] Although Loconomics is not strictly a worker-owned cooperative, we have included it here since it is structured in a similar spirit to support workers, and because the conversion process included steps that would be similar in the conversion of company to a worker-owned cooperative.

- A Promissory Note (attached as a sample),
- Amended and Restated Articles of Incorporation (attached as a sample),
- Amended Bylaws, and
- Amended Terms of Use for the platform.

## Redemption of Stock and Stock Options

To convert the Benefit Corporation into a California Consumer Cooperative Corporation, Loconomics first redeemed all outstanding stock shares and stock options in exchange for promissory notes. Loconomics was fortunate to have all shareholders agree to forego the potential for profit maximization, in exchange for locking in a fixed return based on the agreed-upon valuation of the company. Had even one shareholder refused to voluntarily redeem stock for a promissory note, the conversion process would have had to be different (a Type C conversion), since the only way to force redemption of the stock would be to create a second entity and merge the original Loconomics entity with the new entity. Fortunately, since everyone consented, the process was simpler, and Loconomics needed only to amend its Articles and Bylaws to become a cooperative.

## Valuation and Promissory Notes

There was no clear way to value the company, given that very few people were using the platform at the time. Appraising tech start-ups is difficult, because Loconomics could have become huge and worth billions, or it could have fizzled out and been abandoned. Josh proposed and everyone agreed that the company be valued at approximately $750,000, based on a decision to compensate each of the eleven people at a rate of $75 per hour for the time they put into the creation of the platform and the risk they took in building the company. Thus, Loconomics now has $750,000 in outstanding promissory notes. These promissory notes accumulate interest at a rate of 5%, and are repayable over the term of 5-10 years, with repayment beginning two years after executing the notes. Each shareholder signed a Stock Redemption Agreement in which they relinquished their interest in the company in exchange for promissory notes that outlined the terms of repayment.

## Amending Articles and Bylaws

After redeeming all stock, Loconomics filed Amended and Restated Articles of Incorporation that officially converted the company into a cooperative corporation. The Board had the power to adopt and file the amended Articles, because the corporation, at the time, had no shareholders, and had not yet admitted members. After filing the Articles, the Board appointed a new Board to serve on behalf of the cooperative. At the time of this writing, members have not yet been admitted into the corporation.

## Membership Structure

Ultimately, Loconomics adopted Bylaws that made it a multi-stakeholder cooperative, allowing the following to be members:

1. Individual freelance service providers (who would make up the vast majority of members),
2. Worker-owned cooperative service providers,
3. Nonprofit service providers filling unmet needs in the community,
4. Loconomics employees, and
5. Loconomics independent contractors.

Each member, regardless of their above category that they fall into, receives one vote in the election of the Board of Directors. When there is surplus income, each member would receive a patronage dividend on the basis of how many hours of services they booked using the Loconomics platform, or, in the case of the company's workers and independent contractors, how many hours they worked for the company.

# Legal Case Study: Real Pickles

## Background

Normally food business founders dream of an exit strategy that involves selling the business to a large player in the food chain. Think *Odwalla* or *Naked Juice*. For Real Pickles owners Dan Rosenberg and Addie Holland, however, selling their business to a large corporation would have compromised their business' social mission "to promote human and ecological health by providing people with delicious, nourishing food and by working toward a regional, organic food system."[70] Converting to an employee-owned business was a way for the owners to preserve Real Pickle's social mission long after selling their ownership stake. In 2012 they formed a cooperative with their employees. And in 2013, after owning the business for twelve years, sold Real Pickles to the new cooperatives, Real Pickles Cooperative, Inc.

## The Deal

The founders landed on a sales price of $524,000 for the business and entered into an MOU with their three employees to sell the business to the new coop. The founders stayed on in the business and, alongside their three employees, became worker-owners of the coop. The buy-in for each work-owner, including the two founders, was $6,000—which was a total of $30,000 in member capital invested in the cooperative. The plan was to raise the bulk of funds to purchase the business from the direct public offering. The owners agreed to extend a loan, at 4% simple interest rate, for the balance of whatever was not raised by the direct public offering.

The breakdown of the deal was that the new cooperative would purchase all of the assets and liabilities of Real Pickles, the partnership. Included in that purchase was $400,000 of goodwill. In addition, the cooperative assumed about $145,000 in debts. The owners owned the property out of which Real Pickles operated and agreed to a long-term lease at an annual rent of $67,500 and granting a right of first refusal to the Cooperative upon sale of the property.

