



Limited Liability Companies as Worker Cooperatives

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HELPING PEOPLE AND COMMUNITIES BECOME, AND REMAIN, ECONOMICALLY SECURE

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. Cooperatives also promote economic participation, education and training, and development of community.²

Why make it a Limited Liability Company?

A worker cooperative can structure itself in different ways. It may choose among several different entity types including corporation, non-profit corporation, limited liability company (LLC), or a state recognized cooperative.³ However, the limited liability company model offers many advantages to worker cooperatives.

Ease of Formation

An LLC is established by filing a short form with the Secretary of State. While this document creates the entity, a more important governing document is an operating agreement that sets out all of the agreements among the members regarding company operations, sharing of profits and losses, management, and other essential issues.

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.⁴ In contrast, every state allows some form of LLC.⁵ All 50 states and the District of Columbia have passed some form of limited liability company legislations.⁶ In addition each state LLC law empowers LLCs to carry on business outside of state lines.⁷ Thus a worker cooperative organized as an 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 United States Federation of Worker Cooperatives- About Worker Cooperatives, <http://www.usworker.coop/aboutworkercoops>.

² Gary B. Hansen, E. Kim Cootz & Audrey Malan, *Steps for Starting a Worker Co-op*, Northwest Cooperative Federation and the Center for Cooperatives, University of California, (1997), available at http://www.usworker.coop/public/documents/start_worker_coop.pdf.

³ Steven Deller, et al., *Research on the Economic Impact of Cooperatives*, University of Wisconsin Center for Cooperatives, March 2009, <http://www.cccd.coop/files/UWiscReportFULL.pdf>.

⁴ Lewis Solomon & Melissa Kirgis, *Business Cooperatives: A Primer*, 6 DePaul Bus. L.J. 233, 234 (1994).

⁵ Welcome from the Uniform Limited Liability Company Act Committee Chair, <http://www.11cproject.org/> (last visited Oct. 23, 2009).

⁶ NTS Am. Jur. 2d *Limited Liability Companies* § 2 (2009).

⁷ J. William Callison & Maureen A. Sullivan, *Limited Liability Companies: A State-by-State Guide to Law and Practice* § 11:1 (2009 ed.).

An LLC allows for a company to be managed by its members or a by an outside manager. Member management may take multiple forms, including decision-making by consensus, a managing member or a board comprised of members. Members of an LLC worker cooperative choose how they want to manage their company in developing their operating agreement. Each member is an owner and is given the power to make this decision.

LLCs are also flexible with respect to membership. Under an LLC model a worker cooperative can structure its membership in various ways. For example, it may allow for different levels of participation in the distribution of profits and losses, and for passive, active, manager, non-manager, temporary, and provisional members. The rights and privileges of each class of members would be defined in the company's operating agreement

There are some important restrictions on the business purposes of LLCs. For example, in California, LLCs cannot be used for professional services or engage in banking, insurance or trust company business.⁸ This prohibits the use of an LLC for a cooperative like a credit union.

Can have Foreign Members

A significant advantage of setting up a worker cooperative as an LLC is that its members need not be citizens. An LLC 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

Establishing a worker cooperative as an LLC allows members to be treated as owners rather than employees. The members have the power to democratically decide how to run their business. They have a personal stake in its success.

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.⁹ 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.

Taxes

An LLC may elect to be taxed as a partnership or as a corporation. It is more common and generally more advantageous for a worker cooperative to opt for partnership taxation. Partnership taxation is "pass-through," meaning the LLC is not taxed at the company level. In contrast, Corporations are subject to "double taxation" in that they are taxed at the entity level and the payments to shareholders and income to employees are also taxed. Members of an LLC worker cooperative can reap the benefits of pass-through taxation at the federal level.¹⁰

⁸ *Cal. Corp. Code* § 17002 (West 2009).

⁹ Callison & Sullivan, *supra* note 7 § 5:1.

¹⁰ IRS Limited Liability Company, http://www.irs.gov/irm/part5/irm_05-001-021.html.

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 each state's specific regulations regarding LLCs.¹¹ 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 accurate cash flow projections.

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.

Another important element of starting a worker cooperative, which should not be overlooked, is educating the members of the rights and responsibilities of membership. If the workers choose to form 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 then for every member to understand the impacts of their actions. If the cooperative opts for the manager-managed LLC structure, then members are held to the duty of good faith and fair dealing and only the manager has a fiduciary duty and power of agency.

Operating Agreements

An operating agreement is the most important document the members of a worker-cooperative will create as it will establish the 'ground rules' for the company's membership, management, operation, and payment procedures among others. The operating agreement binds the members of the LLC as a contract would.¹² It governs the relations among members, managers and the company.

The members of the cooperative come together in meetings and work democratically to draft the document, which will govern their company. They have broad discretion in deciding the content of the agreement.¹³ This document may be written in a language other than English if it is the language of the members. There are many options for structuring the company, and the members must reach an agreement on each aspect, and solidify it into the operating agreement.

A sample table of contents for an operating agreement follows, along with descriptions of the more important sections.

Sample Table of Contents for an Operating 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

¹¹ Callison & Sullivan, *supra* note 7 § 3:2.

¹² NTS Am. Jur. 2d *Limited Liability Companies* § 3 (2009).

¹³ Callison & Sullivan, *supra* note 7 § 3:7.

