

Limited Liability Companies as Worker Cooperatives

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What is a Worker Cooperative?

A worker cooperative is a business comprised of members that are both workers and owners of the business. Worker cooperatives can help empower workers, create stable jobs and sustainable business practices and create a more equitable work environment.¹ Members are able to control how they structure and manage the business. They have a stake in the success of the business. This framework helps to put workers on equal footing and create democracy in the workplace, something especially powerful among groups of typically disenfranchised peoples.

Why make it a Limited Liability Company?

A worker cooperative may choose to establish itself as a limited liability company (LLC). An LLC is an unincorporated business organization whose members do not have personal liability for the debts of the company. California LLCs cannot be used for professional services or engage in banking, insurance or trust company business.

A worker cooperative may find the LLC model to offer many advantages.

Recognized by Other States

In some states there is an option to establish a worker cooperative as a cooperative corporation, however not every state has such an entity. In contrast, every state allows for the formation of LLCs. Thus a worker cooperative organized as a LLC could be recognized in other states and abroad.

Flexibility

LLCs provide a great deal of flexibility for the organization and management of a worker cooperative. This flexibility makes LLCs a good choice of entity for a new business that is expected to have future structural changes.

¹ <http://www.usworker.coop/aboutworkercoops>

Members of an LLC worker cooperative choose how they want to manage their company. This is determined in their operating agreement. This choice is made democratically. Each member is an owner and is given the power to make this decision. An LLC allows for a company to be either member-managed or manager-managed. The workers are given this choice.

LLCs are not only flexible with respect to management but this also applies to membership. Under an LLC model a worker cooperative can structure its own membership in various ways. For example, it may allow for multiple, passive, active, manager, non-manager, temporary, and provisional members. This would all be defined in the company's operating agreement.

Can have Foreign Members

A significant advantage of a setting up a worker cooperative as an LLC is that it may have foreign members or members that are outside of the United States. This is particularly advantageous for a business that works with importing and exporting.

Empowering, Equitable/democratic Management

An important element of starting a worker cooperative is educating the members of the rights and responsibilities of membership. If the workers choose to become a member-managed LLC then every member has a fiduciary duty to the company and is considered an agent of the company with the power to make decisions binding on the company. It is important for every member then to understand the impacts of their actions. If the cooperative opts for the manager-managed LLC structure, then members are only held to the duty of good faith and fair dealing and only the manager has a fiduciary duty and power of agency.

Liability

A worker cooperative may find an LLC advantageous because it limits the liability of its members. Member's personal liability for the obligations of the company is limited to their investment in the company. If the business incurs a debt the debt is the company's and not that of the owners. In an LLC, members are not personally liable for the debts, obligations or liabilities of the company. Members may only be liable to the extent they agree in writing to be liable for debts. Members may also be liable to third parties for tortious conduct, to return an unjustly awarded distribution, or if a court pierces the company veil.

State Taxes

Depending on the state in which the LLC is established, there may be special tax requirements. A company should seek advice in their own state regarding these procedures.

In California, unlike at the federal level, an LLC is taxed at the entity level. While, California adopts the federal tax rules for the most part, there is an \$800/year minimum franchise tax imposed on every LLC, regardless of gross receipts or net income. Also, every year an LLC must file the FTB Form 568. If the LLC makes over \$250,000 it must pay an annual fee based on the total income for the taxable year.

How to set up a worker cooperative as an LLC?

Setting up a worker cooperative as an LLC will vary from state to state depending on their specific regulations regarding LLCs. However, there are some common steps that any worker cooperative seeking LLC status must complete.

First, the group of workers must do their research regarding their business plan and local regulations. It is very important to have a sound business plan and cash flow projections in order to be able to estimate the advance dividend payments.

Next the group must come together to draft an operating agreement. This document gives life to the cooperative. It establishes how the business will be managed, who the members will be, how membership will be granted or terminated, and many other important details. See the section on operating agreements below.