## The Financing Strategy

Real Pickles used a direct public offering of preferred shares to finance the majority of the sale of the business to the cooperative. The preferred share program was similar to that used by Equal Exchange, a large Massachusetts-based coffee roaster. In determining the preferred share offering terms and sale price, the founders sought financial expertise from PVGrows, a local organization that provides financial and technical advice to area food businesses. For the actual legal involved in doing the direct public offering, Real Pickles hired Cutting Edge Capital (CEC), a consulting firm that specializes in providing legal and technical assistance for direct public offerings.

Real Pickles started the crowdfunding campaign in March 2013 and amazingly, finished it in two months. They were able to get seventy-seven community investors, including other cooperatives, to purchase the minimum share amount, and raise the entire $500,000 offering amount.

Each share cost $25, and investors were required to purchase a minimum of 100 shares, which meant the minimum investment was $2,500. Rosenberg described this minimum investment amount as "low

---

[70] Jonathan Ward, *Community Investment in the Local Food System* at 2 (Cmty. Involved in Sustaining Agric., 2014) *available at http://community-wealth.org/content/community-investment-local-food-system*.

enough to allow for relatively broad participation, while high enough to keep our investment pool a manageable size."[71]

## Preferred share terms

The terms of the offering were laid out in the articles of incorporation, the offering prospectus and the investment flier. The cooperative had two classes of shares- membership shares and preferred shares. Membership shares are reserved for the worker-owners, and are the only voting shares in the cooperative. The preferred shares carried no voting rights, but had a target dividend rate, set at 4% annually. The preferred shares were non-cumulative and the board reserved the right not to declare them in a given year. The preferred shares were non-transferable, except to the Cooperative. Preferred shareholders were able to redeem their shares after five years, if the Cooperative had sufficient funds to repay them. The Cooperative could redeem the shares (i.e. buy out the shareholders) at any time. The offering prospectus clearly laid out the risk for preferred share investors- that they were not guaranteed a dividend, and were not guaranteed that their preferred shares would be redeemed when they requested it. The prospectus further explained that preferred shareholders had no voting rights, beyond the minimum voting rights guaranteed by Massachusetts law. Election of the board of directors was the sole power of the membership shares.

---

[71] *Id.*

## Legal Case Study: Colorado Recovery

### Background

In 2006, Dr. Richard Warner founded Colorado Recovery Center, a Boulder-based residential treatment facility for adults suffering from serious mental illness. Dr. Warner founded the Center to create an ideal environment for patient recovery, in which patients would be respected, encouraged, socialized and empowered. Currently, the Center has over 40 employees, and provides psychiatric services and therapy as well as daily outpatient services for over 100 patients in the Boulder area.

Two years after opening the Center, Dr. Warner was diagnosed with terminal cancer, and realized that he would eventually have to either close or sell the Center. Because the Center boasted a highly motivated staff, and because so many Boulder residents had come to rely on the Center's services, Dr. Warner decided to sell it and ensure that it remained in operation. But Dr. Warner did not want outside investors to purchase the Center and treat it merely as a means of acquiring a return on investment.

To ensure that the Center continued to fulfill its mission, Dr. Warner decided to sell the Center to interested employees, who would exercise voting power on the Board, and to interested patient families. It took three years from the time that Dr. Warner decided to convert his business into an employee-owned business to the time when the first employees gained an ownership stake in the business.

### Key Personnel

Converting Colorado Recovery Center into to an employee-owned business required a great deal of professional assistance and internal support from individuals with crucial business knowledge and acumen. Warner worked with two attorneys, Jason Wiener, who joined the board as a founding member and consultant, and external counsel Maureen Eldredge. Throughout the entire process, external board member R.C. Mercure helped structure and navigate the conversion, drawing upon his 57 years of experience in business management and investing.

### Determining the Sales Price and Incorporating

In order to create transferable equity interests, Dr. Warner converted Colorado Recovery Center from an LLC into a Colorado Corporation. The new corporation included a board of directors, which included Dr. Warner. The board needed to determine a sales price for the business, but decided that an external evaluation would be cost prohibitive. Thus, the board's finance committee decided to conduct its own valuation. The finance committee came up with a price, about $100,000, that they thought would enable the transaction to move forward.

### Corporate Structure and Financing

To structure the sale of the business, the board created three classes of shares. Class A shares would be the common voting shares. Class A shares would be restricted to employees, who would be restricted to ownership of one Class A share. Class B shares would be preferred, nonvoting shares sold to interested patient family members who were interested in ensuring that the Center would continue providing high quality care to their loved ones. Although Class B shareholders did not have direct voting rights, they were able to select two Board seats indirectly through a nominating committee. After determining the sales price, the board sold the Class B shares to patient family members through a private placement. This provided the board with sufficient capital to proceed with the sale of Colorado Recovery to the Class A shareholders.

