The ICA Group

SETTING A SHARE PRICE

Selecting an Appropriate Membership Fee for a Worker Cooperative

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When forming a worker cooperative, in order to become a member of the firm, a worker has to buy a membership share, but how do you determine what is the right price to set the membership fee? There is no 'right' answer - 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 $20,000 to help capitalize the business and 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.

This report provides a brief overview of the role and purpose of the membership fee and offers guidance on how to think about this decision and what issues and factors you should consider. As with any decision regarding the issuance of a security, it is critical to consult with an attorney or other expert to ensure you are in compliance with federal and state securities law.

What is the Membership Share?

One of the key distinguishing factors of worker cooperatives is their use of the membership share. In a worker co-op, each member can only own one membership share, which unlike traditional capital stock, it does not increase or decrease in value. It can never be worth more than the membership fee. This allows new members to join a successful co-op easily.

The holder of a membership share is entitled to one vote and gives the member a right to an internal capital account and to a labor-based share of the net income - it is the internal capital accounts that increase in value, not the membership shares.

Considerations in Setting the Membership Fee

Today, most co-ops require a membership fee – the thought is that payment of a fee by a prospective Member tends to reinforce their commitment to and understanding of the responsibility and risk of membership in a cooperative enterprise.

The Membership Fee should be set high enough to meet certain capital needs of the corporation and to demonstrate a serious commitment by the Member. It should be set low enough to be affordable, perhaps through direct payments or payroll deductions. The Board of Directors has responsibility for establishing the amount of the Membership Fee, and the terms for payment. The Fee could be a standard amount (periodically changed to account for inflation) or a percentage of starting salary, but should not be changed in an arbitrary or discriminatory manner.

Some co-ops use an outside benchmark to set their membership fee. South Mountain Company in Martha's Vineyard for instance pegged its initial membership fee to the price of a decent used car. They felt this was something that everyone working at the firm could achieve, but wasn't something that people would take lightly. Still others look at what is reasonable for the workers to pay on a monthly basis and base it off that. For instance if a member could contribute $100 a month for three years, the fee could be set for $3,600. In an industry with low pay, however, paying $100 a month might be considered too high, in which case, setting the monthly contribution much lower might make sense.

Putting it into Perspective

As stated earlier, there is no 'right' answer to the question of how much the membership fee should be. To help startups and selling owners think through the various issues they should consider, however, we have laid out some of the issues that various stakeholders in the company will consider in setting the membership fee.

The Perspective of the Cooperative

A worker co-op serves as a mechanism to create a stable source of employment and income for its members. It is also a business that needs to consider the market realities it faces and ensure that it able to succeed over the long term. As such, the co-op *as a business* may have a different perspective than its members do as workers.

In many ways, this is the most important perspective to consider in setting the membership fee. The membership fee is an equity investment that stays in the company until a member retires or otherwise leaves. In either a startup or co-op conversion, it's critical to understand how much capital the business will need to ensure it can operate effectively.

Borrowed money needs to be repaid on a set schedule, preferred shares generally need to be paid a dividend and are often redeemed (meaning the co-op has to buy the share back) after a relatively short period of time. Member equity on the other hand is a long term investment in the business – from the company's perspective it is that safest form of finance capital.

In this way, the membership fee can be set by looking at the company's financial projections. After you determine how much capital it can realistically attract from outside sources, you simply take what's left and divide it by the number of members – this is the equity you need to make the business successful.

For example, if your company required $200,000 to get started and you have determined that you could borrow $100,000, you would need another $100,000. If you had 10 members, a reasonable membership fee would be $10,000. Similarly, if you had 20 members, the fee could be reasonably set at $5,000. It may be the case that this is too high, or cannot be raised quickly, but as a starting point to consider - understanding the business reality your firm faces should be of paramount importance.

The Perspective of the Selling Owner

In a situation where the firm is converting to a democratic corporation, the perspective of the selling owner is critical to understand. For most small businesses, the owner has poured much of their life into the business in order to make it succeed. In passing on the company to the employees, they are trying to ensure that the firm becomes an intergenerational enterprise. Therefore, many selling owners feel the membership fee should be set relatively high to ensure that only those employees really committed to ownership join.

In many cases, the selling owner is financing the transition to employee ownership. While the employees own a majority of the stock, the original owner carries most of the risk through the debt they have taken on. If the company fails, they stand to lose the most. Therefore, many selling owners want to ensure that the people who take responsibility for the company have invested a substantial amount to ensure everyone is on the same page.

In simple terms, the selling owner, has the right to set the membership fee at whatever price they like. Of course, if the price isn't something workers view as reasonable, most may choose not to become members, effectively defeating the purpose of forming the co-op in the first place. In this sense, a selling owner should consider the workers in setting the price of the membership fee, but it is wrong to consider this a negotiation between the owners and the workers. Ultimately the decision is the selling owners, often developed in conjunction with an initial board of directors.

