



CALIFORNIA CONTINUING EDUCATION OF THE BAR

CALIFORNIA BUSINESS LAW *Practitioner*

A GUIDE TO CURRENT PRACTICE



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Workplace Privacy: A Guide for California Employers

by LINDA HENDRIX MCPHARLIN

As wrongful termination has begun to lose steam and coverage as the hot topic in employment law, issues of privacy in the workplace have arisen to take its place. Technology offers employers varied and improved methods of regulating their workforces by testing, surveillance, and other means that employers find conducive to efficient operations. Employees, however, view these activities as an invasion of privacy and are asserting their rights accordingly.

The California Supreme Court noted in 1975 that increasing collection and retention of data on all facets of an individual's life posed a threat to personal freedom and security. *White v Davis* (1975) 13 C3d 757, 773, 120 CR 94, 105. Privacy concerns, in fact, had triggered a 1972 amendment to the California Constitution that explicitly recognized privacy as a fundamental right in California. "All people are by nature free and independent and have inalienable rights.

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Choosing a Workers' Cooperative—Another Way of Doing Business in California

by NEIL A. HELFMAN



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In recent years, there has been an increasing interest in employee-owned businesses, especially as accomplished through Employee Stock Ownership Plans (ESOPs) and leveraged buy-outs involving large companies such as Avis and Allied Plywood. This article examines another form of employee-owned business, the workers' cooperative, which may be appropriate for smaller ventures, including professional service groups, that generally have not operated under the cooperative form of doing business.

Traditionally, income-producing entities have been created to pursue the economic interest of either the organization or the individuals comprising the organization. This is illustrated by corporations, on one hand, which maintain an existence independent and apart from their shareholders, and partnerships, on the other hand, which are aggregates of two or more persons carrying on a business for profit as co-owners. Cooperatives offer another approach, which combines attributes of corporations and partnerships in a manner that may provide benefits not found in either.

Cooperatives are favored by law and receive privileges not granted to other forms of business. Cooperatives can offer, among other benefits, limited liability for members, exemption from securities laws, and a single level of taxation that can be apportioned between the entity and its individual members.

The purpose of this article is to explore the benefits cooperatives can offer, and to provide guidance and

suggestions to the legal practitioner in the largely undeveloped area of law dealing with workers' cooperatives. The following hypothetical, and additional examples based on the hypothetical, will be used to illustrate some of the issues discussed in this article.

HYPOTHETICAL

Consulting Engineers Cooperative, Inc., a newly formed California cooperative, is engaged in the business of rendering consulting engineering services to architects, developers, general contractors, engineers, industrial plants, and public institutions. Most of the company's work will be done on a fixed-price basis; some work will be charged at an hourly rate. Contracts generally include a 20-percent profit margin, based on total expenses, including salary for the company's principals and employees.

Initial cooperative members consist of eight engineers with varying specialties, three junior draftspersons, and three experienced engineering support staff, for a total of 14 initial members. Four of the engineers have known each other professionally for several years. The other ten members were previously known to one or more members of the founding group. Two additional engineers are working as paid employees. After one year of employment, they can become members of the cooperative on two-thirds' vote of existing members.

Members will receive a salary based on their educational and skill levels, the desirability or undesirability

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of particular tasks, seniority, and prevailing wage and other market factors.

The cooperative has determined that it requires \$100,000 in start-up capital, mostly for computers and general office machinery. Each member will make an initial cash contribution of \$7500, which will be recorded in a capital account for the member. The cooperative's bylaws state that all member contributions to capital made after the initial contribution must be returned to members within five years, together with interest if the cooperative has sufficient funds available for interest payments. The bylaws do not provide for mandatory return of initial capital contributions.

The cooperative expects revenues of approximately \$1 million in each of its first three years. It is expected that around 20 percent of this sum will represent profit (over and above members' salaries), although start-up expenses will result in lower profits in the first year.

COMMENT: Suitability of Cooperative Form of Business. Because the initial members generally share similar professional experience and are at least to some degree known to each other, they will likely have the collegiality and willingness to cooperate that are the hallmarks of a small workers' cooperative. Hopefully, the members also share a philosophy of economic democracy and active participation in decisionmaking, which are also key features of a workers' cooperative. As with any other new business venture, the members' experience and ability to provide adequate capitalization are important factors in the ultimate success of the business.

Corporate Form. The California Consumer Cooperative Corporation Law (Corp C §§12200-12704) expressly provides for the formation of consumer cooperative corporations. As discussed below, however, a cooperative need not necessarily be a corporation, although the corporate form is recommended.

Equity; Debt. The initial capital contribution should be characterized as equity, rather than debt, to avoid thin-capitalization issues. To avoid possible dividend treatment when the cooperative returns subsequent capital contributions to members, such contributions can be recast as loans to the corporation, with suitable documentation.

DEFINING A COOPERATIVE

Business entities operating on a cooperative basis have existed throughout this country's history. As of 1983, there were 41,000 agricultural and nonagricultural cooperatives operating in the United States, consisting of 89.3 million members generating revenues in

excess of \$163 billion. U.S. Dep't of Commerce, Bureau of the Census, Statistical Abstract of the United States: 1984, pp 551, 667 (104th ed 1983), cited by Note, *Cotter & Co. v. United States: The Federal Circuit Finds the Meaning of Subchapter T to be Less than Cooperative*, 47 Ohio St L J 565 (1986). Among this group are several household names such as Sunkist, the Associated Press, Land o' Lakes, and the California State Automobile Association.

A Starting Place for Research

Readers can obtain information and assistance generally from the Industrial Cooperative Association, Inc. (ICA), a nonprofit consulting organization that assisted in drafting Massachusetts' Employee Cooperative Corporations Act. The ICA has model bylaws and other documents and resources available for review. Write to the Industrial Cooperative Association, Inc. (ICA), 58 Day Street, Suite 203, Somerville, MA 02144. The telephone number is (617) 629-2700.

