

LEGAL CONSIDERATIONS FOR LLC COOP STRUCTURE REVIEW

PREPARED BY SUSTAINABLE ECONOMIES LAW CENTER, APRIL 2016

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INTRODUCTORY NOTE

This memorandum was prepared for a California worker cooperative formed as an LLC with many undocumented immigrant members. Its governance structure had evolved over time and no longer matched the provisions of its Operating Agreement; Sustainable Economies Law Center was hired to advise on the legality of that structure and potential amendments needed to the Operating Agreement. Although an LLC can provide opportunities for workers to avoid employee classification, that can only be done if governance is shared among the members as a member-managed LLC. The coop for which this memo was prepared used a static management team. At least one of the managers was not an LLC member (i.e. did not have an ownership stake in the company), which is problematic for a member-managed LLC. Many of the members and all of the member candidates were subject to supervision and training. The coop currently had about 10 members and several member candidates, and was hoping to grow larger. The cooperative at that time did not withhold employment taxes, carry workers compensation insurance, collect I-9s for its members, or follow certain other employment and labor law provisions.

The name of the coop for whom this memo was prepared has been replaced with “LLC Coop” and certain non-consequential details have been changed to protect client confidentiality.

This memo is not legal advice on your specific situation. You should seek independent legal counsel before relying on any of this information.

SUMMARY OF RECOMMENDATIONS FOR LLC COOP

In California, worker-owners of LLCs are not employees for **tax withholding¹ and workers compensation purposes.²** However, LLC members might be employees for **employment law and immigration law purposes**, depending on several factors. Based on our conversations with LLC Coop staff, we believe that many LLC Coop members, and probably all of its member candidates, would be considered employees under employment law and immigration law. As detailed below, we believe that LLC Coop is currently not in compliance with immigration law, employment law, securities law, and LLC law. Below we describe why we think this is the case and what strategies LLC Coop might try to bring their business into compliance with these areas of law. We have attempted to describe strategies below that we believe meet the desires of LLC Coop's worker members.

Most importantly, every member of LLC Coop needs to help manage the business. Until LLC Coop provides every worker-member with management authority, the cooperative:

- Owes its workers employment law protections like overtime payment, paid sick leave, and meal/rest breaks;
- Violates immigration law if it does not follow I-9 requirements for its workers and/or if it knowingly employs or recruits workers who are undocumented;
- Is potentially issuing unregistered securities (that is, member investments) that would not fall under the exemption for LLC managing members;
- Violates LLC law governing member-managed LLCs, and possibly breaches fiduciary duties (that is, the obligation to act in the LLC's best interest).

To best protect the coop from negative legal consequences, we recommend that LLC Coop:

- Put into operation a non-hierarchical governance structure or other distributed authority model that gives members more influence over business decisions (see more specific ideas below);
- Operate as a member-managed LLC by giving every member management authority;
- Do not give any management authority to non-members;
- Continue to choose partnership taxation;
- Avoid growing too large as an individual LLC; consider a network of smaller LLCs;
- Develop a candidacy process that does not require hiring candidates as employees and/or adopt a candidacy program that does not create an employee-employer relationship (most likely by making them members from day one)
- Alternatively, consider converting the LLC to a marketing/referral cooperative model.

Note that these recommendations are meant as measures to *best* protect LLC Coop from liability, but the cooperative should discuss what degree of risk it is willing to take. If it decides it is worthwhile to run the risk of lawsuit and/or administrative sanction, it is important that current and future members are aware that the cooperative is operating in a legal gray zone, and should be informed about the risks and potential consequences of joining the cooperative.

¹ Assuming the LLC is taxed as a partnership (most common)

² For members who work in a member-managed LLC or whose pay is tied to the profits earned by the LLC.

IMMIGRATION LAW OBLIGATIONS

Federal law prohibits businesses from employing workers it knows are unauthorized to work in the US. To enforce this law, employers must fill out an I-9 for every employee, and keep the paperwork on file for possible inspection. The I-9 requires the employee to give information that proves he or she is authorized to be employed in the United States.

If an employer fails to comply with the Form I-9 requirements, or knows its employees are undocumented, the fines and penalties can be severe. A first-time violation can be up to \$3,200 per worker or per violation, and fines for subsequent offenses can be up to \$16,000. If the business has engaged in a “pattern or practice” of violations, the employer (which includes individual owners and managers) can face criminal penalties, including jail time.

According to decisions by the Office of the Chief Administrative Hearing Officer (“OCAHO”), forms I-9 do not need to be completed for owners of a business. For immigration law purposes, a worker is an owner and not an employee if he or she has a **substantial ownership interest** in the business and **controls all or part** of the business. This is a slightly different test than the ones used to determine whether a worker is an employee for employment law, workers’ compensation, or tax purposes.