Setting up in California

The following describes the steps a company must go through in California in order to become an LLC.

To become an LLC a person or group must file articles of organization with the Secretary of State along with a \$70 fee. The articles are developed by simply filling out a form available on the Secretary of State's web site.² An organizer of the company must sign the articles.

The group must also develop a written operating agreement. In this the members must determine management style and record keeping and accounting methods. In California the Beverly-Killea Limited Liability Company Act, Corp C §1700-17655 contains rules governing internal management.

Within 90 days of filing the articles of organization, the LLC must file a Statement of Information with the Secretary of State. This includes the names and addresses of LLC management or all of the members if the LLC is member-managed, the general nature of LLC's business activities, the name and address of the LLC's agent for service of

² <http://www.sos.ca.gov/business/business.htm>

process and the address of the LLC's principal business office. This Statement of Information is to be filed every two years and when the information changes.

Whether or not it has employees, the LLC must obtain an Employer Identification Number (EIN) as its tax identification number. The EIN can be obtained online at the IRS web site.³

The LLC should also apply for any permits or licenses required for its business.

The LLC must pay an \$800 annual franchise tax by the 15th day of the 4th month of the LLC's taxable year. The LLC must also pay property taxes to the county in which it is located, based on the value of the taxable real and personal property it owns or possesses.

Operating Agreements

An operating agreement is the most important document the members of a worker-cooperative will create as it gives life to the business by defining keystone issues including membership, management, operation, and payment procedures.

The members of the cooperative come together in meetings and work democratically to draft the document, which will govern their company. This document may be in the language of the members. There are several different ways for workers to structure their company however, the members must come to a consensus and solidify it into functioning procedures as defined in the operating agreement.

Organization

The first part of an operating agreement should spell out the official name of the company and its general purpose.

Management

Management of a worker cooperative can be structured in many different ways. Members may decide to make the business member-managed if they want hands on control. Other groups may decide to have a manager or a board of directors to control the business operations allowing the worker-owners to focus on their work. This is a decision left up to the members.

The company can decide if it wants a decentralized, democratic, informal method of management or a centralized form with a manager or a board of directors. They may also restrict the transferability of management rights.

³ www.irs.gov

If a company is member-managed it is important for all of the members to understand that they are agents of the company with a fiduciary duty. Their actions can bind the company. In a manager/board of directors managed cooperative only those designated in the operating agreement will have the power to bind the company.

Membership Rights, Economic Interests, Voting Rights

The operating agreement also lays out the criteria for becoming a member of the cooperative and allows for admitting new members or limiting membership. This typically requires the investment of some capital. It may require a certain amount of work hours or even a period of provisional membership. A company could create different levels or classes of membership as well, such as temporary, provisional or long-term.

The operating agreement should also explain how voting rights will be allocated within the company. Voting rights may be distributed equally or they may be proportionate to the member's investment. The members should also determine in the agreement whether voting rights will be transferable.

Generally member's economic interests in the company are transferable, but membership rights like voting are protected by procedures in the operating agreement in order to restrict or restrain transfer.

It is important for an operating agreement to determine the procedure and ability of members to withdraw or be terminated from the company.

The operating agreement may also create different powers and responsibilities for members. A company may wish to attach the names of each member to the operating agreement.

Elections and Meetings

The cooperative must decide how company decisions will be made. They can choose to establish an election system and voting rights in their operating agreement. Voting procedures and apportionment of votes would also need to be defined in the agreement. Apportionment of votes can be done in many different ways be it one member one vote, votes proportionate to investment or votes restricted to only certain classes of members.

A cooperative may also decide to hold meetings. The procedure on calling these meetings and proper notification of members for the meetings should be included in the operating agreement.

