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A Layperson's Guide to the Teamworks Cooperative Network's Financial and Legal Structures

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Introduction

I believe that solving big problems like global poverty and global warming will require the emergence of business organizations that have democratic, social, and environmental values deeply integrated into their core "DNA". These kinds of businesses must become mainstream and contend in the economy at scale. As this happens, we can flip the traditional assumption that businesses often, if not normally, create social inequity and environmental destruction as byproducts of their operations (and that without government action and private philanthropy much of the resulting mess would go unaddressed). The emerging norm will be that most businesses contribute not only products and services to society but also genuine social development and environmental restoration.

The cooperative movement is one of many efforts that hint at the possibility of one day realizing this long-term vision. However, we have not seen worker-owned cooperatives go to scale and become part of the economic mainstream in the United States. In my view, this is largely due to the financial structure adopted by cooperatives. This document briefly describes this problem, how TeamWorks is addressing it, and specifically how our solution is reflected in the Operating Agreements that are at the core of our legal structure. It also provides a guide to the other major provisions of those legal documents.

Key concepts and terms used in our system are highlighted in ***bold italics.*** Those who are interested can use the footnotes to learn more about the technical details of implementation and find the corresponding provisions in the legal documents. Unless otherwise noted, sections and page numbers cited are for the ***Operating Agreement of TeamWorks Services [location] LLC***, which we informally refer to as the ***"model operating agreement".***

The legal and financial framework described here came out of three and half years of collaboration with attorney Bart Deamer, a partner at the Silicon Valley office of Bingham McCutchen LLP. He has extensive experience in corporate and financial structures having served as lead counsel on over 90 acquisitions and as acquisition counsel for Oracle. He also had prior familiarity with some of the legal and financial challenges faced by cooperatives from his experience serving as counsel to agricultural cooperatives. Deamer has been extraordinarily devoted to the TeamWorks project, investing countless hours and bringing in colleagues from different Bingham McCutchen offices on specific questions as needed. All of this has been done on a *pro bono* basis. The overused phrase "wouldn't have been possible without him" truly applies in this instance. In the last year, attorney Ilan Hornstein has worked closely with Deamer and has also made important contributions.

Spinning in the Sand:
The Legal-Financial Challenge of Co-op Structure

Most cooperatives pay out all or nearly all of their profits to their members, either in the year the profits are earned, or some years later. "Isn't that the point?" one might ask, "to distribute the fruits of their labor to the people who did the work?"

Yes, it is. But in order to gain traction, go to scale and make a more significant contribution to society, cooperatives need to engage in *long-term shared capital formation*. This requires that they develop some assets that are not constantly being paid back out to members.

Traditional corporations would never have developed scale and sophistication without having *permanent equity* that does not have to be monetized and paid out to investors. Imagine a new company that issues stock to investors in exchange for cash to get started. It then uses the cash to purchase equipment for a small manufacturing plant and to train the company's first group of workers. It might in future years invest some of its profits – retained earnings – in further expansion and better technology that makes its work more efficient.

This entire process would be severely curtailed if along the way the company had been required to come up with the cash to buy the stock back from the initial investors, or if it had to pay out all of its retained earnings as dividends. Even in a successful company, much of that equity value is tied up in physical infrastructure and human capacities that cannot be readily converted back into cash without severely retarding or even killing the business.

Yet this latter scenario is something like what happens to many worker-owned cooperatives. If they weather the start-up years, they often reach an equilibrium point at which they can sustain one group of workers at one location but can't generate the capital to create more employment/ownership opportunities at other locations. When new worker-owners join, they make a modest initial capital contribution. Profits may be retained and used for some number of years as working capital, but by the time the worker leaves the cooperative she is paid in cash both her original membership investment and her share of the earnings from the years she participated.

The Mondragon network of cooperatives in the Basque region of Spain is the striking exception to this pattern. In my view, its financial structure is one of the most important factors behind its ongoing growth and development. About half of earnings each year are allocated to a

permanent capital account. This equity will never be paid out to individual cooperative members, and the resulting steady growth of net assets has allowed the network to develop sophisticated business, training and development, and financial institutions that are responsive to the interests of the members who own them.