Further information is available from:

- Cooperative Resources & Services Project, Los Angeles, CA (213) 233-2667;
- National Center for Employee Ownership (NCEO), 2201 Broadway, Suite 807, Oakland, CA 94612 (415) 272-9461;
- National Cooperative Business Ass'n (NCBA), 1401 New York Ave. N.W., Suite 1100, Washington, D.C. 20005 (202) 638-6222; Davis, CA (916) 757-2233.
- National Economic and Development Law Center, 1950 Addison St., Berkeley, CA 94704 (415) 548-2600.

The law governing cooperatives is not comprehensively set forth in any single body of law. As with most forms of business, state law governs the organization, operation, and dissolution of cooperatives. Federal law applies to at least some aspects of a cooperative's organization and operation, especially to the extent that a cooperative seeks application of the favorable tax provisions of Subchapter T of the Internal Revenue Code (IRC §§1381-1388).

No particular plan of business organization sets the standard for what constitutes a cooperative. A cooperative does not necessarily require incorporation, or incorporation under a particular statute, although the regulatory aspects of a cooperative's operation may be different for different forms of entity status. California

law does not specifically define the term "cooperative" (see *California State Auto. Ass'n v Franchise Tax Bd.* (1987) 191 CA3d 1253, 1257, 237 CR 44, 47), although the significant attributes of a cooperative, for purposes of the Consumer Cooperative Corporation Law, can be gleaned from Corp C §12201, and additional conceptual guidance is provided by similar provisions covering agricultural cooperatives (Food & Ag C §§54401-54462), fishing cooperatives (Fish & G C §§1200-1206), and by federal law governing tax-exempt farmers' cooperatives (IRC §521). (In *California State Auto. Ass'n*, the court held that the state automobile association was a cooperative for purposes of the favorable tax provisions of Rev & T C §24405, even though the association was not organized under the Consumer Cooperative Corporation Law.)

"A collective of professionals—e.g., engineers—inclined to form a partnership may find that it is more advantageous to operate instead as a cooperative."

One legal commentator has observed that cooperatives exhibit the following operational characteristics:

- There is substantially equal control and ownership by each member;
- Members have a functional role in the cooperative;
- Transfer of ownership interest is prohibited or limited;
- There is an absence or limitation of return on capital investment;
- Economic benefits pass to the members on the basis of their patronage with the cooperative;
- Members generally are not liable for the cooperative's obligations;
- Death, bankruptcy, or withdrawal of one or more members does not terminate the cooperative;
- The cooperative's services are furnished primarily for use by its members.

Packel, *Organization and Operation of Cooperatives* 4 (4th ed 1970), cited in *California State Auto. Ass'n v Franchise Tax Bd.* (1987) 191 CA3d 1253, 1259 n5, 237 CR 44, 48 n5. However, presence or absence of any one of these factors usually is not in itself determi-

native of cooperative status. 191 CA3d at 1258, 236 CR at 48. In particular, the equal-control requirement is the subject of much debate. As discussed below, although the Consumer Cooperative Corporation Law generally requires equal voting among members, the Internal Revenue Service apparently does not impose this requirement for favorable tax treatment under Subchapter T of the Internal Revenue Code.

According to one leading case, a cooperative generally is an entity that (1) is created to provide its members with benefits brought about through members' collective participation in the cooperative's income-producing activities, beyond merely making a capital contribution; and (2) distributes these benefits in direct proportion to members' participation. See *Puget Sound Plywood, Inc.* (1965) 44 TC 305, 309, acq 1966-1 Cum Bull 3.

Workers' Cooperatives

Although cooperatives can be formed for a variety of purposes, they generally are categorized as consumer cooperatives or producer cooperatives. The Corporations Code does not use this terminology, but implicitly acknowledges the distinction (see Corp C §§12201, 12243) and presumably includes both kinds of cooperatives within the definition of "consumer cooperative." See Corp C §12200. However, in *Puget Sound Plywood*, the Tax Court noted that a consumer cooperative operates to benefit its members in their capacity as individual consumers, and a producer cooperative benefits its members in their capacity as producers, and markets or processes the entity's, or the members' goods or services. 44 TC at 306. See also Gurnick, *Business Opportunities Under California's Unknown Consumer Cooperative Corporation Law*, 8 LA Lawyer 22 (July/Aug. 1985). Producer cooperatives include marketing cooperatives (commonly found in the agricultural sector) and workers' cooperatives that market members' services. Under this terminology, based on the facts stated in the hypothetical, Consulting Engineers Cooperative, Inc. is a worker's cooperative that will market its members' professional engineering services.

The term "workers' cooperative" can be somewhat of a misnomer, because this type of cooperative is not restricted to production by physical toil. In fact, a collective of professionals—e.g., engineers—inclined to form a partnership may find that it is more advantageous to operate instead as a cooperative. Further, workers' cooperative members are not merely workers or employees; rather, they are both employees and proprietors simultaneously.

In statutory language, the term "patronage" is used to signify a member's participation in the revenue-pro-

ducing activities of the cooperative. See Corp C §12243; IRC §1388(a). In a workers' cooperative, patronage is work performed by members. "In a worker's cooperative . . . the 'business' which the patrons . . . do with the cooperative is work. Workers 'sell' their services to the cooperative." *Linnton Plywood Ass'n v U.S.* (1976) 410 F Supp 1100, 1105. Further, the workers, themselves, benefit from their labors. "Thus, the basic and distinguishing feature of a workers cooperative association, as compared with a corporation-for-profit, is that in the case of a workers cooperative association the fruits and increases which the worker-members produce through their joint efforts are *vested in and retained by* the workers themselves, rather than in and by the association." *Puget Sound Plywood, Inc.* (1965) 44 TC 305, 309.

