

What is an Employee Cooperative?

How does it work?

An introduction for employee-members

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What is an employee cooperative?

An employee cooperative is a membership organization set up to market the labor and skills of its members through owning a business. It is owned by the members. Each member has one voting share. Its profits are allocated among the members on the basis of how much labor they put into the co-op. In co-ops, financial ownership is separated from share ownership, and each member has an internal account which holds his/her financial interest in the co-op.

Employee cooperatives are part of a broad family of cooperative businesses, which include agricultural co-ops like Land of Lakes or Agland, which are owned by their farmer members; credit cooperatives like credit unions, which are owned by their depositor members; mutual insurance companies like Nationwide and State Farm, which are owned by their policy holder members; and consumer co-ops like some natural food stores, which are owned by their customer members.

This introduction assumes that you are buying the business you are working in from a retiring owner using a cooperative, and makes regular references to redeeming the shares of former owners and paying down the debt incurred to do so. If you are starting an employee-owned cooperative business from scratch, just ignore the language that pertains to retiring owners.

Becoming a member

Employees will work for a period before becoming eligible to become voting members and owners. Members pay a membership fee, which may be smaller or larger depending on the capitalization needs of the cooperative. In return for the payment of the membership fee, the member receives a voting share.

Future employees will also have the opportunity to become members and owners after a probationary period.

Members receive the Articles of Incorporation and the Bylaws of the cooperative.

Governance

The basic procedures for the co-op are laid down in the company's articles of incorporation and bylaws.

Members elect the board of directors on a one-person, one-vote basis, and the board hires

the management.

There's an annual membership meeting for all co-op members, and regular and special meetings may be called.

Your financial interest in the co-op

Initially, the value of your financial interest in the co-op is the value of your membership share. The value of your ownership interest will build over time, however, if the co-op makes a profit.

Co-ops typically divide their profits ("net margins") between two accounts -- (1) a "collective reserve account" which absorbs losses if the business loses money and (2) members' accounts -- and (3) a cash allocation to members. The board decides how each year's retained earnings are divided between the collective account and the members' accounts and members' cash allocations.

How retained earnings are allocated depends typically on the age of your co-op (new co-ops need to build their capital and pay more into their collective reserve accounts while making the minimum legal cash distribution to members), your co-op's capital needs (including paying down debt taken on to redeem shares from retiring owners selling to you), and how profitable your co-op is.

Here's how it works initially in a new co-op business that employee members bought from a retiring owner:

Early years while paying for the business:

Annual profit

- significant allocation to reserve account to cover potential losses

allocations to members

There of: typically 75% or 80% to members' capital accounts in co-op

20-25% to members in cash to pay taxes (20% is legal

minimum)

Later years after the business has been paid for, capitalized, and reserve account is adequate:

Annual profit

- little or no allocation to reserve account to cover potential losses

allocations to members

There of: typically 50-75% to members' capital accounts in co-op

25-50% to members in cash to pay taxes

If the co-op's losses exceed the amount in the collective reserve account, the additional loss is deducted from the members' accounts.

Once the collective account reaches an adequate level to absorb eventual losses, most or all of the additional annual retained earnings are allocated to members' accounts or distributed in cash to members.

Allocations among the members' accounts and cash allocation follows a labor-based formula laid down in the co-op's bylaws. The formula is based on labor input ("patronage") into the cooperative. You can use hours worked, W-2 earnings, seniority up to a cap, or other measures of labor input. The formula is that you divide each member's labor input (however measured) by the total input of all members and multiply that fraction by the total dollars being allocated among all the members' accounts.

Here's how it works:

$$\begin{array}{r} \text{Your labor input} \\ \text{-----} \\ \text{Total members' input} \end{array} \quad \times \quad \begin{array}{l} \text{Total \$ to be} \\ \text{allocated among} \\ \text{all members} \end{array} \quad = \quad \begin{array}{l} \text{Your allocation} \\ \text{for that year} \end{array}$$

The co-op can make its allocation in what is called a "capital allocation" into your account

Taxation

In tax terms, co-op allocations to the "collective reserve account" are taxed at the normal corporate income tax rate. Co-op allocations to members, however, are not taxable at the corporate level (so there's no "double taxation") but are taxable to the members as personal income. Consequently, you need a cash distribution to pay your taxes.

Therefore, in new cooperatives which typically need to retain capital in the business, 75% or 80% of the members' allocations are retained in the members' accounts and 20% or 25% is allocated in cash to members to pay their taxes. Twenty percent is the legal minimum cash distribution because you need close to that much to pay your income tax on your capital allocation in your account in your co-op.

On the other hand, when you take your account out of the co-op, you don't pay income tax because you paid the tax when your money went into your account originally.

Getting the value of your ownership in cash

While you can't tap your capital account in your co-op to buy a car when you want to as

you would your credit union or bank account, it is your personal property and you will eventually get the cash value in the future.

While you pay down the debt the co-op took on to buy the business from the owners by redeeming their stock, the co-op will be putting all its profits into paying down the loan. When the debt is paid off, the board of directors will determine what portion of the profits need to be kept in the business and what part can be paid out in cash to members. You shouldn't expect to get much cash out of the co-op in these early years.

On the other hand, your financial interest in the co-op includes your membership fee and your annual allocations. If the co-op makes money, your account will grow every year, and the longer you work in the co-op, the bigger it will be.