In order for an employee to obtain a voting Class A share and become an owner, he or she would be required to purchase a predetermined number of Class C shares. In order to ensure that all employees would have the option of assuming an ownership role, the board created a novel, income-based share purchase plan for high-income employees, middle-income employees, and low-income employees. High-income employees, such as psychiatrists, would be required to purchase more class C shares relative to lower income employees in order to obtain one Class A share and become an employee-owner. Low-income employees were afforded the option of purchasing the required class C shares over the course of three years.

In December of 2014, one third of the employees at Colorado Recovery became worker owners. While Colorado Recovery does not necessarily plan for every employee to become an owner, the owners and the board have resolved to ensure that the potential for ownership remains open to all employees.

## Sample Documents

The sample documents provided in this section include three documents used for a Type A conversion, where the original business entity simply files amended Articles and adopts amended Bylaws (as opposed to forming a second entity):

1. **Amended and Restated Articles of Incorporation for a California stock corporation converting to a California Consumer Cooperative Corporation**, along with a sample letter to the Secretary of State. Note that the California Corporations Code is not entirely clear about the exact process and documents required to convert a conventional corporation to a cooperative corporation. Nevertheless, the Secretary of State has accepted a document substantially similar to the following, and explained to us on the phone that the process to convert to a cooperatives is the same as to convert to a nonprofit, as described in California Corporations Code Section 911.

2. **Redemption Agreement** by which any shareholders and stock option holders may relinquish their interests in the company in exchange for a promissory note.

3. **Promissory Note** to be held by any former shareholders and stock option holders in exchange for the redemption of their interests.

4. **Articles of Incorporation for a Massachusetts Cooperative Corporation using Preferred Share Financing.** These are sample articles of incorporation based on those used by *Real Pickles* for their preferred share financing program described in the case study.

**Restated Articles of Incorporation**

The undersigned certify that:

1. They are the president and the secretary, respectively, of OLD CORPORATION, Inc., a California Benefit Corporation.

2. The Articles of Incorporation of this corporation are amended and restated to read as follows:

> Article 1. The name of this corporation is NEW CORPORATION COOPERATIVE, INC.
>
> Article 2. This corporation is a cooperative corporation organized under the Consumer Cooperative Corporation Law. The purpose of this corporation is to engage in any lawful act or activity for which a corporation may be organized under such law.
>
> Article 3. The voting rights of each member of the corporation are equal, and each member is entitled to one vote.
>
> Article 4. The proprietary interests of each member of the corporation are unequal and the rules by which the proprietary interests are determined shall be prescribed in the Bylaws of the Corporation.
>
> Article 5. The liability of the directors of this corporation for monetary damages shall be eliminated to the fullest extent permissible under California law.
>
> Article 6. The corporation is authorized to indemnify the directors and officers of the corporation to the fullest extent permissible under California law.

3. The foregoing amendment and restatement of Articles of Incorporation has been duly approved by the board of directors.

4. The foregoing amendment and restatement of Articles of Incorporation does not require approval by shareholders because there were no outstanding shares of the corporation on the effective date of this amendment.

We further declare under penalty of perjury under the laws of the State of California that the matters set forth in this certificate are true and correct of our own knowledge.

Date: ___________________

_______________________________
NAME, President

_______________________________
NAME, Secretary

April ____, 2015

Secretary of State
Document Filing Support
Unit, 1500 11th Street, 3rd Floor
Sacramento, CA 95814

RE: Restated Articles of Incorporation of OLD CORPORATION, Inc.

Dear Secretary of State:

With this letter, we file Restated Articles of Incorporation for OLD CORPORATION, Inc., which also hereby changes its name to NEW CORPORATION COOPERATIVE, INC. Please contact me at ______ if you have any questions.

We have enclosed a check for $30.00 and a self-addressed stamped envelope.

Sincerely,

…

# Redemption Agreement

**Background Information:** NAME OF COMPANY is a California Corporation that is in the process of converting to a California Consumer Cooperative Corporation, which requires COMPANY to first redeem all stock and stock options from current shareholders. Now, COMPANY and NAME1 wish to clarify the terms of the redemption of NAME1's stock.

1. **Parties:** The parties to this agreement are NAME OF COMPANY and any of its successor entities ("COMPANY") and FULL NAME ("NAME1"), a shareholder of NAME OF COMPANY

2. **Value and Purchase Price of Stock:** NAME1 is the holder of stock and/or of stock purchase options (collectively referred to as "the Stock") in COMPANY. COMPANY and NAME1 hereby agree that the current value NAME1's Stock is __________, and this amount shall be the Purchase Price for the purpose of this Agreement.