The much more commonly found agricultural cooperative is distinct from the workers' cooperative in that, in the former, goods are produced individually and then marketed collectively. In a workers' cooperative, the cooperative performs both production and marketing functions. (Agricultural cooperatives are governed by Food & Ag C §§54401-54462 and Subchapter T, and may qualify for exemption from taxation under IRC §521 and Rev & T C §24404. This article deals only with nonexempt cooperatives.)

THE CALIFORNIA CONSUMER COOPERATIVE CORPORATION LAW

The California Consumer Cooperative Corporation Law (Corp C §12200-12704) became operative on January 1, 1984. The law is intended to apply primarily, but not exclusively, to consumer cooperatives organized and operated for the mutual benefit of members as patrons of the corporation. Corp C §§12200, 12201. If the corporation is organized to provide goods or services to its members, patrons are persons who buy or use those goods or services. If the corporation is organized to market or handle its members' goods or services, patrons are the persons whose goods or services are marketed or handled by the corporation. Corp C §12243. A consumer cooperative has the power to carry on a business at a profit (Corp C §12320(1)), but not for itself, as such, or for its members, as such, "but primarily for [its] members as patrons" (Corp C §12201).

Formation of Cooperative Corporation

One or more persons may form a cooperative corporation under the Consumer Cooperative Corporation Law by executing and filing articles of incorporation. Corp C §12300(a). Any person may be admitted as a member, with the exception of a cooperative's subsidiary. Corp C §12403. The term "member" is synony-

mous with "shareholder." Corp C §12247. A member is any person who has the right to vote for directors, or has a proprietary interest in the cooperative. Corp C §12238(a). In a workers' cooperative, participants are both members and patrons.

Capital Accounts

A system of capital accounts can be used to maintain the records of a member's proprietary interest in a workers' cooperative. Although the term "capital account" is not defined in the Corporations Code, such accounts are commonly used by cooperatives. In Massachusetts, which enacted a comprehensive Employee Cooperative Corporations Law in 1982, an "internal capital account cooperative is an employee cooperative whose entire net book value is reflected in internal capital accounts, one for each member, and a collective reserve account, and in which no persons other than members own capital stock." Mass Gen L ch 157A, §10(a). Under the Massachusetts law, a member's "internal" capital account is credited with the member's initial and subsequent capital contributions, and is credited or debited with the member's share of retained net earnings or losses, determined according to patronage. Mass Gen L ch 157A, §10(b). Connecticut, Maine, New York, and Vermont also have enacted employee cooperative laws.

Legal Existence; Officers and Directors

The legal existence of a cooperative begins when its articles of incorporation are duly certified by the Secretary of State. See Corp C §12315. An entity formed as a cooperative corporation must include within its name the word "cooperative" and some word or abbreviation signifying its corporate status. Corp C §12311(a). As with other corporations, a cooperative is a distinct legal entity. See *California Employment Comm'n v Butte County Rice Growers Ass'n* (1944) 25 C2d 624, 636, 154 P2d 892, 898.

The activities and affairs of a cooperative corporation are conducted by a board of directors (Corp C §12350). As with other corporations, officers generally are designated to run the cooperative's daily affairs (see Corp C §12331(c)(5)). There is no restriction against employing nonmembers as officers.

Liabilities; Operational Requirements; Dissolution

A cooperative member is not personally liable as such for the debts, liabilities, or obligations of the cooperative. Corp C §12440(a). Although an individual may be liable for his or her own malpractice, the limited liability feature of Corp C §12440(a) should serve to limit a member's vicarious liability for acts of other

members. This liability protection could be a significant reason in itself for choosing a cooperative form of business for individuals otherwise inclined to form a partnership. For some professionals, such as engineers, who are not prohibited from limiting their malpractice liability, this can be an especially attractive benefit. (The cooperative also must comply with rules that apply to professional corporations within the cooperative's profession.)

A cooperative corporation must meet specified operational requirements. Generally, a cooperative must be organized and must conduct its business for the mutual benefit of its members as patrons of the corporation. Corp C §12201. Benefits resulting from cooperative undertakings must be used for the general welfare of the members or distributed in proportion to members' patronage. Corp C §12201. In the absence of a contrary provision in the articles of incorporation or bylaws, a cooperative is empowered to apply its profits to any activity in which it may lawfully engage. Corp C §12320(d). However, the cooperative must be democratically controlled and must be organized not to earn a profit for itself or its members as such, but for its members as patrons. Corp C §12201.

The Consumer Cooperative Corporation Law covers in detail such matters as sales of assets, mergers, reorganizations, and dissolution of a cooperative corporation. See generally Corp C §§12550-12560, 12620-12663. In many respects, these provisions are parallel to their counterparts in the General Corporation Law. Distribution of assets on dissolution is to be made in accordance with the articles or bylaws, or, in the absence of such provisions, in accordance with the members' respective rights in the assets. Corp C §12656. The articles or bylaws of a workers' cooperative should generally provide for distributions to members in accordance with their capital accounts on dissolution, or within a specified period of years, or on cessation of membership. The cooperative should also determine how it will deal with unrealized appreciation and unallocated nonpatronage-source income, if any, in the foregoing circumstances.

A member may resign from a cooperative at any time, although the articles or bylaws may state a reasonable notice requirement. Corp C §12430(a). Because a cooperative corporation is a distinct legal entity, the resignation of a cooperative member will not dissolve the cooperative, as might be the case with a partnership (see Corp C §15031(d)(7)). Memberships are redeemable only if so provided in the articles or bylaws. Corp C §12422(a). A cooperative corporation may create a sinking fund or other method to redeem memberships. Corp C §12422(b). (There may be limitations, independent of the Corporations Code, on the

right to redeem "memberships," as opposed to evidences of capital contributions.)

Other states have enacted statutes tailored to the creation and maintenance of workers' cooperatives. The most notable example is Massachusetts' Employee Cooperative Corporations Act (Mass Gen L ch 157A), which defines basic cooperative terms (*e.g.*, patronage) with specific reference to the activities of workers' cooperatives, and which provides statutory guidelines for members' internal capital accounts. The Massachusetts law is also coordinated with the terminology and concepts of Subchapter T. However, the absence of such a statutory structure in the California Consumer Cooperative Corporation Law is not a serious impediment, because tailored provisions can be included in a cooperative's articles of incorporation or bylaws as long as they do not conflict with the law or with each other. Corp C §§12313(c)(4), 12331(c).