Note that OCAHO is an administrative court. Federal courts that have authority over OCAHO have never decided whether undocumented immigrants may own and work for a business. Therefore, although OCAHO decisions do not currently require owners to fill out I-9s, a federal court decision on this matter could change that.

Below is a discussion about how to minimize the risk that Immigration and Customs Enforcement (ICE) will see worker-owners as employees.

EMPLOYMENT LAW OBLIGATIONS

- Employment law obligations in California for LLCs with worker-members who qualify as employees include:
 - Paying minimum wage and overtime;
 - Providing paid sick leave;
 - Complying with standards for hours and working conditions;
 - Payment of payroll taxes and other withholdings (if taxed as a corporation);
 - California law has recently clarified that LLCs taxed as partnerships do NOT need to withhold any CA payroll taxes, including unemployment insurance, for any of their *members*.
 - Complying with occupational safety and health laws;
 - Posting of certain kinds of notices and posters related to employees’ rights; and
 - Adhering to certain recordkeeping requirements.
- Obligations for an LLC with non-member employees (e.g. workers in the candidacy period) also include:
 - Payment of payroll taxes and other withholdings (regardless of tax election)
 - Provision of workers compensation insurance (see below)

LLC members are clearly exempt from payroll tax and workers compensation insurance.³ They might *not* be exempt from the other requirements listed above, such as proper record keeping and paid sick leave. An enforcement agency could

³ As long as the LLC is member-managed and taxed as a partnership.

audit or inspect the LLC and issue penalties. Also, an LLC member who is treated more like an employee might be able to file a claim for unpaid overtime wages, unpaid sick time, etc. Additionally, LLC managing members that knowingly violate the law are breaching their fiduciary duty of care to the LLC and could risk a lawsuit on that basis.

STRATEGIES TO AVOID EMPLOYEE CLASSIFICATION UNDER IMMIGRATION AND EMPLOYMENT LAW

The following hierarchy is a general ranking of entity structures and governance practices for avoiding employee classification under immigration and employment law, starting with the safest option at the top. Note that the risk of members being seen as employees for *immigration law* purposes increases as the *size* of the cooperative increases.

STRUCTURES RANKED FROM LEAST RISKY TO MOST RISKY

1. Non-hierarchical, member-managed LLC, partnership taxation
2. Non-hierarchical, member-managed LLC, corporate taxation
3. Non-hierarchical cooperative corporation
4. Member-managed LLC with clear hierarchy/management/supervision, of any size
 - a. Based off our discussions and research, this is probably where LLC Coop falls on the spectrum.
5. Manager-managed LLC of any size
6. Hierarchical cooperative corporation

WHAT ENTITY TYPE AND TAXATION OPTION IS SAFEST?

Below, we describe why we've come to this conclusion, but in short, to avoid "employee" status for immigration law and employment law purposes, an **LLC with partnership taxation** is likely the safest choice.

IMMIGRATION LAW

Entity type does not automatically determine whether a worker is an employee or an owner, according to decisions by OCAHO. Neither does tax treatment of worker pay. So neither the worker's title ("partner", "member", "shareholder", etc.), nor whether a worker receives a K-1 or a W-2, decides the question for immigration law. Rather, ICE is looking primarily at how much **ownership and control** over a business the worker has.

Although entity type and tax treatment are not determinative, ICE may still consider them when deciding whether a worker is an employee or an owner. For example, a worker who is on payroll and receiving a W-2 may look more like an employee and ICE may require more evidence to the contrary. Cooperative corporations and LLCs that choose corporate taxation must issue W-2s to their workers. Therefore, the safest entity and taxation for a worker-owned business with undocumented members is probably an **LLC with partnership taxation**.

LLC Coop may feel it is valuable to choose corporate taxation for the purpose of issuing W-2s, because LLCs taxed as partnerships may not issue W-2s to its members and this may cause friction and confusion when members are filing their taxes. However, in a scenario where LLC Coop issues W-2s, we advise LLC Coop to ensure that the other factors below point strongly toward member ownership and control.

EMPLOYMENT LAW

Entity type is more important for employment law purposes than immigration law. In California, there is a presumption that workers in a corporation are employees. A worker-owner in a corporation is more likely to succeed in claiming they are an employee than a worker-owner of an LLC would be. It has not been tested in court, but a cooperative corporation with all members on the board could argue that its members are not employees. But it is very risky for cooperative corporations to not treat their workers as employees.

It is unclear whether an LLC that is taxed as a corporation would run the same risk as a corporate entity. Like a corporation, the LLC would then issue W-2s to its members, rather than K-1s. Because this is employee taxation, rather than self-employment taxation, it might be one factor the court would use that could point toward employee status for purposes of employment law protections.

WHAT GOVERNANCE AND MANAGEMENT STRATEGIES WILL HELP AVOID EMPLOYEE CLASSIFICATION?

