



The Framework for Democratic Control

An Introduction to Articles of Incorporation
& By-Laws for Democratic Firms.

The Framework for Democratic Control: Articles of Incorporation & By-Laws

A worker cooperative is a democratic corporation, owned and controlled by the people who work in the company - a firm that applies the principle of democracy to the legal structure of the workplace.

Simply put, it is a business where the people who work in the company own and control the business on a democratic basis of “one person, one vote”. In a worker cooperative, ownership and control of the business derive from *working* in the company, rather than from simply investing capital in it.

All corporations operate according to their governing documents, the articles of incorporation and the by-laws:

- ✓ A corporation’s existence ordinarily begins when the **articles of incorporation** are accepted by state officials, which act like the constitution of the company. Most importantly, they include what kind and how much stock the company will authorize and information such as the name of the corporation, the corporate purpose, and the list of initial directors.
- ✓ The **by-laws**, as their name implies are like laws that determine how a firm will be run. Ordinarily, the details about the cooperative structure is reflected in the by-laws, which are not usually filed with state officials and are thus easier to amend.

This introductory guide is intended to provide a basic framework of the legal documents democratic firms require. For a more detailed analysis of these issues and copies of the model documents, see the ICA publication *The Democratic Corporation* available at our website.

This publication is not intended to provide advice on the proper application of state, corporate or Federal law. A qualified attorney or other expert should be consulted for assistance with by-law formation and tax law.

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Money, Power, Information

A democratic firm's Articles of Incorporation and By-Laws are the framework under which democratic control is laid out. In simple terms, a co-op's by-laws determine how money, power, and information flow through the company. These are the things that matter most when it comes to the pressing issues of ownership and the details of all three have to be clear to all the people involved.



Money: The articles & by-laws outline how an owner enters and leaves the company and how profits are distributed. This is done through outlining what types of stockholders a firm has and what rights they hold. In a worker co-op, the value of the company is tracked using the internal capital account system.



Power: What rights do the members have? What rights does the Board of Directors have? Will there be outside investors allowed and what rights do they have? The articles & by-laws determine who has the right to control the corporation. How the board will be elected and who can make changes.



Information: How often will the members or board meet? How much notice must be given when certain types of meetings will occur? The by-laws outline communication systems to ensure democratic principles are fully realized. Otherwise the formal power members have can be curtailed.

Can I form a Worker Co-op in My State?

YES! The ICA Model Bylaws create a democratic cooperative structure within the legal shell of a general corporate, cooperative, or worker cooperative statute. What this means is that using the ICA model by-laws, you can form a worker co-op *in any state*, regardless of whether they have a co-op statute or not.

Time and again, people say that they can't form a worker co-op because there is no law on the books – this is wrong! You can form a co-op under the general corporation law.

The Capital Structure of a Democratic Firm

This capital structure outlined in a worker co-op's by-laws is quite different than a conventional corporation. The net worth of a conventional corporation is reflected in the stock shares. As a conventional company grows, the net worth of the company (and thus the value of the shares) increases. Were a co-op to use this structure, as the firm succeeded, it would make it increasingly difficult for new workers to afford to buy a share and become members.

The plywood worker co-ops of the Pacific Northwest, clearly the most financially successful worker co-ops that have ever existed in this country, were all eventually sold off from the workers exactly because of this issue.¹ While democracy is at the heart of a co-op, the other key element is creating an inter-generational firm that provides a steady source of income for current *and* future worker-owners.

The Membership Share

The innovation of the Mondragon Cooperatives and the ICA Model By-Laws is to issue membership shares and shift the function of carrying the net worth of the company away from the shares and into the internal capital accounts. Thus in a co-op, you do not have capital shares, but rather capital accounts.

Key Elements of the Membership Share



- Can only be owned by workers
- Monetary value does not change
- Entitles holder to one vote
- Entitles holder to an Internal Capital Account
- Non-Transferable
- Is redeemed when member leaves

A membership share does not increase or decrease in value like a share in a standard corporation, it is the internal capital accounts that increase in value not the membership shares.

¹ For more on the importance of the capital structure of worker co-ops, see ICA' report: *Internal Capital Accounts*.