3. **Payment and Redemption:** NAME1's Stock shall automatically be surrendered to COMPANY when COMPANY delivers a signed promissory note in the principle amount of the Purchase Price to NAME1. The parties agree that the promissory note in the amount of the Purchase Price represents full consideration for the purchase of NAME1's interest in COMPANY. Upon receipt of the promissory note, NAME1 shall no longer have voting rights in NAME OF COMPANY

4. **Representation and Warranties:** NAME1 warrants and represents to COMPANY that NAME1 is the absolute beneficial owners of the Stock, with good and marketable title thereto, free and clear of any liens, charges, encumbrances, securities interests, or rights of others, and that NAME1 is exclusively entitled to possess and dispose of the same.

   COMPANY warrants and represents to NAME1 that the Corporation is not bound by any agreement or restricted by any provisions contained in its incorporation documents or bylaws that would prevent or prohibit the transactions described in this Agreement. COMPANY warrants and represents to NAME1 that the purpose of this stock redemption is to convert COMPANY into a cooperative corporation.

By signing below, COMPANY and NAME1 agree to the above terms and conditions of this Redemption Agreement.

Dated: ____________________ COMPANY

________________________________
By: PRESIDENT NAME, President

Dated: ____________________ ________________________________
FULL NAME

## Promissory Note

**Background Information:** NAME OF COMPANY is a California Corporation that is in the process of converting to a California Consumer Cooperative Corporation. COMPANY and NAME1, a former shareholder of COMPANY, have entered into a separate Redemption Agreement requiring COMPANY to deliver this promissory note to NAME1, thereby converting NAME1's stock in COMPANY to a loan payable to NAME1 by COMPANY. COMPANY and NAME1 wish to clarify the terms of the repayment of this loan, as follows:

1. **Promise to Pay:** Thus, for value received, COMPANY ("Borrower") hereby promises to pay to the order of FULL NAME ("Lender"), at an address provided to Borrower by the Lender, a sum of $__________________(the "Principal"), together with interest on the unpaid Principal balance accruing at an annual rate of ______%, with all Principal and interest due and payable by the following date: _______________________________.

2. **Payment Plan:** Borrower shall pay Lender _____________________ [monthly/quarterly/annual] installments of at least $_______________ commencing on or before _______________ (some date in the future). Each payment under this Note shall be credited first to interest then due and any remainder to Principal. This Note may be prepaid, at any time, in whole or in part, without premium or penalty, as long as any Principal prepayment is accompanied by a payment of interest accrued to the date of prepayment on the amount prepaid.

3. **Default:** If Borrower fails to pay any sum due under this Note within six months of when it becomes due and payable, this shall be considered a Default. In the event of a Default, the Lender may, at his/her option, declare this Note to be immediately due and payable.

4. **Collection Costs:** Borrower agrees to reimburse the holder of this Note for all costs of collection or enforcement of this Note, whether or not suit is filed (including, but not limited to, reasonable attorney fees and expenses), incurred by the Lender.

5. **No Intention to Resell this Note:** Lender represents and warrants that he/she is purchasing this Note for his/her own account and not for the purpose of re-selling the Note to someone else.

6. **Lender is a California Resident:** Lender represents that he/she is a resident of California.

7. **Relationship Between Borrower and Lender:** Lender represents that he/she has a preexisting personal or business relationship with PRESIDENT NAME and this relationship has involved sufficient contact to enable Lender to be aware of the character, business acumen, and general business and financial circumstances of COMPANY and its founders.

8. **Governing Law:** This Note shall be governed by and construed in accordance with the laws of the State of California.

By signing below, Borrower and Lender agree to the above terms and conditions of this Note.

| | | |
|---|---|---|
| Dated: _____________________ | | COMPANY, **Borrower** |
| | Signature: | _________________________________ |
| | By: | PRESIDENT NAME, President |
| Dated: _____________________ | Name: | FULL NAME, **Lender** |
| | Signature: | __________________________________ |
| | Address: | __________________________________ |
| | | __________________________________ |

# ARTICLES OF INCORPORATION

**Article I** (Name): The exact name of the corporation is Converted Cooperative, Inc. (the "Cooperative").

**Article II** (Purpose): The purpose of the Cooperative is to operate a small, democratically-organized business helping to build a regionally-based, organic food system that supports ecological and human health.

