# A Worker Cooperative as an Employee Ownership Fund

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## Introduction

In a conventional corporation, where the employees own a sizable amount of the equity shares, it may be desirable to set up an Employee Stock Ownership Trust or ESOT to organize and to perpetuate the ownership by employees. The ESOT systematizes the employee ownership so that when an employee shareholder retires (if not sooner), the Trust will buy back the shares which will then be automatically redistributed to the ownership accounts in the Trust of all the current employees who are the members/beneficiaries of the Trust. In that manner, the ownership of the shares by the employees is sustained instead of slowly leaking to outsiders who might eventually take over the company.

Without a separate ESOT, the only way to sustain employee ownership when an employee-owner retires or leaves is to have the company directly buy back the shares or to have the shares individually purchased by active employees. But new employees cannot afford to individually buy the shares of a retiring employee-owner. And if the company buys back the shares (which are then retired to the company treasury), then only the existing shareholders benefit since they then own a larger percentage of the company—but it was *all* the current workers who produced the company income to buy back those shares. It is only with an external trust that *all* the existing employees will benefit in their ownership accounts of the Trust by the repurchase of outstanding shares from retiring employee owners or from other shareholders. In what follows, we will assume that the company is a joint stock company but the same ideas work for a limited liability company (LLC) where there are ownership percentages instead of ownership shares.

In the United States, a special legal category of a retirement trust has been created to function as this sort of employee ownership vehicle. Since retirement trusts normally can hold only a small percent of their assets in employer stock, special legislation was required to “carve out” a special Employee Stock Ownership Trust that could hold 100% of its assets in employer stock. But corporations in other countries might also want to set up a similar ESOT where there is not as yet any special legislation. Until such legislation can be passed, what sort of legal vehicle might serve as an ESOT (but possibly without all the tax advantages of the specially-legislated ESOT)?

Since all countries should have some form of legislation for worker cooperatives, the *suggestion here* is for a worker cooperative to serve as an employee ownership trust for a conventional corporation with significant ownership by employees (and perhaps also significant ownership by non-employees). In this manner, the employee portion of the ownership of a conventional joint stock company can be maintained, if not increased, prior to special employee stock ownership trust legislation.

## A worker cooperative as an Employee Ownership Fund

In the American ESOT, contributions made by the company to the ESOT are counted as deferred labor compensation expense and thus are deduced from taxable corporate income at the company level. If a worker cooperative is to serve as an ESOT, then how can money go from the company to the co-op/ownership-trust as a tax-deductible expense? The idea is simply to consider the members of the cooperative (i.e., the permanent employees in the company) as supplying part of their labor in a collective labor contract from the worker cooperative to the company. This mimics the key feature in the American ESOT where the money going from the company to the trust counts as a deductible labor expense and the benefits in the trust are typically assigned proportionally to each employee’s share in the payroll.

As an example, let’s say that a certain percentage of each co-op member’s payroll as employee in the company was counted as the payment for a collective services contract between the co-op and company. The percentage could be in addition to current take-home cash pay or a subtraction from current take-home pay depending on the financial situation of the operating company. Then that part of the labor expense would be paid as a deductible expense to the worker cooperative with every payroll and that cash would be credited to each member’s capital account in the cooperative. Then the co-op can use that money to buy back shares from retired employee-owners or other outside shareholders such as existing or retiring founders. And those shares are then credited to the worker-members' ownership accounts. The collective labor contract payments might also be in newly issued shares. Thus each co-op member gets a certain percentage of each payroll as a bonus in company shares.