The other half of a Mondragon cooperatives' annual earnings are allocated to members' ***individual capital accounts***, which are paid out to them when they leave the cooperative. The two halves of the equity structure counter-balance one another and make it possible for a well-managed cooperative to steadily build net assets.

From its beginnings in 1956, this financial model has allowed Mondragon to meet its goal of making significant contributions to the economic and social development of the Basque region, an area that suffered from chronic unemployment and the repression of its language, culture, and political life during the decades of the Franco dictatorship. Today, Mondragon is the leading business organization in the region, with more than 66,000 workers-owners, $15 billion in annual sales, and $14 billion of assets under management in its financial institutions. Not only do member-owners enjoy greater economic security than they would in traditional companies (there have essentially been no layoffs during its 52 year history, even during severe recessions), their cooperatives have also had sufficient resources to creatively adapt to changing conditions and technologies, and invest in an array of shared human and community development projects like Mondragon's own social security system, training programs, state-of-the-art research labs, and even a university.

The mechanism for retaining shared capital in the Mondragon cooperatives' permanent capital accounts is widely known by students of cooperativism around the world. But my impression is that few have actually implemented comparable structures in other cooperatives. When one gets down to the technical details, it turns out to be quite challenging to set up. But without finding a way to balance the pay-out requirements of individual member accounts with permanent capital, the vehicle is left spinning its wheels in the sand – continually distributing earnings and never gaining sufficient traction to really go somewhere.

Permanent Capital in the TeamWorks' System

Attorney Deamer and I started our discussions and research in the fall of 2004. We sought a legal structure that would allow the creation of something like Mondragon's capital accounts system that would be appropriate for a service business operating in the U.S. context. The solution had to be compatible with a number of other objectives, such as democratic governance. We looked at corporations, "cooperative corporations" (an option under California and a number of other states' laws), and limited liability companies (LLCs).

For a variety of reasons, the LLC structure provides an appealing legal vehicle for cooperatives. It is very versatile and allows LLC owner-members to adopt their own Operating Agreement with essentially whatever governance and financial structures they want.

However, in most LLCs any retained earnings left in the business must be allocated among the individual LLC members for income tax purposes, and they must pay personal income tax even on these earnings that were not paid out to them in cash. In other words, in an ordinary LLC there isn't an obvious way of holding permanent capital that will never be paid out to individuals.

After we had studied and ultimately dismissed many possibilities, Deamer came up with a strategy that would meet all of our criteria: create the cooperatives as LLCs and then create for each cooperative a corporation that will be one of the members of the LLC for the purposes of holding the permanent capital. We refer to it as the ***Permanent Capital Member*** and it pays corporate income tax on the LLC's retained earnings.[1]

The Permanent Capital Member is itself owned by the LLC. While this may appear circular, as a practical matter the members of the cooperative have governance authority over the corporate member just as they do over every other aspect of the cooperative. The Permanent Capital Member does not have a separate bank account or other separate activities; it simply is an entity within the LLC to which retained earnings that are on the LLC's books can be attributed for tax purposes.

The TeamWorks System in Action:
The Journey of a Member

Because it is difficult to sit down and read a legal document like the Operating Agreement from start to finish, I describe here how the TeamWorks system works in practice. We follow the journey of Maria, a hypothetical new recruit, through the process of joining the cooperative, participating in its governance and financial distributions, and then retiring six years later.

Joining the cooperative*.* When Maria first starts in the cooperative, she works for five to seven months as a ***Provisional Employee*** or ***Provisional Member.*** [2] She receives extensive training in

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[1]For those interested in the details of our tax strategy: the Permanent Capital Member actually holds and pays corporate income taxes on both the Permanent Capital Account (PCA) and the retained earnings that are allocated to members Individual Capital Accounts (ICAs). By doing this, individual members do not have to pay personal income tax on allocations to their accounts until they actually receive those amounts in cash years later. While it may appear that these earnings would face double taxation (once by the corporate member, and then again by the individual when their ICA balance is eventually distributed to them in cash), this problem is avoided: when ICA distributions are eventually made to the member, those distributions reduce the profit allocated to the corporate member that year. On average over time, the Permanent Capital Member only pays corporate income tax on the amount that is allocated to Permanent Capital Account (PCA). "Exhibit A – Allocation of Net Income, Etc." on p. 21 contains technical language that makes this system conform to the tax code.