DEFINING A COOPERATIVE UNDER SUBCHAPTER T

In addition to farmers' cooperatives exempt from tax under IRC §521 (see IRC §1381(a)(1)), Subchapter T applies to any corporation "operating on a cooperative basis." IRC §1381(a)(2). Because neither the Code nor regulations define "operating on a cooperative basis," guidance must be sought from case law and revenue rulings. The Tax Court and other federal courts have set forth the following operational requirements that a cooperative must satisfy to receive Subchapter T treatment:

- Subordination of capital;
- Democratic control of the cooperative by its members; and
- Patronage distribution, *i.e.*, vesting and allocating of patronage-source net earnings on a patronage basis.

See *Puget Sound Plywood, Inc.* (1965) 44 TC 305, 308; Updegraff, *Operating as a Nonexempt Subchapter T Cooperative (Part I)*, 29 Prac Law 29, 33 (June 1983).

PRACTICE NOTE

Because, with the exception of farmers' cooperatives exempt from tax under IRC §521, Subchapter T applies only to corporations, it is highly recommended that a workers' cooperative organize as a corporation in order to qualify for favorable tax treatment under Subchapter T.

Subordination of Capital

An important distinction between a cooperative and other forms of business entities is that, in a cooperative, invested capital does not determine either economic or participatory rights. Brault, *Equity Financing of Cooperatives: Advantageous Federal Securities Law and Tax Treatment*, 21 Willamette L Rev 225, 227 (1985). Unlike a for-profit corporation, members' rights to distributions with respect to capital (*i.e.*, dividends) and to exercise control of the entity are not directly proportional to the members' relative capital contributions. In this sense, the role of capital is "subordinated."

"A cooperative's bylaws generally should not allow return of a member's initial contribution, so that members will always have a 'stake' in the cooperative."

In a cooperative, economic or participatory rights are personal rights derived from a member's functional role in the cooperative. See Corp C §12201 (cooperative corporations are "democratically controlled"); Corp C §12404 (members' voting rights must be equal); Ellerman, *Workers' Cooperatives: The Question of Legal Structure* (unpublished manuscript available from ICA). Cooperative members receive a return on labor, not capital. Any distributions paid with respect to a member's capital contribution to a cooperative should either be forbidden entirely or expressly limited, *e.g.*, to state usury rates. See *Puget Sound Plywood, Inc.*, *supra*; Updegraff, 29 Prac Law at 35. In California, distributions on contributed capital may not exceed 15 percent annually. Corp C §12451. (Although state usury rates can be used as a guide, such distributions are more in nature dividends than interest. See Corp C §12235.)

Unlike holders of an equity interest in a corporation or partnership, members in a cooperative must directly participate in the entity's revenue-producing activities to obtain rights to the benefits achieved through cooperative efforts. See Corp C §12201; *B. Rosenberg & Sons v St. James Sugar Cooperative, Inc.* (ED La 1976) 447 F Supp 1, 4.

In "stock" cooperatives, members must purchase stock as a condition of membership. (Under California's cooperative law, the terms "shareholder" and "member" are synonymous (Corp C §12247) and the term "share certificate" is synonymous with "membership certificate" (Corp C §12248).) In some of these,

most notably the plywood workers' cooperatives in the Pacific Northwest, the stock reflects the net worth of the cooperative. Some courts, however, after examining the bylaws, have ruled that cooperative shares were not growth stocks and did not have any intrinsic value other than the participatory rights that inured to members by virtue of such stock ownership. See *Lambert v Fisherman's Dock Cooperative, Inc.* (NJ Super Ct 1971) 280 A2d 193, 196; *B. Rosenberg & Sons v St. James Sugar Cooperative, Inc.* (ED La 1976) 447 F Supp 1, 3.

The following scenarios illustrate the process by which capital contributions can be obtained from and returned to Consulting Engineers Cooperative, Inc.'s members:

Scenario 1: In 1991, each of Consulting Engineers Cooperative, Inc.'s original 14 members makes an additional \$5000 contribution for capital improvements. Shortly thereafter, the two nonmember salaried engineers are voted in as full members. The new members are required to make membership contributions of \$8400. This represents a 12-percent increase over the original members' \$7500 contributions and is required to cover increased operational costs.

Scenario 2: In 1995, six new members join the cooperative and are required to pay \$8700, plus an additional \$300. The \$8700 figure results from a 16-percent increase in operational expenses, as compared with original projections. The additional \$300 reflects the member's share of a balloon payment due on a loan the cooperative took out in its first year of operation. All other members are required to make a \$300 contribution at this time.

Scenario 3: In 1998, the cooperative votes to return to the 14 original members all their noninitial capital contributions, totaling \$5300 per member (\$5000 contribution in 1991 + \$300 contribution in 1995).

Scenario 4: In 1999, the cooperative pays back the additional \$300 contribution provided by the two members who joined in 1991. Because the members who joined in 1995 made their entire contribution in the form of an initial contribution, the bylaws do not allow them to recover their contributions until termination of their memberships.

COMMENT: (1) *Distributions.* If the cooperative generates sufficient revenue, it may be able to pay members distributions on all contributed capital, at a rate of up to 15 percent annually. See Corp C §12451. Such distributions are taxable as dividends, *i.e.*, they are not deductible by the cooperative and are treated by members as ordinary income. See Updegraff, 29 Prac

Law at p 35. If the cooperative has patronage- and non-patronage-source income, dividends are deemed made pro rata from both kinds of income, thereby reducing the amount of patronage income that will qualify for Subchapter T treatment. See *Des Moines County Farm Serv. Co. v U.S.* (SD Iowa 1971) 324 F Supp 1216.