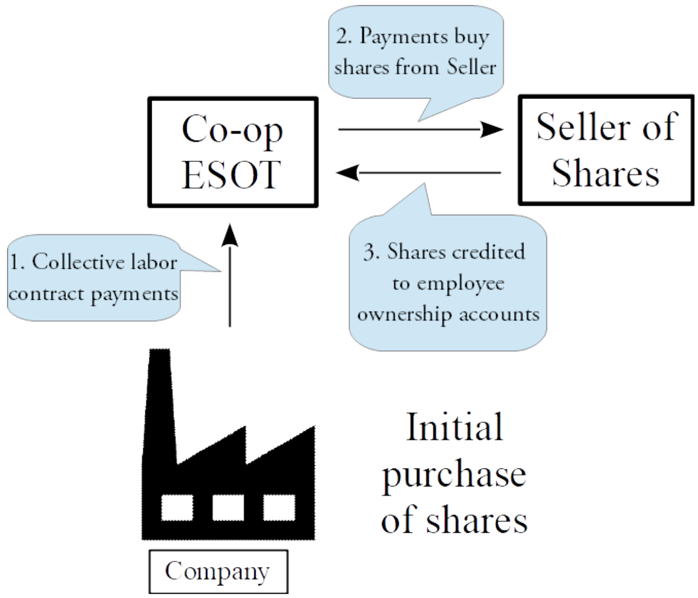


Figure 1. Initial purchases of shares by worker co-op ESOT

The process of buying shares from a retiring owner could be speeded-up if the worker cooperative was able to take out a loan guaranteed by the company with the size of the collective labor contract payments adjusted to be passed through the cooperative to pay off the loan. Also that credit to buy retiring owner shares could be seller-supplied credit so that the seller transferred shares to the cooperative ownership trust in return for a debt-note guaranteed by the company (and collateralized by the shares) to be paid off by the appropriate collective labor contract payments passed through to pay off the note.

Depending on local tax legislation, the income to the cooperative from the collective labor contract might well be taxable—which is not the case in the specially-legislated American ESOT. When special legislation is passed, then the money transferred to the ownership trust should be exempt from taxes at both the company and fund level.

## The members of the worker cooperative as EOF

The idea is for the members of the worker cooperative to be *all* the permanent employees of the company. “Permanent employee” includes full-time and part-time employees as long as it is an ongoing arrangement, not just a temporary or seasonal matter.

There might be a probationary period for each new employee of the company. After that period, the rule should be “up or out.” That is, the employee continues to work in the company and is accepted as a member of the worker co-op ESOT (along with opening the member’s capital account)—or the worker should be released from the company. There should be no permanent employees of the company who are not members of the co-op ownership trust.

## The internal capital accounts in the worker cooperative as ESOT

Each member in the Employee Ownership Fund (EOF) is to have an individual capital account which would have credits in the form of cash and/or in the form of company shares (or ownership percentages). The credits to the account might initially be the individual employee-member’s share of the collective labor contract. In the normal course of operation, the monetary credits to a member’s account would be turned into so-many shares in the company that were repurchased from retiring or exiting shareholders. The shares “in” a member’s account are held in trust for the member; they may not be sold or mortgaged by the member as if they were individual property. Eventually, the shares will be “repurchased” by the EOF and then redistributed to the current co-op members.

When a member retires or otherwise leaves the company, then the account is closed to new credits, and the EOF is then obliged to buy back the shares credited to the account (and any monetary amounts) over a fixed period of time as established in the by-laws of the EOF.

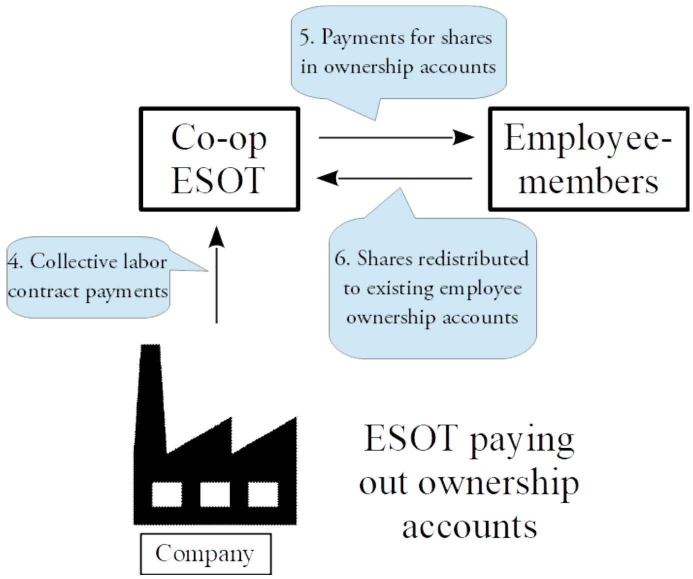


Figure 2. Eventual EOF paying out ownership accounts to existing or retired members

When an employee-member wants a "special payout" due to some family emergency or special need, that should be handled—if at all—by special loans from the company paid back out of payrolls deductions, not by breaking the rules on paying out EOF accounts.