How authority is delegated and how workers relate to each other are **the most important considerations**. *Clackamas Gastroenterology Associates, P.C. v. Wells* (2003) is the US Supreme Court decision that is the most often cited when determining whether a worker is an employee or a partner. The factors the court weighed in that case were:

1. Whether the organization can hire or fire the individual or set the rules and regulations of the individual's work
2. Whether and, if so, to what extent the organization supervises the individual's work
3. Whether the individual reports to someone higher in the organization
4. Whether and, if so, to what extent the individual is able to influence the organization
5. Whether the parties intended that the individual be an employee, as expressed in written agreements or contracts
6. Whether the individual shares in the profits, losses, and liabilities of the organization.

Although the case was about the American with Disabilities Act, it has been cited in other contexts, including by the OCAHO in determining employee versus owner status. Additional factors that other courts have considered include:

1. The right and duty to participate in management;
2. The right and duty to act as an agent of other partners;
3. Exposure to liability;
4. The fiduciary relationship among partners;
5. Use of the term "co-owners" to indicate each partner's "power of ultimate control;"
6. Participation in profits and losses;
7. Investment in the firm;
8. Partial ownership of firm assets;
9. Voting rights;
10. The worker's ability to control and operate the business;
11. The extent to which the worker's pay was calculated as a percentage of the firm's profits;
12. The extent of that individual's employment security; and
13. Other similar signs of ownership.

In the I-9 context, OCAHO has also paid attention to the **size** of the entity. As an LLC grows, each individual member has less direct influence on business decisions. The OCAHO may find that an undocumented worker with little ability to control the business is not actually an owner exempt from the I-9 requirement. This will be even more likely if certain members have more influence and authority than others.

SHOULD AN LLC BE MEMBER-MANAGED OR MANAGER-MANAGED?

If members want to avoid employee classification, they need to be managers. An LLC that is member-managed grants management authority to all of its members; thus, a **member-managed LLC is the best choice if none of the members will be treated as employees**. Additionally, member-managers are agents of the LLC, have the authority to bind the company in contracts, and have fiduciary duties to each other. These abilities and duties are all indicators of ownership rather than employee status.

In contrast, a manager-managed LLC clearly indicates that some members have greater ability to direct business affairs, bind the business in contracts with third parties, etc. than other members. While managers in these LLCs may not be considered employees (assuming they have an ownership stake in the LLC), the other non-manager worker-members would be.

Even if an LLC's governing documents state that it is "member-managed," the most important factor for determining whether members are employees is whether or not the LLC is *functionally* member-managed. Employment and immigration agencies have been clear that labels do not determine the employee status of workers, if in fact they are being treated otherwise.

HOW CAN AN LLC STRUCTURE A CANDIDACY PERIOD TO AVOID CREATING AN EMPLOYER-EMPLOYEE RELATIONSHIP?

Most cooperatives, including LLC Coop, require prospective members to first serve as employees of the cooperative for a certain length of time. This allows the cooperative to evaluate their fit and qualifications for becoming a co-owner. However, even if LLC Coop complies with employment law with regard to these workers, it is violating immigration law if it knows the workers are undocumented and/or if it does not follow I-9 requirements.

LLC Coop should consider designing a candidacy process that does not create an employer-employee relationship between the candidates and the cooperative.

One possible process is the one that the Paleteria incubated by Prospera is adopting. Candidates are members of the cooperative from day one. This requires a lot of vetting before admitting the provisional member. The candidate-member has the same voting rights and patronage rights as the others. But for the first six months of being a member, the other members can more easily remove the new member. For example, if the new member repeatedly does not follow the rules, they can be removed by the agreement of $\frac{3}{4}$ of the members. Additionally, there are three extreme situations, such as violence, that would trigger immediate expulsion. After six months, it becomes much more difficult to fire the member.

Another possible model is the Cooperative Home Care Associates candidacy model. CHCA created a nonprofit arm, PHI, to promote "quality jobs for low-income workers as the foundation for quality care for elders and people with disabilities." PHI not only provides advocacy to lift up the standards of care and the livelihoods that facilitate that care, but also works with CHCA to "strengthen and fundraise for its training program and organizational development." In

short, CHCA has effectively offloaded the training of new members to PHI through PHI's workforce development program. If LLC Coop was to have a collaborative relationship with a nonprofit performing workforce training and education with an offer of employment for those who graduate the training program, that might also provide protection for LLC Coop from "knowingly hiring, recruiting or referring for a fee unauthorized aliens." Note that such training should be purely educational and the nonprofit should not compensate participants, in order to avoid an employer-employee relationship.