(2) *Seed Money.* In the author's opinion, a cooperative's bylaws generally should not allow return of a member's initial contribution, so that members will always have a "stake" in the cooperative.

(3) *Patronage.* As discussed above, the amount of capital contributed by a member will have no bearing on the member's salary or patronage dividends.

(4) *Equity versus Debt.* To avoid possible characterization of returns of capital as dividends, the parties should consider recasting and suitably documenting subsequent capital contributions as loans to the corporation.

Democratic Control by Worker Members

It is sometimes believed that a cooperative must follow the traditional practice of allowing each member one vote and one vote only. See *Puget Sound Plywood, Inc.* (1965) 44 TC 305, 308. The plywood cooperatives adhere to this principle, and the ICA advocates this position, under the rationale that a member's personal rights should not be determined by his or her net worth in the cooperative.

In California, a cooperative that is organized under the Consumer Cooperative Corporation Law and that is a "central organization" of cooperatives (Corp C §12256) may provide in its articles of incorporation that constituent members have unequal voting, *i.e.*, voting on a basis of other than one vote per member. If so, the articles or bylaws must specify the rules for determining voting power. Corp C §12310(d). These rules would generally reflect the relative size of constituents' memberships. However, a constituent member may not have less than one vote. Corp C §12314. For all other cooperatives, all voting rights must be equal (Corp C §12404), although a cooperative may provide in its articles or bylaws for the issuance of memberships having different rights, preferences, restrictions, or conditions (Corp C §12420).

The bylaws can provide that a delegate may have some or all of the authority of a member, as long as the delegate acts personally at a meeting or by written ballot. A delegate may not act by proxy. Corp C §12332. The bylaws may also provide for voting by members or delegates on the basis of chapter or other organizational unit, or by region or other geographical grouping. Corp C §12333. It is unclear whether a cooperative's bylaws, in defining "other organizational units," could provide for a voting agreement by members who

do not necessarily share the same operational function in the cooperative, or who are not associated with a particular cooperative department.

"A cooperative's net earnings from business done with or for patrons are distributed to cooperative members in proportion to the 'quantity or value' of their participation."

The one-person, one-vote position advocated by the ICA is motivated in part by a concern that a great disparity in voting rights would discourage some members from participating in the decision-making processes of the cooperative and would conflict with the democratic principles underlying the cooperative form. On the other hand, it seems fair that those members whose participation is significantly greater than others should have a greater say in corporate affairs. See Updegraff, 29 Prac Law at 34. One way to resolve this dilemma is to allow unequal voting rights within limits that would not nullify the participation of any member. However, this would not be permitted for a cooperative organized under the Consumer Cooperative Corporation Law.

Federal courts have not addressed the issue of whether unequal voting rights affect an entity's claim for cooperative status. One commentator believes that the absence of judicial authority on this subject explains why the IRS, as of 1983, instructed its field agents not to raise this issue when examining cooperatives. Updegraff, 29 Prac Law at 34. It is likely that the IRS does not require one-person, one-vote as a prerequisite for cooperative status.

Proportionate Returns

Generally, a cooperative's net earnings from business done with or for patrons are distributed to cooperative members in proportion to the "quantity or value" of their participation. See IRC §1388(a)(1), (3); Reg §1.1388-1(a)(1)(i), (iii). The IRS has accepted "hours worked" as a basis for computing a proportionate distribution. Rev Rul 71-439, 1971-2 Cum Bull 321. But statutory language refers to "value" as an alternative to "quantity" and suggests that factors other than hours worked may be considered in determining apportionment of distributions. (It is likely that less stringent rules apply with respect to allocation of non-patronage-source income, inasmuch as such income is not subject to Subchapter T. As discussed below, the

dispute in many cases is distinguishing between patronage- and nonpatronage-source income.)

The Corporations Code is more explicit in this regard, specifying that earnings are to be distributed equitably on the basis of patronage (Corp C §12201), and providing that "patronage of a patron is measured by the volume or value, or both, of . . . products and services provided by the patron to the corporation for marketing." (Corp C §12243).

For Consulting Engineers Cooperative, Inc., compensation can be in the form of a patronage distribution, or a combination of salary plus a patronage distribution from patronage earnings. Because a cooperative must make distributions of patronage-source earnings on the basis of patronage to qualify for Subchapter T treatment, compensation must be based on an hourly rate or other measure of patronage, rather than a set salary. If an hourly based salary is used, the hourly rate can be determined in the same manner as for noncooperative forms of business, *e.g.*, on a comparable wage or rate basis. Earnings remaining after payment of salaries would be distributable ratably in accordance with the percentage of total cooperative patronage income generated by each member. Thus, (1) if Consulting Engineers Cooperative, Inc. pays \$500,000 in salary in a fiscal year and has a surplus of \$200,000 remaining after payment of salaries; (2) members and nonmembers produce cooperative earnings in direct proportion to their salaries; (3) the cooperative's bylaws provide that patronage- and nonpatronage-source income will be distributed according to members' relative percentage of generated patronage income; (4) \$450,000 of the \$500,000 (*i.e.*, 90 percent) in salary was paid to cooperative members and the balance (*i.e.*, 10 percent) was paid to the cooperative's two prospective members; (5) Member A received a salary of \$50,000, or 1/9 of total members' salary; then (6) Member A is entitled to a total additional distribution of \$22,222 (1/9 of \$200,000), 90 percent of which would qualify as a patronage distribution and 10 percent of which would be treated as a distribution of nonpatronage-source income.

Alternatively, instead of paying salaries, the cooperative can keep track of members' hours worked and respective hourly rates, and divide patronage income in accordance with the relative cumulative value of members' work. Note that, in the foregoing example, it is the member's total output, not his or her hourly rate, which determines patronage dividends. An office clerk earning half the hourly rate of an engineer can receive an identical patronage dividend by working twice as many hours.