In addition to the individual capital accounts, there might be a "suspense account" to hold shares obtained with seller credit or some outside loan used to purchase shares from an existing owner. The idea is that the shares should only be individually allocated to the employee-members who earn them by paying off the loan, not to the employees who happen to be with the company when the loan or credit arrangement was made. Hence the credit-purchased shares would be held in the suspense account, and would only be individuated to the individual accounts as the loan was paid off.

In the American ESOT, it is required by law that the shares (in a company that are not publicly traded) are valued each year by an independent certified valuator. In  an EOF arrangement, there needs to be some similar rule by which a share's value is determined that is *not* subject to individual negotiations, e.g., a fixed percent of book-value per share, and that has some resemblance of fairness to both buyer and seller. If the rule was a fixed percentage of book-value per share, then the book-value (not the fixed percent) would be determined at the end of each accounting year, and be fixed for transactions during the coming year.

When an EOF is originally set up, there might be existing or retired employees who individually own shares in addition to the shares of, say, the retiring or exiting major owner. The still-working employee shareholders should be strongly encouraged or cajoled to put those shares into their individual capital account in the EOF in return for some priority arrangement to have them repurchased. Similarly, the already-retired employee shareholders should be strongly encouraged to trade their shares to the trust in exchange for the usual buy-back arrangement (or some speeded-up version) *as if* they had just closed their account. Employee owners who choose to keep their shares outside the EOF may well harbor some schemes to accommodate an outside buyer—which would flout the purpose of the whole EOF arrangement.

## The Collective Labor Contract

In the American ESOP, the payments from the company to the ESOP are counted as deductible "deferred labor compensation" without saying they are payments for specific hours of work. Until special legislation can be passed, the collective labor contract between the company and the worker cooperative serving as the EOF could serve that same purpose. The idea of the collective labor contract could be illustrated with a simple example.

> **Example**: Suppose the company management wants to get a factory room painted but it is used during the work week so they propose to hire an outside contractor to paint it on a weekend. Now suppose that some of the company employees had organized a worker cooperative to pick up some extra money doing various jobs during the weekends. They hear about it, and offer their own cooperative to do the paint job.

Surely there is nothing wrong with that example. The idea of the collective labor contract is to have the coop include all the employees of the company, and then to count, say, one hour during the week as being work supplied through the cooperative. One hour out of 40 is 2.5% of the time, so the company could pay out the usual cash wages and salaries but for 39 hours instead of 40 hours. Then an additional 2.5% of the payroll is paid to the coop as a labor expense for that 40th hour. That is an example. In this example, all the workers get the same *cash* income, but they get an additional employee benefit of 2.5% in the Coop-ESOP serving as an EOF which will be used to buy shares in the company.

There is an alternative interpretation of the collective labor contract. Suppose the company is willing to pay an extra 2.5% of payroll to all employees in order for them to “work like owners” instead of just as employees. And this deductible employee bonus-benefit is going to be paid out to a worker cooperative of all the company employees serving as an Employee Ownership Fund—*so that they will actually become owners* through this arrangement, The 2.5% is just an arbitrary percentage since it represent one hour a week. Surely this employee bonus or benefit would be allowed in the legislation of most any country.

Under either interpretation, the members of a worker cooperative need to do some work “for” or “in” the cooperative which would be the extra hour(s) or extra effort, depending on the interpretation.

## The rollover plan

The basic idea in the optional rollover plan is for the EOF to repurchase shares in a member’s ownership account after the shares have been there a fixed number of years, say five or eight years. There are dates attached to each entry of shares credited to a member’s account so that after the fixed “rollover period,” the employee shareholder could be paid the cash for those shares that had “matured.” In this manner, the employee shareholders do not have to wait until retirement to see some cash for their shares.