THE SI SE PUEDE! MODEL

Si Se Puede! is a housecleaning cooperative incubated by the Center for Family Life in New York. In order to avoid employee status for its workers, it formed as a marketing and referral cooperative. Each member has its own individual clients, and the clients contract only with members, not with the cooperative itself. The members receive 100% of the client payments. The members share the costs of marketing the services that each member provides individually. They make collective decisions and jointly manage the cooperative. In this model, the cooperative receives calls from clients and assigns them to members, but the client and not the coop pays the worker, so she is less likely to be seen as an employee of the cooperative. Her relationship to the client is as an independent contractor.

RECOMMENDATIONS

To treat members as partners rather than employees, and avoid the I-9 requirement, consider:

- Implementing a non-hierarchical structure where responsibilities are delegated to certain members, but all members have authority over some part of the business.
- Allowing members to have more autonomy in choosing work assignments. Perhaps use an online scheduling platform?
- Implementing a procedure whereby other members can call a vote to decide a course of action if they disagree with decisions made by members with delegated authority.
- Using rotating, non-static roles.
- Avoiding the use of the term "management team" or "governing committee."
- Forming a subsidiary organization or collaborating with an outside organization that provides certain services to the cooperative that would otherwise be done by the management team.
- Giving new workers membership status from the start, after training and vetting them through a separate workforce development program.
- Operating as a marketing/referral cooperative, so members work for individual clients rather than for the coop (this is Si Se Puede's model).

WORKERS COMPENSATION INSURANCE EXEMPTION

Working members of an LLC are exempt from the requirement to be covered by workers compensation as long as the LLC is member-managed. It is unclear whether forming a "member-managed" LLC that practically functions as manager-managed will limit which members are exempt. In that case, **it is possible that members who do not manage the LLC may be entitled to workers compensation insurance.**

Additionally, LLC members who receive pay dependent on the profits of the business are exempt from the workers compensation insurance requirement. Members who receive guaranteed payments (a consistent salary independent of profits) are only exempt if they are managers.

In corporations, officers and board members are exempt where they are the only shareholders of the company. For example, a cooperative corporation that has all of its members on the board and no outside investors, could avoid providing workers compensation insurance for its members.

Even if members are exempt from the workers compensation insurance requirement, they can still elect to be covered.

Employees in their candidacy period must be covered by workers compensation insurance.

CALIFORNIA LLC LAW AND RECOMMENDED CHANGES TO LLC COOP OPERATING AGREEMENT

- LLC Coop should comply with the procedures described in its operating agreement, or revise the operating agreement to reflect actual practices. Failure to do so could become a factor in establishing that individual members are personally liable for obligations of the LLC.
- LLC law requires a statement in the articles of organization and the operating agreement if the LLC will be manager-managed (that is, not every member will be managing the business). Because LLC Coop currently does have managers, but its governing documents state it is member-managed, it is not in compliance with LLC law.
- Only manager-managed LLCs may have non-member managers. LLC Coop should not allow non-members to manage the company.

SUMMARY OF CONSIDERATIONS

	LLC member-managed	LLC manager-managed	LLC taxed as partnership	LLC taxed as corporation	Cooperative corporation
Immigration consequences for members	Exempt from I-9 if non-hierarchical (risk increases as business grows)	Subject to I-9 requirements	Exempt from I-9 if member-managed, non-hierarchical (risk increases as business grows)	Probably exempt from I-9 if non-hierarchical (risk increases as business grows); potential SSA no-match letter	Probably exempt from I-9 if non-hierarchical (risk increases as business grows); potential SSA no-match letter
Workers compensation	Member-managers excluded unless elect to be covered	Member-managers excluded unless elect to be covered	Tax treatment not relevant	Tax treatment not relevant	Officers and directors who are sole shareholders excluded unless elect to be covered
Employment law	Any member exempt who meets the classification of "partner" rather than "employee".	Member managers exempt who meet the classification of "partner" rather than "employee".	Any member exempt who meets the classification of "partner" rather than "employee".	Most workers probably not exempt, could make an argument if non-hierarchical	Most workers probably not exempt; could make an argument for exemption of worker-members on the board
Members receive W-2	Management structure not relevant	Management structure not relevant	No	Yes	Yes
Delegation of management and governance	All members are managers and all managers are members; delegation of responsibilities possible in Operating Agreement	Can have non-member managers; non-managers	Tax treatment not relevant	Tax treatment not relevant	Must have board of directors, possible for all workers to be on the board
Permanent capital	Management structure not relevant	Management structure not relevant	Yes but members are taxed, unless using a workaround (like a corporate member)	Yes	Yes
Securities law	Membership investment is exempt if members active in managing the business	Investments by non-managers may not be exempt	Tax treatment not relevant	Tax treatment not relevant	As of Jan. 2016, first \$1,000 of any coop member is exempt (currently the cap is \$350). Additional investments by members not on the board may not be exempt