The IRS requires that distribution of proportionate patronage-source earnings be made pursuant to a preex-

isting written agreement. Reg §1.1388-1(a)(1)(ii). The agreement to pay or allocate earnings on a patronage basis can be created under a cooperative's bylaws. *United Cooperatives, Inc.* (1944) 4 TC 93, 107, acq 1945 Cum Bull 6; see Rev Rul 83-135, 1983-2 Cum Bull 149.

FEDERAL INCOME TAXATION OF WORKERS' COOPERATIVES

As between cooperative members and a cooperative that makes distributions on a patronage basis, there is but one level of taxation. The cooperative pays no tax on patronage earnings properly paid or allocated to members. The members pay tax on such earnings.

Although taxpayers can use partnerships and S corporations to achieve a single level of taxation, unlike either of these other entities, a cooperative has flexibility to structure the amount of tax to be paid either by the entity or the individual.

Under Subchapter T, a cooperative can deduct the entire amount of patronage dividends paid to patrons (*i.e.*, members) in money or specified other property. IRC §1382(b)(1). A patron is "any person with whom or for whom the cooperative association does business on a cooperative basis." Reg §1.1388-1(e). A patronage dividend is an amount paid by a cooperative to a patron (1) on the basis of quantity or value of patronage (2) under a preexisting obligation, and (3) from net earnings of business done with or for its patrons. IRC §1388(a); Reg §1.1388-1(a). Net earnings are amounts retained in excess of expenses. Reg §1.1388-1(a)(1)(iii); Rev Rul 68-228, 1968-1 Cum Bull 385.

As previously discussed, a patronage dividend in a workers' cooperative is a return on labor and services only. To the extent that distributions are not derived from net earnings generated by members (*e.g.*, distributions of earnings generated by Consulting Engineers, Inc.'s two prospective members), or distributions of patronage-source earnings are not paid ratably in accordance with patronage, a cooperative will not receive a deduction. See IRC §1388(a); Rev Rul 68-228, 1968-1 Cum Bull 385; Rev Rul 74-20, 1974-1 Cum Bull 242.

Sources of Income

As a prerequisite for Subchapter T treatment, the IRS requires that at least 50 percent of a cooperative's business be produced by its members. Rev Rul 72-602, 1972-2 Cum Bull 510. Some courts have not followed this stricture, and in one case, a court conferred cooperative status on an entity that derived over 60 percent of its income from nonmembers. *Conway County Farmers Ass'n v U.S.* (8th Cir 1978) 558 F2d 592, 600.

See also Corp C §12201 (cooperative corporation must be organized and conduct its business "primarily" for members).

Federal courts have taken a liberal approach in determining what constitutes patronage-source income. The regulations provide that "income derived from sources other than patronage" means "incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association." Reg §1.1382-3(c)(2). The IRS, presumably in an attempt to give the "directly related" rule practical application, devised the following test: Income produced by transactions that facilitate a cooperative's income-producing activities is patronage-source income; income derived from transactions engaged in merely to enhance the overall profitability of a cooperative is nonpatronage-source income. See Rev Rul 69-576, 1969-2 Cum Bull 166.

Federal courts, apparently disagreeing with the IRS on the scope of Rev Rul 69-576, have expanded on the "directly related" rule by making this determination in light of the "totality of the circumstances." In *St. Louis Bank for Cooperatives v U.S.* (Ct Cl 1980) 624 F2d 1041, the court held that income produced by a cooperative bank from the investment of surplus borrowed money met the "directly related" test. The court found that the bank's management of occasional surplus funds allowed it to lower the cost of credit to its patrons, thus making this activity "integrally intertwined" with the service it provided to its members. 624 F2d at 1052.

In the leading case of *Cotter & Co. v U.S.* (Fed Cir 1985) 765 F2d 1102, the court allowed a cooperative of independent hardware retailers to deduct income derived from short term CDs and rental of warehouse space as "business done with or for patrons." The court viewed these transactions as byproducts of the cooperative's fluctuating need for storage space and capital, and when placed "in the context of the totality of the business environment," they met the "integrally related rule" propounded in *St. Louis Bank*. This decision extended the holding of *St. Louis Bank* by providing a patronage deduction for income-producing activities that were distinct from the cooperative's primary business.

Some legal commentators have criticized *Cotter*, arguing that it ignores the restrictions that Congress intended to place on the tax benefits allowed under Subchapter T. See, e.g., Note, *Cotter & Co. v. United States: The Federal Circuit Court Finds the Meaning of Subchapter T to be Less than Cooperative*, 47 Ohio State L J 565, 581 (1986). The Tax Court and federal courts, nevertheless, have chosen to follow *Cotter*. See, e.g., *Certified Grocers, Ltd.* (1987) 88 TC 235; *Illinois*

Grain Corp. (1986) 87 TC 435; *Caldwell Sugars Co-Op., Inc. v U.S.* (ED La 1988) 692 F Supp 659.

Notices of Allocation

A cooperative may deduct patronage distributions paid "during the payment period" in cash or property, or by "qualified written notice of allocation" accompanied by 20 percent cash. IRC §1382(b). The "payment period" ends eight months and 15 days after the close of the tax year in which the income was earned. IRC §1382(d).

Stated more technically, a deduction is allowed to a cooperative for the tax year with respect to which it makes patronage distributions of (1) money; (2) qualified written notices of allocation; (3) money or property paid in redemption of nonqualified written notices of allocation; and (4) property other than nonqualified written notices of allocation. IRC §1382(b).