The Perspective of the Worker-Owner

From an economic perspective, the worker owner as the buyer 'sets' the price of the membership share. Set the price too high and people won't join the co-op – they may continue to work there, but they won't be owners. For a worker, the real question is whether the initial investment is worth it. Will being a member of the co-op provide them with the stability of long term gainful employment? Will the return on the membership share provide a financial return that creates economic stability?

For low income workers, making a significant investment in their business is not only something they likely haven't considered before, but a serious undertaking. The membership fee will likely compete with other investments workers need to make, say a house, a car or even just the money necessary to pay their bills. Therefore, the real financial situation that members are facing needs to be considered when setting the price. Simply put, the fee should be something everyone working at the co-op should be able to afford. If the fee is set high, it's probably a good idea to allow members to pay for the share over time, or provide a long enough probationary period so potential members have time to save up all or part of the fee.

It's critical to remember, however, that the membership fee is only one way members can invest in their co-op. The other way is to retain earnings, either permanently through an indivisible reserve or on a temporary basis through written notices of allocation (for more on this subject see ICA's publication *Internal Capital Accounts*). A business with a low membership fee that retains a significant portion of its earnings is taking funds that the members as the common shareholders have a claim over, and using that to strengthen the balance sheet. In this way, the membership fee is only part of the answer, how profits are paid out or invested back in the company is equally critical.

How ESOPs Work

Within the context of the member's perspective, it's helpful to understand how Employee Stock Ownership Plans (ESOPs) are structured. Because ESOPs are qualified retirement plans, the members generally do not make any cash contribution to the company to buy the stock. The shares of the company are put into a trust that is allocated to the members over a period of time. In this way, the ESOP participants use the future cash flows of the company to buy the stock over time, a mechanism very similar to reinvesting profits into internal capital accounts or the collective account.

The Perspective of the Lender

One of the key issues lenders look at when considering whether to issue a loan to a business is the strength of the firm's balance sheet, in particular, how much equity the firm has. In this sense, it's important to make sure that the membership fee is high enough to ensure that a lender will recognize that the worker owners have invested a meaningful amount in the company. Lenders generally want to see that there is collateral to back up their loan and that the owners have 'skin in the game' – that they've either contributed equity through a membership fee or retained earnings through their capital accounts. Both mechanisms strengthen a co-op's balance sheet.

Putting it all Together

So given these differing issues, what's the right amount to set the membership fee? When ICA works with clients, we start at two extremes and work backwards to arrive at an appropriate price.

The first extreme takes a page out of the ESOP book and says the membership fee should be zero. Simply by working at a democratic firm, workers should have a say in the governance of that firm and there should be no barriers – in the same way that a citizen pays nothing to register to vote (although, they must pay taxes to assure the proper functioning of the government).

The second extreme looks that the value of the company (in a conversion) or the initial capital needs of the firm (in a startup) and divides this by the number of employees. The democratic firm is a business and the responsibility of equal ownership requires an equal and adequate contribution of capital to ensure the business can function.

Either of these extremes may be unacceptable or unachievable, so to determine where in the middle the actual fee should land, it is necessary to adjust based upon the various perspective laid out above. If the business already has assets and positive cash flow, a low fee and a dedication towards retaining earnings is likely an approach that will work. If on the other hand, the business model is unproven, setting the fee high enough to show both customers and other stakeholders that everyone at the co-op is in this for the long haul is a good strategy.

If a selling owner has concerns about employees new to ownership controlling the Board of Directors and protecting the equity they've built up in the company, a significantly higher fee may be justified. If you're going to be borrowing money or seeking other outside investment, these partners will want to know that workers are committed to the business. Therefore, depending upon your firm's balance sheet, you may need a relatively high fee.

Finally, if the wages for workers are not very high, the fee should be something that everyone working at the company can save up during their probation period without causing financial harm.

In framing this conversation, it is critical to adhere to the best practices of democratic management. Namely, the reasoning behind the decision should be clear, and the information used to make the decision should be available and understood by all the parties involved.

Does the Membership Fee Have to be paid for Upfront?

Previously, we've mentioned that the membership fee can be paid over time. While this is usually the case - many states permit purchase of stock in installments, generally stock Shares cannot be issued in exchange for a promise to pay. Nonetheless, a cooperative might want to extend membership rights while an employee is in the process of paying their Fee over a period of time, such as through payroll deductions. In that case, payment or consideration for the Membership Share might be set at a lesser amount than the full Membership Fee in order to allow for issuance of the share, with the Member making a further contribution to capital through payroll deductions or payments over time until reaching a certain level. Again, be sure to consult with local counsel, since the law and procedures vary from state to state.

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

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

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.

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.

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. For copies of these and other ICA Publications, visit our website.

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.

For more information visit our websites:

www.ica-group.org

www.workercooplaw.org