Financial Matters

Cooperatives established with limited liability companies (LLC) normally elect partnership taxation. The members are not employees and are compensated through distributions of the company's profits. Losses are also distributed, and the members must pay business expenses. Each member has a capital account, which represents their interest in the company including all of their investments (money, property) and their shares of profits and losses, minus the shares of the profits already distributed to them. The value of the company is equal to the value of all of the capital accounts.

An important part of the operating agreement is determining how capital will be accounted for and how profits and losses will be distributed. The operating agreement may establish a minimum initial capital investment for members and a method of obtaining additional capital commitments. The agreement may also include provisions on accepting loans and member responsibility for payment.

Distribution to members and capital accounts should be clearly explained in the written operating agreement. Restrictions on members' withdrawals from their capital accounts can be created in order to prevent members from draining the company. The agreement should also determine the procedure for allocating profit and loss.

If the company has outside investors that are not members, procedures on payment should be included in the operating agreement.

In an LLC, unlike a corporation, there are no shares of stock, there are dividend shares that are typically divided among members into capital accounts. There are several ways of distributing funds into these accounts. Whatever method is agreed upon should be clearly described in the operating agreement. Some cooperatives select a schedule for when they will distribute dividends. Others may hold the funds in capital accounts in order to invest in assets and other long-term ventures. This will depend on the type of business and the objectives of the members. Other cooperatives, especially those that employ relatively low-wage workers in a labor-intensive industry such as cleaning or home health care, may choose an option that allows for the more frequent flow of dividend payments because their objective as a cooperative is to enhance the income of member-owners.⁴

Typically, profits and losses are calculated every quarter but the members need money more frequently. They may receive regular payments, which are calculated as anticipated profit distributions payments. They payments are reconciled at the end of the quarter, when profits and losses are allocated to the members in proportion to each member's capital account balance. A business may also choose to reinvest a certain percentage of the profits in order to promote growth of the company. These reinvested funds are allocated to the members' capital accounts based on their percentage of investments.

⁴ http://www.ncdf.org/documents/worker_coop_toolbox.pdf

"In Good Company: A Guide to Cooperative Employee Ownership" Published by Northcountry Cooperative Foundation

Tax and Accounting Matters

In the operating agreement the company members must agree upon a record keeping system, an accounting method and a fiscal calendar. The agreement should also provide details on how the company will be taxed. Members may also include how the company is to be valued.

Federal Tax Issues

An LLC may elect to be taxed as a partnership or as a corporation. It is more common and generally beneficial for a worker cooperative to opt for partnership taxation, which is the default option. Partnership taxation is ‘pass through,” meaning that the LLC has no identity separate from the members, and is not taxed at the company level. Corporations are legally separate from their owners and are taxed at the entity level.

If an LLC is taxed as a partnership, then each member pays individual taxes on their distributive shares of the profits and losses, rather than the company paying as a whole. Income, loss, deductions, gain and credit are not taxed at the entity level but pass through to partners or members. .

This can be disadvantageous where the company reinvests significant portions of its profits since members are taxed on their share of profits without receiving cash distributions with which to pay the taxes.

A worker cooperative set up as an LLC must have the same tax year as its members. The LLC must file an IRS Form 1065 every year it receives income or incurs expenditures allowable as deductions.

Dissolution, Termination

It is important to include a section on dissolution and termination in the operating agreement in order to deal with removing members or dissolving the company as a whole. This section should establish a system of distributing assets upon dissolution.

Disputes

A company may also wish to include a method of dealing with internal disputes among members. This could take the shape of an internal member hearing or even move to external mediation/arbitration.

The agreement may also establish penalties for members that do not fulfill their obligations under the agreement.

Sample Table of Contents for an Organizing Agreement

Construction and Definitions

Introduction

Article I: Organization

Article II: Members

Article III: Management/Board of Directors

Article IV: Company Capital

Article V: Distributions to Members

Article VI: Voting, Meetings

Article VII: Company, Policies, Records, Reports

Article VIII: Duties to the Company

Article IX: Tax and Accounting Matters

Article X: Dissolution/Termination