[2] The two provisional pathways into the cooperative are provided to give administrative flexibility and make little practical difference for the prospective member. A new cooperative that will have many candidates seeking to become members will be expected to have arrangements to administer employees (payroll service, workers comp insurance policy). Because full members of the cooperative are owners not employees, they are exempt from these requirements; a mature cooperative may not have any reason to maintain these capacities. In such a scenario, the Provisional Member status provides a legal way to occasionally bring a new member into the

both the work of the business (e.g. the craft of cleaning, operational systems, etc.) and the knowledge needed to successfully participate in the governance of the cooperative. She must pass a series of written, oral, and practical exams administered by her peers to achieve the Apprentice, Certified Cleaner, and Member-Owner levels of our training program. (These training levels are not mentioned in the Operating Agreement.) Having passed these, her candidacy is voted on by the current members of the cooperative, and if she receives a majority vote she joins them as a full ***Active Member.***[3] If she fails to pass the exams or win the vote within seven months, the members may vote to extend her provisional period for another seven months to give her an additional opportunity to become a full member.[4]

Members' Basic Rights and Responsibilities. As an Active Member, Maria has one vote in the governance of the cooperative. The Members as a group have the ultimate authority[5] over the cooperative. The members approve policies and budgets, admit and expel members[6], and may delegate authorities to a manager and other members to run the operations of the business. A manager comes into the cooperative like any other candidate, working for five to seven months under provisional status and finally seeking an affirmative vote to become a full Active Member.

We make a clear distinction between *governance* and *management*. Governance is the final authority as described in the Operating Agreement to oversee the business. Management is the day-to-day implementation of policies and systems, and authority is delegated to different members (not only the manager) to handle specific functions based on demonstrated capacity.

So, for example, our first cooperative has selected one member who is responsible for ordering all supplies. Each cleaning team has a captain that keeps track of client keys, maintains job files, creates receipts, and logs payments made by clients. The manager conducts estimates for new business, handles communications with clients in English and relays requests to the cleaning teams, takes the lead role in updating the schedule, does bookkeeping, and works with the members to develop new policy proposals as needed to address issues that arise. Except for stating that authorities may be delegated, the Operating Agreement does not address the details of any of these arrangements.

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cooperative without having to re-establish these administrative systems. Provisional Employees are defined on p. 18 in under "Section 10-Definitions" and Provisional Members on p. 2 under "Section 2.1- Types of Members".

[3] See p. 2 "Section 2.1 – Types of Members".
[4] See p. 3 "Section 2.2 (c) – Promotion of Provisional Members; Admission of Provisional Employees".
[5] See p. 3 "Section 2.3 – Management by Active and Provisional Members".
[6] The process for removing a Member is described in on pp. 4-5 under "Section 2.7 – Removal of Member" and includes appeals process that allows an expelled member 30 days during which they may request a special meeting to make a final case. During another 30 day period from the special meeting, the members may vote to reinstate the expelled member; if they do not take action, the expulsion stands.

Capital Accounts and Distributions. When Maria becomes an Active Member, she is required to make a $500 investment in the cooperative.[7] She may pay in cash or over the course of a year by having $21 deducted twice a month from her regular pay. This investment opens her ***Individual Capital Account*** (ICA). ICAs are not bank accounts but rather equity ownership account lines that can be seen on the cooperative's balance sheet; the actual cash is used by the business as working capital to do things like pay for advertising and equipment.