At any given time, members may have differing claims on the company's net worth, but they all have the same membership rights and only one membership share per worker. This creates a business that is multi-generational in nature and sustains the democratic corporate structure over time.

Does This Really Matter?

Today, most worker co-ops in the US use internal capital accounts. However, unless you have specified how the value of the company is determined, two issues may arise. First the expectation of the members may be different than the reality which can cause strife and hurt feelings. Secondly, if the role of the membership share is not clearly spelled out in your governing documents, it is possible that in reality, your firm's value is tracked using capital shares. This could lead to litigation in a co-op that has succeeded when members leave.

For this reason, ICA strongly recommends that firm's use the ICA Model By-Laws as a template for your co-op and be sure to only engage legal advice from people who clearly understand this issue.

Structure & Content of the Articles

To create a corporation, all states require the filing of the articles² and a filing fee with the state government — usually, the Corporations Division of the Secretary of State's office. Most people choose to define the corporate purposes broadly and keep the articles brief. Amendments to the Articles require shareholder voting and the filing of Articles of Amendment and a fee to the state.

The specific form of the articles will vary depending upon your state laws and your choice of incorporation statute, however, the provisions on the following page are standard for most states and for most LLC registrations.

² Depending on what state your business is located, or whether you're an LLC or a corporation, the 'articles' may actually be called something else such as "articles of organization" or "certificate of incorporation." In this document, we refer to the legal document that brings a company formally into existence as the 'Articles'.

Typical Elements of Articles of Incorporation

CORPORATE NAME

This section sets the official name of your business. Be sure to check whether the name you choose is available and if there are requirements or restrictions, i.e. whether you can use the word cooperative.

PURPOSE

This provision of the Articles communicates the basic purposes of the corporation, but should also be broad enough to allow for flexibility.

AUTHORIZED STOCK

A stock corporation can only issue shares of stock if the number and type of shares is authorized in the Articles. In a co-op, the membership shares are the “common” stock and have a residual claim on corporate earnings & assets. While LLCs do not technically issue shares, the ICA Model By-Laws for an LLC mirror this structure for ease of understanding and consistency. This section is also used to authorize other classes of shares. If you are issuing non-member shares, be sure it is permitted under your selected incorporation statute.

RELATIVE RIGHTS OF DIFFERENT CLASSES OF STOCK

If you intend to issue non-member shares, this section defines the relative voting, dividend, redemption, and dissolution rights of the classes. This provision must be drafted with care, in consultation with legal counsel.

RESTRICTION ON THE TRANSFER OF STOCK

In a worker co-op, the transfer of stock shares is restricted so that only the members can hold membership shares and that membership shares can only be sold back to the company. Check your applicable state law to determine if such restrictions, if any, are required to appear in the Articles.

OTHER LAWFUL PROVISIONS

This is an open-ended section for any additional provisions. While nothing may be necessary, the election of the worker cooperative statute can appear in this section. In many states, certain authority of the Board of Directors or certain corporate powers are available only if authorized in the Articles.

OTHER DETAILS

The remainder of the Articles ordinarily is limited to basic information not treated as a permanent part of the Articles. Changes in these initial facts usually appear in annual reports or other filings, but do not require an amendment.

Structure & Content of By-Laws

The ICA Model By-Laws are broken up into 8 sections or articles. Your by-laws can deviate from this format, but it should incorporate all the elements outlined.

ARTICLE I: CORPORATE AFFAIRS

This section includes the basic information on the firm, such as its name, fiscal year end date, and the corporate purpose. If you're going to have a social mission listed in your by-laws, this is the place to put it.

ARTICLE II: MEMBERS AND SHAREHOLDERS

This section lays out the powers of the various shareholders, a fundamental element of how power flows through a firm. It determines who the members (worker-owners) are, what powers they have, how they'll vote on issues, and if there are non-working shareholders, what powers they have.

ARTICLE III: INTERNAL CAPITAL ACCOUNT SYSTEM

This section lays out how money flows through the company and how the company's value will be calculated. In a worker co-op, the net value of the firm is not reflected in the value of the stock, but rather in the values in the internal capital accounts (i.e. capital accounts versus capital shares).