A "written notice of allocation" is a written notice of a stated dollar amount allocated by the cooperative to a member, which specifies the portion, if any, that constitutes a patronage dividend. IRC §1388(b). A mere credit to a patron's account without written notification to the patron does not satisfy this definition. Reg §1.1388-1(b). A "qualified written notice of allocation" is a written notice of allocation that can be redeemed in cash at a stated dollar amount any time from the date of notification until at least 90 days thereafter (IRC §1388(c)(1)(A)), or which the distributee has consented, in a specified manner, to take into account at its stated dollar amount (IRC §1388(c)(1)(B)). A qualified written notice of allocation that is paid as part of a patronage dividend is a qualified notice of allocation only if at least 20 percent of the patronage dividend is paid in cash or qualified check. IRC §1388(c)(1). (The 20-percent cash portion of the patronage dividend is designed to partially offset taxes payable on the distribution.) A "nonqualified written notice of allocation" is a written notice of allocation that does not meet the requirements for a qualified notice of allocation, as set forth in IRC §1388(c). Although not immediately obvious from the language of IRC §1388(d), it is possible for a written notice of allocation to be neither qualified nor nonqualified, e.g., when a written notice of qualification is issued after the payment period. IRC §1388(d).

Members must include in gross income the amount of any patronage dividend paid in (1) money, (2) qualified written notices of allocation, or (3) property other than nonqualified written notices of allocation. IRC §1385(a)(1). Because a cooperative's payment period ends eight months and 15 days after the close of the tax year in which the income was earned (IRC §1382(d)), a member can recognize ordinary income in the mem-

ber's tax year that follows the year with respect to which the cooperative takes a deduction for a patronage dividend.

EXAMPLE

Consulting Engineers Cooperative, Inc. is on a calendar year for both fiscal and tax purposes. On January 1, 1991, the amount of patronage source income is calculated for the year that ended December 31, 1990. On February 1, 1991, the cooperative makes distributions to each member, consisting of cash (at least 20 percent) and qualified written notices of allocation. The cooperative can deduct these distributions from its 1990 taxable income. The members include the distributions in their gross income for 1991.

COMMENT: In this author's opinion, Subchapter T should apply to the taxation of a workers' cooperative that renders professional services. Nothing in the law or literature suggests that a professional service workers' cooperative would be treated differently from other forms of cooperatives that have qualified under Subchapter T. However, to allay any doubts, counsel should consider asking the IRS for a private letter ruling on this issue.

Nonqualified written notices of allocation are not included in a member's gross income until redeemed by the member. The cooperative, however, is subject to tax at regular corporate rates for the amount of its earnings corresponding to the nonqualified written notices of allocation. When redeemed by the member, the member recognizes ordinary income in the amount actually received (IRC §1385(c)(2)(A), (C)), and the cooperative receives a corresponding deduction (IRC §1382(b)(2)). A cooperative that redeems a nonqualified written notice of allocation can take a deduction for the year of redemption or the year with respect to which the notice was issued. See IRC §1383; Reg §1.1383-1. Any amount realized by the member in excess of the amount stated in the written notice is considered ordinary income. IRC §1385(c)(2)(C).

Compensation

The varied means of making distributions under Subchapter T enable a cooperative to plan short and long term financial objectives for both the entity and its members. In contrast to a corporation, a cooperative can distribute all of its net earnings (to the extent that the earnings are patronage-source income) to members without being subject to reasonable-compensation restrictions that otherwise might arise under IRC

§162(a)(1). See *Linnton Plywood Ass'n v U.S.* (D Or 1976) 410 F Supp 1100, 1105; Berman, *Worker-Owned Plywood Companies—An Economic Analysis* 168 (1967).

A cooperative can also pay its members reasonable wages and distribute remaining net earnings in the form of patronage dividends. The wages portion of members' distributions will be subject to the reasonable-compensation requirements of IRC §162(a)(1). In some cases a cooperative can pay wages to its members on the basis of "weighted hours" and still withstand scrutiny under IRC §162. In *Linnton Plywood Ass'n v U.S.* (D Or 1976) 410 F Supp 1100, 1107, the court determined that cooperative members' wages, which were weighted 30 percent higher than nonmembers' wages, were reasonable, based on a factual showing that members were more productive than nonmembers, did better work, were more efficient and experienced, and made many more on-line management decisions. (The court also upheld a weighting of 50 percent for another cooperative that did not use a wages system of compensation. The cooperative treated interim distributions to members as advances on patronage distributions, rather than as wages.)

Planning Opportunities

A cooperative's various means of distributing earnings offer planning opportunities for the cooperative and its members, at least in smaller organizations whose members have similar tax situations. In a year when the distribution of a ratable share of net earnings would be taxed to members at a higher marginal tax rate than the cooperative, the members can be paid in a combination of cash, property, or qualified written notices of allocation (as long as 20 percent of the patronage dividend is paid in cash) up to the point at which members' marginal rates exceed the cooperative's tax rate. (The cooperative will be taxed at C corporation rates.) The balance of the distribution can be made by way of nonqualified written notices of allocation. On the other hand, the cooperative should not distribute nonqualified written notices of allocation to the extent that its marginal rate exceeds that of its members.

Favorable Subchapter T treatment can also foster the cooperative's and its members' long term financial objectives. Although cooperatives may be at a disadvantage in raising outside investment capital, the tax laws facilitate a cooperative's self-financing of capital expansion from retained earnings in a manner unavailable to other forms of business entities. By making distributions in the form of nonqualified written notices of allocation instead of cash, a cooperative can retain

and use capital, without being subject to the tax on accumulated earnings (see IRC §§531-537). Although IRC §533(a) allows a corporation to retain earnings for the reasonable needs of the business, when the earnings are distributed to shareholders as dividends, the shareholders will pay a second tax on the distribution. In a cooperative, there will be only a single level of tax, payable by shareholders when they redeem a nonqualified notice of allocation. (In the latter case, the cooperative's tax liability on issuance of the nonqualified written notice of allocation is offset by a corresponding deduction if the notice is later redeemed at face value by the member.)

Qualified notices of allocation can also be used in this manner by a cooperative. However, because such notices are taxable on receipt by members and generally are used by cooperatives as a short term financing device designed to even out cash flow, they are not as well suited for capital expansion needs as are nonqualified notices of allocation.