Article VII:	Company, Policies, Records, Reports
Article VIII:	Duties to the Company
Article IX:	Tax and Accounting Matters
Article X:	Dissolution/Termination

Organization

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

Members

The operating agreement also lays out the criteria for becoming a member of the cooperative and allows for admitting new members or limiting membership. The requirements for membership typically include the investment of some capital. Contributions can be made in cash, property or even services.¹⁴ It may require a certain amount of work hours or even a period of provisional membership, as well as approval by the current members. A company could create different levels or classes of membership as well, such as temporary, provisional or long-term. The operating agreement may also create different powers and responsibilities for members.

Generally an LLC 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. In a cooperative, the operating agreement normally limits or prohibits any transfer of rights without member approval.

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

In California, the operating agreement must list the names of the member-managers as parties to the agreement in the opening sentence. If there are many members, the names can be listed in an exhibit referred to in that first sentence.¹⁵

A company may wish to attach the names of each member to the operating agreement.

Management/Board of Directors

Management of a worker cooperative can be structured in many different ways. 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. 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.

Company Capital

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.

¹⁴ NTS Am. Jur. 2d *Limited Liability Companies* § 8 (2009).

¹⁵ *Forming and Operating California Limited Liability Companies* 273 (David Peyerwold, ed. Continuing Education of the Bar 2d ed. 2006).

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

Cooperatives established with limited liability companies (LLC) normally adopt a partnership model. 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. An important part of the operating agreement is determining how capital will be accounted for and how profits and losses will be distributed.

Many cooperatives operate under a system where each member has a capital account, which represents their interest in the company including all of their investments (money, property, and labor), their shares of profits and losses, minus the shares of the profits already distributed to them. Typically the value of the company is equal to the combined value of all of the capital accounts, but it may have additional value when sold because of 'goodwill,' customer lists, and other intangible aspects of the business.

Some cooperatives select a schedule for distributions, listing dates 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 desire of the members. Other cooperatives, especially those that employ relatively low-wage workers 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.¹⁶

Distributions to Members

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 of resources. The agreement should also determine the procedure for allocating profit and loss.

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 with members that are 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. This allows the cooperative to enhance the income of member-owners.

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 distribution payments. The 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.

¹⁶ *In Good Company: A Guide to Cooperative Employee Ownership*, Northcountry Cooperative Foundation, 2006, http://www.cccd.coop/files/worker_coop_toolbox.pdf (last visited Oct. 26, 2009).

Voting, Meetings

The cooperative must decide how company decisions will be made. The members 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. The members should also determine in the agreement whether voting rights will be transferable.

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.

Company Policies, Records, Reports

This section of the operating agreement could specify the type and frequency of reports that would be required. It could also specify who has a right to review the reports. Most LLCs require some form of books and records and give members inspection rights.¹⁷

Duties to the Company

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 binding decisions. It is important for every member to understand the impacts of their actions. It is a good idea to define what the duties mean in the operating agreement.

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.¹⁸ Further duties can be included in the operating agreement.

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.

An LLC may select 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, 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 and taxed as an entity.

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.

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.

¹⁷ Callison & Sullivan, *supra* note 7 § 4:6.

¹⁸ NTS Am. Jur. 2d *Limited Liability Companies* § 11 (2009).

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. The form requires companies to report their annual income/losses and the balance on partners' capital accounts.

Members of an LLC may also be subject to self-employment tax.¹⁹

At the state level, there may be special tax requirements. A company should seek advice in their own state regarding these procedures.

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 or arbitration.

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

Setting up an LLC 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 their Articles of Organization with the Secretary of State along with a \$70 fee. The Articles are developed by filling out a form available on the Secretary of State's web site. An organizer of the company must sign the articles.²⁰

The group must also develop a written operating agreement. In this the members must determine management style and record keeping and accounting methods. As a practical matter, it is best to develop the operating agreement before filing the articles of organization. The members need to make a number of decisions in developing the operating agreement, and this decision-making process can require a great deal of time. All members should sign onto the document once an agreement has been reached.²¹

Within 90 days of filing the articles of organization, the LLC must file a Statement of Information with the Secretary of State. This includes:

¹⁹ Callison & Sullivan, *supra* note 7 § 12:42.

²⁰ California Secretary of State-Forms, Samples and Fees, available at <http://www.sos.ca.gov/business/be/forms.htm#llc>.

²¹ In California, the Beverly-Killea Limited Liability Company Act contains rules governing internal management. *Cal. Corp. Code* §§ 1700-17655 (West 2009).

- 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 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 the LLC will be an employer, it is necessary to get an Employer Identification Number (EIN) to serve as its identification number for tax purposes. The EIN can be obtained online at the IRS web site.²²

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

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, Limited Liability Company Return of Income. If the LLC makes over \$250,000 it must pay an annual fee based on the total income for the taxable year.²³ The LLC must pay the \$800 annual franchise tax and the fee based on the annual total income of the entity by the 15th day of the 4th month of the LLC's taxable year.²⁴

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.

²² IRS How to Apply for an EIN, <http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/How-to-Apply-for-an-EIN>.

²³ California Franchise Tax Board, California Forms and Instructions 568 (2000), available at https://www.ftb.ca.gov/forms/2011/11_568bk.pdf.

²⁴ *Form LLC-1, Limited Liability Companies Articles of Organization*, State of California Secretary of State, available at <http://www.sos.ca.gov/business/lc/forms/lc-1.pdf>.