ARTICLE IV: MEETINGS OF MEMBERS

The members (or shareholders) hold an at least annual meeting to among other things elect the Board of Directors. This section outlines when this meeting will happen, what issues should be addressed, and how notice related to these meetings should be dealt with.

ARTICLE V: THE BOARD OF DIRECTORS

The Board of Directors set policy in a firm, therefore, how they are selected and what power they hold is essential. This section outlines who is eligible to serve on the Board of Directors, how they are selected, what their term of office will be and how often they will meet.

ARTICLE VI: OFFICERS

The Officers of the firm are responsible for the operations of the firm, entering into contracts and maintaining the records of the company. This section lays out who the officers of the firm (President, Treasurer, Secretary, etc.) are and what

their roles and responsibilities are. If you are a benefit corporation, this is where the role of the Benefit Officer is laid out.

ARTICLE VII: AMENDMENTS

The by-laws also need to determine how they can be changed. This section lays out how changes to the by-laws will be made, what percentage of members need to vote, what components are set in stone, which can be changed, and who has the power to change them.

ARTICLE VIII: OPERATING RULES

What are the rules you'll set up as a firm? This section allows the Board to set its own operating rules. We recommend that this section be left vague to allow the firm to set its own policies. If you want to specify issues that the members should vote on, how the firm will conduct meetings, or issues related to employment policies, you can specify them here. It's best to leave your by-laws simple and easy to understand. Specifying too much detail is a sure fire way to make sure members don't read and understand the business they own.

Customizing Your By-Laws or Operating Agreement

The ICA Model By-Laws & Articles of Incorporation are designed to be used with minimal support from an attorney. Every company is slightly different, however, so we've developed the following questions broken out by section (article) to help you identify the areas you need to change to reflect your co-op's culture.

Many worker cooperatives diverge from a "pure" cooperative form, while still maintaining a commitment to democratic work. These firms couple core democratic attributes with more conventional artifacts of business and finance.

ICA's model by-laws are designed so a worker co-op is able to qualify for the preferential tax treatment co-ops enjoy under Subchapter T of the IRS code. However, using this incentive is a business decision, not a requirement. For instance, under subchapter T, outside investor's dividend rate is limited to 8%. Some investors or selling owners might want voting rights, profit participation, or guaranteed board seats and a strong business rationale might warrant such arrangements. Worker co-ops are permitted to forego the tax treatment under Subchapter T in exchange for greater access to investment capital. Of course, if the workers no longer democratically elect a majority of the board directors, the enterprise can no longer be legitimately described as a worker cooperative.

Article I: Corporate Affairs

When will your fiscal year end?

Many firms select a calendar year, however, when choosing a fiscal year end date consider the following: When is the 'natural' or predictable end of your business cycle? Will you be recognizing returns from the holiday season in January? If so, a calendar year end is probably not a good idea. In any case, you should select the end of a fiscal quarter: The end of March, June, September, or December.

What will the Corporate Purpose Be?

If you want to have a mission statement that drives the nature of your business, this is where you should include it.

Article II: Members & Shareholders

How will members be admitted into the firm?

The model by-laws leave this power to the Board of Directors and require a simple majority to admit new members. In a very small co-op with less than 15 or 20 people, it may be logistically possible to have the members decide this.

What is the eligibility requirements for members?

Membership must be open to all eligible workers, but determining what makes someone eligible is critical. The model by-laws require a one year probation with the possibility to extend the probation for an additional six months. Your firm may want to extend this period, especially if the membership fee will take a fair amount of time to save up. If you have members from more than one state, you may face additional securities regulation. If this is the case, you should consult an attorney.

Will non-members be permitted to work at the co-op?

You can require that workers join the co-op in order to work there. In smaller co-ops this is quite common, although in larger co-ops it can present problems. There is no 'right' answer, but the factors that you should consider in making this decision are whether by requiring members to join, you are limiting the firm's ability to succeed, versus setting up a situation where one group of owners benefits off the labor of another group of workers.

What will the Membership Fee cost?