One possible use of nonqualified notices of allocation—as yet unexplored by commentators—is to provide retirement-plan type benefits to members. Capital retained by a cooperative can be distributed to members either on a prescribed redemption date or on a member's retirement or termination of membership, to the extent of any positive balance in the member's internal capital account. If distributions are to be made on a member's retirement, the process is akin to a nonqualified plan, *i.e.*, the member is not taxed on "contributions" made in the form of nonqualified notices of allocation, and is taxed only when the nonqualified notices of allocation are redeemed. Although such "contributions" would not be subject to annual retirement plan contribution limitations, it should also be noted that, unlike the case with qualified retirement plans (1) the employer, *i.e.*, the cooperative, does not receive a deduction for the employer's "contributions"; (2) earnings attributable to contributions are taxable to the cooperative (although these are later offset by a deduction on redemption, the effect of this process is to nullify the tax-free compounding of earnings that characterizes a qualified retirement plan); and (3) contributions are not held in trust.

CALIFORNIA TAXATION OF COOPERATIVES

California law is considerably more sparse than federal law in the area of taxation of cooperatives. Only one statute essentially covers the taxation of a workers' cooperative. Under Rev & T C §24405, a cooperative may deduct patronage distributions from gross income.

There are no California statutes comparable to federal laws dealing with a cooperative's year of taxation, qualified written notices of allocation, and nonqualified written notices of allocation.

"For persons willing to assume the responsibility of managing their own affairs, and who can accept the distribution of benefits on the basis of what they do instead of what they own, the cooperative form of business is an alternative worth considering."

Although a farmers' cooperative may deduct distributions of nonpatronage-source income (Rev & T C §24404), neither California's legislature nor its courts have been as liberal as federal courts (see, *e.g.*, *Cotter & Co. v U.S.* (Fed Cir 1985) 765 F2d 1102) in allowing deductions for distributions by workers' cooperatives from nonpatronage-source income. A cooperative may deduct only income generated by business activities with or for members, or for activities done on a non-profit basis with or for nonmembers. Investment of undistributed reserves or surplus in interest-bearing securities is not a business activity for purposes of Rev & T C §24405, and is considered income derived from profit-making activities of nonmembers. *Woodland Prod. Credit Ass'n v Franchise Tax Bd.* (1964) 225 CA2d 293, 298, 37 CR 231, 234; *Long Beach Fireman's Credit Union v Franchise Tax Bd.* (1982) 128 CA3d 50, 179 CR 869.

The differences in California and federal law should be considered in the tax-planning strategy of any worker's cooperative.

EXEMPTION FROM SECURITIES LAW

Federal courts have held that cooperative stocks issued to members as part of the patronage relationship are not securities, and therefore are not subject to federal securities laws. The leading federal case in this area is *United Housing Foundation, Inc. v Forman* (1975) 421 US 837, which dealt with a housing cooperative. *Forman* was followed in *B. Rosenberg & Sons v St. James Sugar Cooperative, Inc.* (ED La 1976) 447 F Supp 1, which held that shares in a marketing cooperative did not constitute securities. In *Rosenberg*, the court observed that when purchasers of stock are motivated to use what they have produced by their own la-

bors, and are not motivated by the expectation of an investment return from the efforts of third persons, the securities laws do not apply. Although reported case law has not yet specifically addressed the status of workers' cooperatives, in particular, for purposes of the federal securities laws, federal court decisions holding that workers' cooperatives should receive the same tax treatment as marketing cooperatives (see, e.g., *Linnton Plywood Ass'n v U.S.* (D Or 1964) 236 F Supp 227) should furnish precedent for holding that workers' cooperatives should not be subject to the federal securities laws insofar as securities are issued to members as part of the patronage relationship.

California Securities Laws

Under Corp C §25100(r), a consumer cooperative corporation organized under Corp C §§12200-12704 is exempt from qualification of sale of securities, if the aggregate investment of any shareholder or member in shares or memberships sold pursuant to the exemption does not exceed \$300. The practical effect of this restriction is to require exemption under some other statute (e.g., Corp C §25102(f) or §25102(h)) or qualification of the issuance of the securities of any workers' cooperative that requires significant seed money. In this author's opinion, the \$300 limit unnecessarily restricts the flexibility of cooperatives operating under the Consumer Cooperative Corporation Law.

REASONS FOR FORMING COOPERATIVES

There are many practical reasons for choosing to do business as a cooperative. A cooperative can offer participants liability protection, exemption from securities laws, and a single level of taxation that can be adjusted between the members and the entity. Some studies indicate that employee-owned firms can be more productive and more profitable than nonemployee-owned

firms. In addition, there is no reason to believe that a cooperative, which does not have to pay a return on capital, cannot be as competitive as other forms of business entities in dealing with the open market.

But bottom-line considerations are not the only benefits cooperatives have to offer. People enter into business organizations for a number of reasons. Maximization of personal income obviously is an important and essential goal. However, to adhere to a business course of short term profits at the expense of all else not only reflects a failure to plan for anything beyond immediate financial gratification, but also limits the benefits a business can provide to its participants.

Conflicting interests between those who contribute capital and those who contribute labor and services, found in other forms of business enterprise, are absent in cooperatives. The cooperative's adherence to the principles of workplace democracy means that members themselves decide such essential questions as workplace environment, product development, reinvestment, business purpose, operational principles, and accommodation of personal needs. Because cooperative members, in essence, invest in themselves, these decisions, out of self-interest alone, should be based on long term concerns.

For this reason, businesses that have traditionally experienced high employee turnover, or in which there is a great disparity in the education and skills required for different work functions, may be poor candidates for cooperatives. Similarly, individuals whose interest in participating in a business entity is primarily to obtain appreciation on capital assets or to receive a return on capital, would have little reason for forming a cooperative. But for persons willing to assume the responsibility of managing their own affairs, and who can accept the distribution of benefits on the basis of what they do instead of what they own, the cooperative form of business is an alternative worth considering.