**Article III** (Authorized Stock): This Cooperative is authorized to issue fifty (50) shares of common stock, designated as "Membership Shares," and two hundred fifty thousand (250,000) shares of preferred stock, designated as "Preferred Shares."

**Article IV** (Rights, Preferences, and Privileges of Stock): The Membership Shares and Preferred Shares have the following preferences, voting powers, qualifications, rights, and privileges:

1. Membership Shares

    (a) General Ownership of Membership Shares shall be limited to employees of the Cooperative. No employee may hold more than one Membership Share. Holders of Membership Shares shall be designated as "Members." Individuals seeking to become Members must meet qualifications established by the existing Members in accordance with the bylaws. Membership Shares shall be issued for a fee to be determined by the Board of Directors in accordance with the bylaws. Members of the Cooperative shall have all the rights and responsibilities of stockholders under General Laws Chapter 156B, except as otherwise provided in Chapter 157A.

    (b) Voting Rights. Each Membership Share is entitled to one (1) vote on matters on which the Members are entitled to vote.

    (c) Redemption. When a Membership is terminated for any reason, the amount in the Member's Internal Capital Account will be redeemed in exchange for debt, cash, or a combination thereof in accordance with the bylaws. The Cooperative, when redeeming a Membership Share, shall have the right to reduce the amount redeemed by any debt the Member owes to the Cooperative.

2. Preferred Shares

    (a) Dividend Rights. Dividends shall be payable to holders of the Preferred Shares ("Preferred Holders") when, as, and if declared by the Board of Directors. Dividends shall not be cumulative. Preferred Stock is not entitled to participation rights to distributions paid to Members.

    (b) Redemption By Cooperative. The Cooperative reserves the right to redeem any or all Preferred Shares at any time, at the sole discretion of the Board of

Directors. If the Cooperative elects to redeem Preferred Shares, holders of the redeemed shares are entitled to receive an amount equal to the amount originally paid for the Preferred Shares as adjusted for any future stock splits, stock dividends, recapitalizations or the like ("Original Issue Price") of their shares plus all declared but unpaid dividends ("Redemption Price"). The Cooperative will notify Preferred Holders of the Cooperative's intention to redeem such Preferred Holders' shares in writing thirty (30) days before the effective date of the redemption.

(c) Redemption by Holder. Preferred Holders are entitled to request redemption of their Preferred Shares at the Redemption Price by submitting a written request for redemption to the Cooperative. If the Board of Directors determines that a requested redemption may impair the Cooperative's ability to operate effectively, the Board of Directors may limit, postpone, or refuse the redemption.

(d) Voting Rights. Preferred Holders have no voting rights, except as required by law.

(e) Conversion Rights: The preferred shares are nonconvertible

**Article V** (Restrictions Imposed Upon Transfers of Stock): The Cooperative imposes the following restrictions on transfers of stock:

1. Membership Shares: Ownership of Membership Shares is limited to employees of the Cooperative.

2. Preferred Shares: Preferred Shares are nontransferable, except to the cooperative.

**Article VI** (Other Lawful Provisions)

1. Liquidation Rights: If the Cooperative is liquidated or dissolved, the funds and assets legally available to be distributed ("Available Funds and Assets") to the Cooperative's Members and Preferred Holders shall be distributed as follows:

   (a) first, to Preferred Holders, an amount equal to the Original Issue Price of their shares plus all declared but unpaid dividends; provided that if there are not sufficient Available Funds and Assets to pay the amount due to all Preferred Holders under this provision, the funds will be distributed on a pro rata basis according to the number of Preferred Shares owned;

   (b) second, if Available Funds and Assets remain after the liquidating distribution to the Preferred Holders described in paragraph (1)(a), to the current Members an amount equal to the Members' Internal Capital Account balances; provided that if there are not sufficient Available Funds and Assets to pay the amount due to all Members under this provision, the funds will be distributed on a pro rata basis according to the Members' respective Internal Capital Account balances;

(c) third, any remaining Available Funds and Assets shall be distributed to one or more organizations, selected in accordance with the bylaws, whose missions are consistent with the purposes of the Cooperative.

2. Indemnification: The Cooperative is authorized to indemnify directors for breach of fiduciary duty, unless any provision of law imposes personal liability. This section shall not limit the liability of a director for breach of duty of loyalty to the Cooperative or its stockholders, acts or omissions in bad faith, intentional misconduct, knowing violations of law, actions described in G.L. Chapter 156B Sections 61-62, or any transaction in which the director derived an improper personal benefit.

3. Amendment of Bylaws: The Board of Directors may make, amend, or repeal the bylaws, except with respect to any provision thereof, which, by law, the articles of organization, or the bylaws requires action by the Member