Initially, members' accounts stay in the co-op, capitalizing the co-op by buying tools, paying off borrowed money, building working capital to buy supplies, pay wages, etc. Once the co-op has adequate capital between the collective account and the members' accounts, it may begin to pay out a larger portion of its "net margins" or profits (assuming there are profits) to members in cash dividends each year.

Additionally, after the co-op has paid off its debt to redeem the selling owner's shares and has adequate cash for business needs, the board can choose to "revolve" members' accounts. That means that the board can decide to pay out to members money that was -- for example -- allocated to their accounts ten years ago. That rewards folks for their seniority in the co-op.

Here's how it works when your co-op is fully capitalized and the board decides to "revolve" the members' accounts:

Cindy was an original member of the co-op when it bought the company from the retiring owner ten years ago. In the following years, she got the following allocations to her capital account in the co-op:

Year 1 of the co-op	\$3,000
Year 2 of the co-op	\$3,500
Year 3 of the co-op	\$4,000
Year 4 of the co-op	\$1,500
Year 5 of the co-op	\$1,500
Year 6 of the co-op	\$ 0 (no profit)
Year 7 of the co-op	\$1,500
Year 8 of the co-op	\$3,500
Year 9 of the co-op	\$5,500
Year 10 of the co-op	\$4,000
Year 11 of the co-op	\$2,000

Bill joined the co-op at the beginning of year 5. In the following years, he got the following allocations to his capital account in the co-op:

Year 5 of the co-op	\$1,500
Year 6 of the co-op	\$ 0 (no profit)
Year 7 of the co-op	\$1,500
Year 8 of the co-op	\$3,500
Year 9 of the co-op	\$5,500
Year 10 of the co-op	\$4,000
Year 11 of the co-op	\$2,000

In year 11, the co-op board determines that the co-op has been fully capitalized and can afford to revolve members' accounts on a 10 year basis. Members who have been in the co-op for all 11 years get their first year's capital allocation paid to them in cash.

So Cindy gets \$3,000 that was her capital allocation in year 1. It's tax free because she paid her income tax on it when she got it 11 years ago.

Bill doesn't get his account "revolved" because he didn't get a capital allocation 11 years ago because he wasn't a co-op member then.

If the co-op makes money and is able to continue revolving accounts, Cindy will get her year 2 capital allocation of \$3,500 in year 12, her year 3 capital allocation of \$4,000 in year 4, etc.

Bill will start getting his account "revolved" when he has been in the co-op for 10 years, i.e. in year 16. That's because he didn't become a member until year 5.

Co-ops that start revolving accounts may not do so every year, because they may have capital needs to replace old equipment or to expand the business. They may stop revolving accounts because they cease to be profitable. Or they may stop revolving accounts because they have heavy payouts at the retirement of founding members.

There will be a mechanism through which members who leave the co-op will receive the value of their accounts. If you die, then your account passes into your estate, and the co-op will cash it out to your heirs. Your co-op's board will set the policies for these payouts.

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Key decisions to be made on your co-op's structure

1. Qualifications for membership:

* What should the probationary period of employment be before a new employee becomes eligible for admission as member? (When you are setting up the co-op initially, you would usually count past employment against the probationary period.)

* What should the amount of membership fee be?

* What are the options for paying membership fee (such as, cents per hour worked vs. cash up front)?

2. "Patronage dividends": How will each year's profits be allocated to members?

To qualify as a co-op, the formula for allocation has to be based on labor input into the co-op.

Labor input can be measured by (1) hours worked, (2) W-2 earnings, or (3) other measures of labor input, including seniority.

You need to decide what measure (or which measures) of labor input you will use in your co-op.

You can decide on one of those above or you can "mix and match" these. You can, for example, distribute 25% of "net margins" (profits before taxes) on the basis of hours worked during the year, 25% on seniority with the company up to some cap (such as five years), and 50% on W-2 earnings. Or you could distribute 33 1/3% on the basis of hours worked during the year and 66 2/3% on the basis of W-2 earnings. It's up to you and your fellow co-op members as long as your allocation reflects labor input into the co-op.

If you use seniority as part of your formula for allocation, it needs to be capped at a reasonable level such as 5 or 10 years. (For instance, if you set a 10 year cap, employees with more than 10 years have their seniority for allocation purposes only counted as 10 years.)

If you are setting up the co-op to buy the company from a retiring owner, you can choose to count seniority in employment with the company (rather than from the start of the co-op).

3. Board structure

To qualify as a cooperative, a majority of the members of the board have to be elected by the members of the cooperative.

* How many board members will there be?

- * How long is their term?
- * you will need to specify the officers

* how to provide financial protections for the owner selling to the co-op while they still have more capital in the business than other co-op members (assuming they continue working in the business for several years and become members of the co-op) or to protect their financial interest until they sell the remainder of their stock to the co-op (assuming they leave the business)

4. Annual meeting(s)

- * when
- * procedures
- * how members can call additional meetings

5. How will members be paid out & when?

- * members who leave
- * do you want a provision that permits “revolving accounts” of members who stay

You want to give basic guidance and leave the details to the discretion of the board which needs to evaluate the financial position of the business.

6. Fiscal year

You will need to set the date for your “fiscal year” (i.e., your accounting year).

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