The membership fee can be set at virtually any level, although it should be within reach of the people who work at the firm. Some co-ops set the fee low - \$50 or \$100 to make membership open to everyone. Others set the fee higher, anywhere from \$1,000 to \$15,000 to ensure that only those really committed to ownership join. Still others don't charge any fee, but gift the membership share to workers after completing a probationary period.

What are the rights of outside shareholders?

There is a risk in giving voting power to individuals or organizations that do not work at the firm and generally, outside shareholders are issued preferred shares that pay a dividend but do not provide any voting rights or other powers.

If you are paying capital dividends to shareholders, the dividend rate should be below 8%, to comply with the tax law requirement that a cooperative not be a vehicle for investment profits by outsiders. If you are considering issuing a second class of stock for investors, you should consult with an attorney.

Will you have a Trust Share?

The Model By-Laws contain a provision for a trust share to be held by US Federation of Worker Cooperatives or another non-profit. This share would have no value, but give the community partner the right to stop the sale of the firm to an outside entity. The rationale for this is to discourage successful co-ops from selling to an outside buyer, thus undermining the inter-generational nature of the firm.

Article III: Internal Capital Accounts

How will patronage be calculated: hours worked, wages, or some other formula?

The model by-laws use the proportion of hours worked to determine patronage, although you can also take into consideration the wages paid to an individual member (which provides more patronage to higher paid members).

Will you have an Indivisible Collective Retained Earnings Account?

ICA recommends that co-ops retain a certain portion of your net earnings in a collective account (these funds are retained in the firm and do not have to be paid out to members in the form of patronage dividends). The purpose of this

fund is to build an asset base that the firm can use to grow and succeed. The reason to have an indivisible reserve is that in the event that the company is sold, any gain left after members internal capital accounts are paid out is distributed to a cooperative development support group or non-profit. This discourages co-ops from becoming conventionally owned firms.

What percentage of accounting net income will be retained by the company versus allocated to the membership via patronage dividends?

The model by-laws require that a minimum of 30% of net income is retained in the Indivisible Reserve account and leaves it to the discretion of the board to authorize how the remainder is split. You can, however, change this percentage or set a fixed split in the bylaws.

Will you have a startup loss account?

The model by-laws do not include a provision for a startup loss account, although some firms use this approach which enables them to amortize start-up losses over time by reducing the balance in that account before charging those losses to the other internal capital accounts. Such an account would be a sub-account of the retained earnings account. For more information on the startup loss account see the ICA publication: *Internal Capital Accounts*.

What will your redemption schedule for paying out amounts in the internal capital accounts be?

The model by-laws leave it up to the board of directors to determine the redemption schedule. However, some firms specify in their by-laws the time period during which all written notices of allocation will be redeemed. One way to think about internal capital accounts is that they enable members to invest their share of the profits back into the company for a time. The longer that investment, the more return the co-op can realize. Therefore, establishing a long redemption period (15 years or at retirement, for instance) can have significant long term benefits. At any rate, we recommend that the redemption period be at least 3 years.

Article IV: Meetings of Members

How often will the membership meet?

The model by-laws call for an annual meeting, the main purpose of which is to elect the board of directors. The membership meeting is different than a staff meeting, which will likely be held much more frequently.

How much notice will members be given prior to a membership meeting?

The model by-laws require written notice be given to each member at least 10 days prior to the meeting. You may want to require more time.

Article V: Board of Directors

The Board of Directors is critical for any democratic firm, it is the representative of the membership and the body responsible for setting policy for the business, including establishing the operating rules. Therefore determining who will be able to serve on the Board, what responsibilities they hold, and how they will be elected is essential. The model by-laws make recommendations, however, this is an area that should be discussed amongst the founders of a firm. Questions to consider include:

Should the Directors serve for one, two or three years?

It is common practice for Board members to serve staggered terms of one, two or three years.

Will the co-op allow non-members or others from outside the firm to serve?

The model by-laws allow non-members to serve on the board. This allows you to include community partners or industry experts that can add real value. If you have a good rationale, however, you can restrict the Board to only members.

How many Directors will the firm have?

The model by-laws call for 5 board members, however, if you are planning on having non-members sit on the board, it may be advantageous to increase this number. Similarly, if you are a startup with fewer than 5 members, you may need fewer. In any event, having an odd number to avoid ties is a good practice.