As Maria works, she logs the jobs she helped complete and her share of revenue from those jobs to calculate the amount she receives in her semi-monthly pay.[8] But these earnings are not actually wages – they are advances on her share of the cooperative's profits. Since the precise ***Total Company Profit***[9] will not be known until the books are closed at the end of the year, the system of advances seeks to slightly under-pay members so that they will receive a "bonus" at the end of the year when the final profit numbers are known. The manager and the members review a financial report each month to check how profit advances are pacing against actual profits-to-date.[10] (If too much was advanced, the members would have to repay some of it to the cooperative at the end of the year. The monthly monitoring process is a bit analogous to someone checking each month that their tax withholdings are more than adequately covering their tax liability so that they will get a tax refund at the end of year; if they check frequently, there is a time to make adjustments and they can be assured that they will not owe money at the end of the year.)

Maria is excited to see how profits are distributed at the end of her first full year in the cooperative. The numbers are in and the Total Company Profits were $113,333. The Operating Agreement establishes how it is distributed. The process is somewhat complex in the legal document because of a series of details like paying interest on the members' ICA balances, but at its core:[11]

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[7] See p. 9 "Section 6.1 – Initial Contributions". The $500 required investment will increase over time as it is indexed to inflation.

[8] The details of the system for calculating the profit advances is an operational practice we developed through our experience at our first TeamWorks site; the Operating Agreement authorizes the creation of such a system (See p. 8, "Section 4.5 – Advances Against Distributions" but does not spell out the mechanics.

[9] The calculation of Total Company Profit includes an adjustment that allows expenses incurred to help the business grow to be expensed across three years. This process seeks to more closely match revenues with their associated expenses in a manner that is similar to depreciating the cost of capital equipment. But since in a service business investment in growth primarily relies on expenditures like increased advertising and training rather than the purchase of tangible assets, we created a mechanism called "Multi-Period Expenses" for making this adjustment. As a result, profits are distributed more fairly between longstanding members (who enjoyed less profit in years past because they invested in growing the business) and newer members who positions were essentially created by the sacrifice of the longer standing members. See "Multi-Period Expense" and "Total Company Profits" definitions on p. 18.

[10] This system is workable in a service business like house cleaning but would not work in more complex and capital-intensive industries where variables like commodities prices have a big impact on profits.

[11] The three bullet points here attempt to summarize in the clearest way possible the practical result of implementing all of the provisions of "Section 4 – Capital Accounts; Distributions of Cash; Investments" beginning on p. 6 and the definitions of terms found in "Section 10 – Definitions" starting on p. 17. The actual calculations in the Operating Agreement are done in a different sequence.

- 90% of Total Company Profit is paid out in cash to members in the same year the profits are earned – so in this year $102,000. It turns out that $100,000 was paid out in regular "pay" advances over the year, so $2,000 remains to be distributed as "bonuses". The relative amount each member earned in advances is used to determine each member's ***Percentage Share*.** Maria earned $24,000 during the year; Juanita $27,000; David $26,000; and Cristina $23,000. Their respective Percentage Shares are 24%, 27%, 26%, and 23% based on the total of $100,000 in advances paid. So Maria's "bonus" profit distribution is $480 (24% of the $2,000).

- 5% of Total Company Profit is allocated among the ICAs – in our example year it comes out to $5,667. Maria's share (24%) of this, $1,360, is credited to her ICA. Combined with her $500 initial investment in the cooperative, she now has an ICA balance of $1,860. The profit credited at the end of each year must be vested for two years and then becomes eligible for withdrawal; the initial $500 investment may not be withdrawn until she leaves the cooperative. The cooperative pays a fixed 6% interest on the balances in members' ICA. For the sake of example, let's pretend that at the end of each of the next five years Maria receives the same allocation to her ICA -- $1,360. If she did not withdraw funds, after six years as a member her ICA balance would be $10,615.