The matured shares, like any shares paid for by the co-op trust, are paid for out of the collective labor contract contributions from the company, and thus those shares would be redistributed to the current employee-member accounts according to their part of the current payroll in the collective contract. In this manner, the rollover plan automatically reduces the amount of shares in the older workers’ accounts and builds up the shares in the smaller accounts of the younger employees. Then the older workers are not carrying so much of the risk and can diversity their assets without retiring. In this manner, the younger worker-members are slowly buying out the net-asset-value of the company from the older workers—even before the older workers retire. In addition to allowing worker shareholders to get some cash without retiring, it takes away the stochastic aspect of how retirement affects cash-flow. The company knows well ahead of time when the shares are maturing in the roll-over plan so the collective labor contract can be adjusted accordingly to fund the cash-flow.

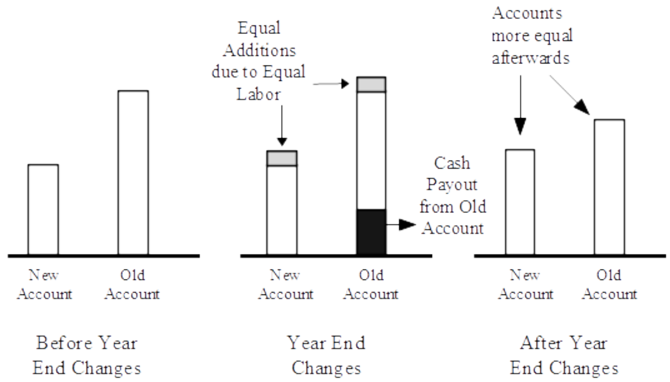


Figure 3. Illustration of rollover plan
(assuming equal payroll of older and younger worker)

The roll-over plan is particularly appropriate in a company where 100% of the ownership has already been captured in the EOF. If there are still outside shares, then a priority might be put on repurchasing those shares before rolling over the shares of existing employee-members.

## Governance

The company is assumed to be a joint stock company whose (supervisory) board of directors is elected in the usual way by the shareholders and that board would select the management (board) of the company in the usual way to run the affairs of the company.

The worker cooperative as ownership-trust also has a board of directors which would be elected by the co-op members on a one-member/one-vote basis (independent of the size of a member's internal capital account). The worker cooperative would also have a management selected by its board to carry out the affairs of the cooperative such as making the collective labor contract with the company and managing the whole internal account system of the co-op as an EOF.

The worker cooperative board, as the deciding body of the ownership trust, decides how to vote all the company shares that are co-op assets as a block. Indeed, in the most democratic version, there might be a vote by the worker-members, on a one-member/one-vote basis, to instruct the board about how to vote the shares as a block in certain decisions.

Since the only "business" of the worker cooperative is the collective labor contract and the management of the system of internal capital accounts, there needs to be an overall agreement with the company on its operation—which is particularly important when the EOF only holds a minority of the shares. That agreement would set out the framework for the operation of the company (e.g., the collective labor contract) and the worker cooperative as the EOF for the employees of the company.

## Appendix: Accounting matters

In the worker cooperative as an EOF, the company shares in the EOF would be assets of the cooperative just like cash on the "Assets" side of the balance sheet. The members' internal capital accounts are subordinate liability accounts (on the "Liabilities" side of the balance sheet) denominated partly in money and partly in shares (or percentages of ownership for a LLC)—with the payback terms of the liabilities determined by whole arrangement with the account payouts (e.g., payout only on retirement or on a rollover plan). The amount of shares and money "in" the accounts are only accounting credits, not like money or share certificates in a safety deposit box. The "balance" in the balance sheet is that the total liabilities, i.e., external liabilities plus the "internal" liabilities of the individual capital accounts plus the suspense account (if any), equals to total of the asset side of the balance. Unlike a conventional company, there is no 'equity capital' in a worker cooperative since it is the member's labor that gives the "patronage" and that accounts for the membership rights in the cooperative.

| Assets | Liabilities |
|---|---|
| Cash | External liabilities |
| Company shares | Internal liabilities (= internal capital accounts): |
| Misc. assets | Individual capital accounts |
| | Suspense account |

Figure 4. Balance sheet of worker co-op as EOF