What is the process for removing Directors from office?

The model by-laws allow both the membership and the Board to remove members of the board. If you have a good rationale, however, you may want to restrict who can remove Directors.

Are there specific issues the Board should engage the membership about?

The model by-laws leave all policy matters to the Board of Directors. However, there may be some issues that you require a membership vote for. If you elect to adopt this policy, it should be specified in the operating rules section. For more detail on the appropriate role of the board versus membership see the ICA publication *Democratic Governance*.

Article VI: Officers

This section is quite straightforward, although if you are going to have a benefit officer, as many B-Corporations do, this is where you specify their role. In most states with a benefit corporation statute, the Benefit Officer cannot be the same person as any other officer.

Article VII: Amendments

What elements of the by-laws should be able to be amended and which parts should be set in stone?

The model by-laws do not allow issues regarding the trust share or indivisible reserves to be amended. They are set in stone to ensure that the power to sell the company is restrained indefinitely.

Article VIII: Operating Rules

The by-laws allow the board and the members to establish operating rules they can use in running the firm. Operating rules could be the method that meetings are run, employment issues, or certain financial issues. It's good practice to have your by-laws be simple, so in general you should provide leeway for the firm to set its own policy outside the by-laws. If there are specific issues you want to be spelled out, however, this is where they go.

Choosing Your Legal Structure

When starting or converting a democratic firm, you have to choose what legal structure your business should take. There are five main types of firms: C-Corporation, Cooperative Corporation, Limited Liability Company, Non Profit Corporation, or S-Corporation. Each form carries with it, certain benefits and drawbacks.

ICA has developed model by-laws and articles of incorporation for all the corporate structures outlined above except an S-Corp, although the C-Corp by-laws could be easily adjusted. But how exactly should you choose which form is right for your particular business?

Choose a **C-Corp** or **Cooperative Corporation** if the worker owners are clearly employees, if you have a need to retain significant earnings to fuel business growth and stability, and you are willing to commit to regular meetings.

Choose an **LLC** if the workers are clearly partners in a business and not employees. This model is used regularly by co-ops in industries like housecleaning, where the individual member acts kind of like an independent business. This is also a good option if you are likely going to seek outside investment from a variety of sources and do not wish to authorize multiple forms of stock. Take care that you don't choose this option to skirt employment issues, not only is this possibly illegal, it doesn't support workers.

Choose a **Non-Profit** corporation if you have a clear charitable mission and do not need to access capital markets to raise funds.

Description of Legal Forms

C-Corp: A 'traditional' stock corporation where the entity is taxed separately from its owners. In this way, the C-Corp is subject to 'double taxation' where profits are taxed at the corporate level and then again when they are distributed to owners. Under Subchapter T, cooperatives incorporated as a C-Corp can avoid this double taxation for dividends paid out to members. While corporations can have an unlimited number of classes of stock, they require the authorization of share classes in the articles—which requires a state filing—and equal treatment of each share within a class. Worker-owners at a C-Corp are considered employees for purposes of employment law.

Cooperative Corporation: A form of stock corporation that specifies that shareholders are members and the corporation operates for the benefit of its members. In states with a worker co-op statute modeled after the Massachusetts Law, the fact that the company is calculated at book value and member's share of that value is recorded in an internal capital account is specified. In states with a cooperative statute, you likely cannot have the word cooperative in your name unless your business incorporates under the statute. In states where the state income tax mirrors Subchapter T, it may be necessary to incorporate under the state's cooperative statute to realize that benefit. Worker-owners in a cooperative corporation are considered employees for purposes of employment law.

Limited Liability Companies (LLC): LLCs are not taxable entities, but rather pass through entities, where the income from the business passes through to the owners (who are called members, even in non-cooperatives). The member then pays personal employment and income tax on their portion of the profits. In most cases LLCs can have unlimited classes of shares and an unlimited number of members. LLCs are also highly flexible vehicles for accepting investment, the terms of each new investment can be easily tailored without reference to a class of securities—and without amending the articles.