- 5% of Total Company Profit, an additional $5,667, is allocated to the cooperative's ***Permanent Capital Account (PCA)***. This is shared capital that will never be subject to withdrawal by any individual member. During the launch of a new cooperative, it will incur start-up losses that are financed by loans. The losses are allocated to the PCA, giving it a negative balance during the initial years. When profits begin to be earned, annual PCA allocations gradually offset the losses, the cash is used to pay off the loans, and the PCA moves towards a positive balance. If the cooperative is ever shut down, any remaining resources that are attributed to the PCA must be donated to a non-profit organization.[12]

Permanent Capital over the Long Haul

I am sometimes asked, "*If the Permanent Capital is going to grow larger and larger indefinitely, what is the cooperative going to do with all that money? And if it is a really large amount someday, won't the members be tempted to close the cooperative and find a way to cash out all that money – or fight about what to do with it?"*

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[12] See on p. 12 in "Section 8.3 – Liquidation and Termination (a)(3)". Members may not change this provision of the Operating Agreement without the permission of the Charitable Trusts Section of the Office of the California Attorney General; see on p. 14 "Section 9.3 – PCA Lock-Up."

These are logical questions. The Permanent Capital is indeed set-up so that it will grow indefinitely.   We have to ground ourselves in a series of realities and simultaneously expand our imaginations of what is possible in order to really explore this issue.

First the realities: I estimate that it will take $90,000 to start a new TeamWorks cooperative, allowing for some reserves that we hope will not have to be expended. For the first six or seven years of the cooperative's life, the amount that will be allocated to Permanent Capital at the end of each year will be used to pay off loans used to finance start-up losses. Most TeamWorks cooperatives will not be generating surplus capital for quite some time.

But the system institutionalizes a kind of financial discipline and eventually it will result in cooperatives that are debt-free and generating surpluses. If we have succeeded as well in creating a culture within the TeamWorks network that genuinely values human and community development, and the democratic governance within the cooperatives is real, then these financial resources will be a force for good.   Funds could be used in endless ways to invest in economic and social development that is democratically accountable to the needs and priorities of working people. For example, just for the sake of stimulating thinking and conversation, TeamWorks cooperatives might:

- Invest in the TeamWorks Capital Fund in order to finance the start-up of new TeamWorks cooperatives. This would be an expression of members' pride in the system they have created and desire to help other low-income people improve their life situations. It would also serve the direct self-interest of members because network expansion will create paid training opportunities for experienced members and will also create additional financial returns that will supplement the interest paid on their ICA balances.[13]

- Invest in using both financial capital and the TeamWorks networks' accumulated knowledge to start cooperatives in the developing countries from which many of our members immigrated, such as Mexico. Immigrants like those working in TeamWorks already send large amounts of money in remittances that help family members to build homes and meet daily living expenses. Why not also send capital back in an organized way that creates work and social development opportunities in our members' home communities?

- Invest in other kinds of cooperative business ventures that are more capital intensive and offer possibilities for advancing TeamWorks' social development objectives. For example, a TeamWorks cooperative could purchase and operate a laundromat in the neighborhood where most of its members live. Such a venture would complement the

[13] See p. 8 "Section 4.3 – ICA and PCA Investments" which establishes that returns generated on surplus capital invested outside the TeamWorks network shall be allocated to the PCA and that returns from investment in "TeamWorks Family Investments" will supplement members ICAs. This creates an financial incentive to invest in the development of the network rather than, say, the traditional stock market.

existing cleaning business because the cooperative launders hundreds of cleaning rags every evening. More importantly, since people have time on their hands as they wait in laundromats, TeamWorks could transform these spaces into self-supporting local community centers that would offer a wide variety of workshops, connect people to other local resources, and host community meetings.

When we imagine these kinds of possibilities, we see the beginnings of what might be possible in what Muhammad Yunus calls the emerging "social business" sector.[14] In this realm, we move beyond philanthropy and charity and imagine ordinary people genuinely controlling their own economic and social institutions that are rooted in their own self-sustaining capacity. This reflects a kind of liberation, but it is difficult to achieve if we are afraid of scale. The Grameen Bank stopped accepting grants and donations in the late 1990s and today has 27,000 employees; its annual loan budget is approaching a billion dollars. But it is still owned by its member-borrowers and the composition of its governing board still reflects the constituency that it serves: low-income women from rural Bangladesh. While our path will look very different, this is the spirit of what Teamworks seeks to build.

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[14] See Yunus' recent book *Creating a World Without Poverty: Social Business and the Future of Capitalism* (Public Affairs, 2007).