EMPLOYEE COOPERATIVE AS A PLAN FOR BUSINESS SUCCESSION

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- Most state cooperative statutes are not available to employee cooperatives.
- Some states have updated their cooperative statute to a comprehensive corporation statute with appropriate cooperative terminology.
- These statutes are now available for the “choice of entity” list for Owners who are seeking a plan for business succession by sale of the business to their employees.
- The Ohio Cooperative Law is one of the best of these updated cooperative statutes.

The Problem of Business Succession

- Eventually an Owner realizes the need to plan for retirement and sale of the business.
- The Owner may consider some form of employee acquisition of the company.
- This inter-generational transfer may be within the Owner's family.
- But many business Owners find that handing the business over to the next generation is not an option.

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Choice of Entity for Business Succession

- The Owner and prospective employee-purchasers have organizational choices to evaluate.
- The choice of entity may be based on considerations of tax, financing, shared vision for business continuity, employee interest and unity, market value of the business, special requirements of the company's business.
- One organizational option is an employee cooperative.

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- There are reasons why an employee cooperative may be ruled out.
- A cooperative may be a more satisfying and unifying plan than a conventional corporation.
- Employees who are Members of an employee cooperative will likely judge the value and obligations of company ownership in terms of their employment and career rather than as a passive investor.

Understanding the Cooperative Model

- The Owner and the employees must understand the distinguishing features of a cooperative and the essentials of "doing business on a cooperative basis."
- A cooperative's business plan and motivation is to produce economic advantage for its Members as Patrons and only secondarily for the Members as investors.

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- An employee cooperative does business on a cooperative basis with its Members as Patrons.
- The business plan is to produce economic benefit for the employees in exchange for their contribution to the company's production.
- Employee investment in the cooperative is a means of access to company profits.
- An employee cooperative is a marketing cooperative. It markets its employees' work.

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Cooperative Principles

- **Patron** is a person with whom a cooperative contracts to do business on a cooperative basis.
- **Operation at Cost** is a central theme of the Patron contract and operating on a cooperative basis.
- If a cooperative realizes a profit from its Patrons, that profit belongs and is allocated to the Patrons in proportion to the profit/value of each Patron's work.
- The resulting combination of employee wage/salary and Patronage Refund should reduce company profit to $0.
- A cooperative earns profit on behalf of its Patrons.

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Workplace and Corporate Culture Considerations

- An Owner's sale to employees in a conventional corporation would likely have little impact on the workplace.
- A shareholder's role in company operations is usually passive.
- The board of a conventional corporation has a particular fiduciary obligation to the shareholders.
- The company's business is conducted to maximize the value of stock.

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- Sale of stock to an employee cooperative will likely result in significant changes in the workplace.
- Labor and management are institutionally combined.
- An employee cooperative must overcome the reluctance of employees to assume responsibility for investment in, and management of, their employer.

- A primary focus in the sale of a company to employees in a conventional corporation is stock value.
- A primary focus of the employee's interest in an employee cooperative is a share of the company's annual profits and control of the company's workplace and methods of production.
- In an employee cooperative, share acquisition is a means to achieve these goals.

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Tax Considerations For an Employee Cooperative

- An employee cooperative brings immediate tax advantage.
- Under subchapter T of the Internal Revenue Code, an employee cooperative may exclude substantially all of its profits (Net Margins) from its taxable income for federal income tax purposes.

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Comparison With An ESOP

- An Owner and close relatives cannot participate in an ESOP, but they can be Members of an employee cooperative.
- ESOP's are subject to extensive ERISA regulation and reporting.
- The initial and annual cost to form and maintain an ESOP is higher than the cost to form and maintain an employee cooperative.
- Direct ownership and annual distributions of corporate profits in an employee cooperative make employees feel directly responsible for the welfare of the company.

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Converting a Company to an Employee Cooperative

- Convert the company to cooperative.
- Owner sells stock to the company under a **Stock Redemption Agreement**.
- Company resells the redeemed stock to the employees.
- Employee cooperative should plan to purchase all or substantially all of the Owner's stock.

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- A single payment sale may be a problem if the Owner is planning a gradual exit from the business or adequate financing is not available.
- Consider a multi-step or installment sale over a period of years.
- Include protections for the Owner's interests in the Stock Redemption Agreement and in the cooperative's governing documents.
- Owner consents to allow the company assets to be pledged to secure corporate borrowing.

Changes From The Conversion

- New **Articles of Incorporation**, **Bylaws**.
- A board of directors, the majority of whom should be elected by and from the employee Members.
- Stock Redemption (Purchase) Agreement With Owner.
- **Membership and Subscription Agreements With Members**.

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Threshold (Watershed) Issues in Selling to an Employee Cooperative

- Majority control of the company's board of directors shifts to the employee Members.
- Each employee-Member's pay and share of the cooperative's profit depends on value of the employee's work.
- The employees should invest in the employee cooperative in proportion to their share of the profits.

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Looking Forward

- Patronage Refunds to employee Members in the form of equity interests (Capital Credits), rather than as a cash payment, until the financing has been repaid.
- What to do about employee Members who leave the cooperative.
- How to handle employees who are hired after the buyout.
- New employees should be required to furnish their fair share of the employee cooperative's capital.

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