Most LLCs are taxed in the same way as partnerships, therefore to retain earnings and not have members have to pay personal taxes, an LLC has to elect to be taxed as a C-Corporation (a more complex workaround is to establish a separate subsidiary corporation whose sole purpose is to retain earnings). LLCs electing to be taxed as C-Corps can retain up to \$250,000 in retained earnings. In most cases, worker-owners at an LLC electing to be taxed as a C-Corp would be considered employees for purposes of employment law.

In LLCs taxed as partnerships it is not assumed that members are employees. As such, “non-resident aliens” can be worker-owners of an LLC without violating any employment law. This non-employment status can have both advantages and disadvantages – careful attention must be paid to ensure you are in compliance with applicable employment law. Furthermore, non-employees are not eligible for social safety net protections such as unemployment.

LLCs also have far less rigorous requirements for shareholder meetings and record keeping. While this simplifies certain things, a democratic corporation should hold regular (at least quarterly) board meetings and at least annual

membership meetings. Despite not being a 'corporation' owners of an LLC retain the corporate shield against personal liability for corporate debts and liabilities.

Not-for-Profit: Many worker cooperatives organize as nonprofits. In fact, the ICA Group is organized as a cooperatively structured nonprofit. The employees are the members of the firm, new members are approved by the existing members, and the staff as members elect the Board of Directors on a one person/one vote basis. Nonprofits that want a 501c(3) status must have a charitable mission and cannot pay out profits to their members, although staff can receive bonuses as compensation for labor. Nonprofits have a number of advantages: (1) corporate income is tax exempt, excepting unrelated business income; (2) all retained earnings are permanently reinvested in the firm (allowing business growth and income stabilization); and, upon dissolution, (3) all assets are protected by the state for distribution to another not-for-profit, such as for the purpose of worker cooperative development. Non-profits cannot usually access capital markets for growth.

S-Corp: S-Corps are not taxed separately from their owners, and thus avoid 'double taxation.' The S Corp has a number of limitations: the corporation cannot have more than 100 shareholders (except in the case of an ESOP), there can be only one class of stock, and all shareholders must be individuals or simple trusts. Moreover, all corporate net income or loss is taken into account each year by the shareholders, without regard to actual distributions. Thus, if the corporation needs to retain substantial earnings, the worker-owners might face tax liability with no cash proceeds to pay the tax. A corporation operating on a cooperative basis in compliance with Subchapter T has much more flexibility to shift the tax burden among the corporation and the members, even while retaining corporate earnings and avoiding double taxation. Owners of an S Corp retain the corporate shield against personal liability for corporate debts and liabilities.

Resources to Help You Succeed

ICA has developed a series of best in class materials designed to help worker co-ops and other democratic firms succeed.

The Democratic Corporation: The ICA Model By-Laws: This publication provides a comprehensive introduction to worker cooperatives and includes a compendium of model by-laws for stock corporations, LLCs, or non-profits. Also included are annotations to the by-laws, as well as multitude of model & sample legal forms.

Democratic Governance: Worker co-ops are built on a framework of democracy, but without an effective means to put this into place, it does worker very little good. This guide walks you through establishing an effective mechanism to ensure you are creating a democratic culture that works with your business.

The Internal Capital Account System: Value in a worker co-ops is tracked using a system of internal capital accounts. This guide covers the basics of co-op finances, including the difference between capital shares and capital accounts, tax treatment for worker co-ops and how to deal with financial losses.

Ensuring Your Legacy – Succession Planning & Democratic Ownership: Many business owners look to employee ownership as a way to cement their legacy, yet the process can be confusing and perceived as risky. This report walks owners through the process of converting to a democratic firm helps owners address whether this is the right thing for them.

A Comparison of Employee Ownership Models: This publication provides a basic overview of the key differences between worker cooperatives, ESOPs, and hybrid models. It walks through the details of the various forms to help business owners weigh the financial and tax impact of a sale.

Business Valuation Basics: Determining the value of a closely held company is a difficult and imprecise science. This publication walks you through the basics of how a firm's value is determined and provides a checklist of what information is necessary to complete the process.



For more information visit our websites:

www.ica-group.org

www.workercooplaw.org

www.altstaffing.org