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CAPITAL-RAISING FOR  
WORKER COOPERATIVES:  
USING THE AB 816  
COMMUNITY INVESTOR  
PROVISION

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In 2016, California worker cooperatives will have their own legal entity. AB 816, the California Worker Cooperative Act (the Act), provides a legal framework for worker cooperatives and a pathway for worker cooperatives to raise capital from their community. Governor Jerry Brown signed AB 816 into law in August 2015, and became effective January 1, 2016.

Currently, California cooperatives form under the Consumer Cooperative Corporation Law (the Coop Law). After January, it will be called the Cooperative Corporation Law, and it will apply to both consumer and worker cooperatives. Worker cooperatives may make a special election under the law by including a required statement in their articles of incorporation.<sup>1</sup>

A worker cooperative corporation includes a special category of investor, the “community investor,” who is not a worker-member, but rather a person who invests money in the cooperative with the expectation of a limited return and limited voting rights. This memo outlines the definition of community investor, discusses the rights they may have, and how to use the community investor exemption in the new Worker Cooperative Law.

### *Major changes made by AB 816*

AB 816 provided an election for a cooperative corporation to be governed as a worker cooperative, provided a definition of worker cooperative, and definitions of “worker” and “worker-member.” AB 816 defines a worker cooperative as a “corporation... that includes a class of worker-members who are natural persons whose patronage consists of labor contributed or other work performed for the corporation.”<sup>2</sup> In order to understand how this new definition integrates with the terms “worker” and “worker-member,” we must first understand how the Coop Law defines “member” and “patron.” A “member” is “*any person who, pursuant to a specific provision of a corporation’s articles or bylaws, has the right to vote for the election of a director or directors, or possesses proprietary interests in the corporation.*”<sup>3</sup> The Coop Law requires that a member must have either a right to vote for the election of directors, or possess proprietary interests in the corporation. The Coop Law defines “patrons” as the

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<sup>1</sup> Cal. Corps. Code Section 12310.5(a) provides that cooperatives make the following statement in their articles of incorporation or amended articles of incorporation, “*This corporation is a worker cooperative corporation organized under the Cooperative Corporation Law.*”

<sup>2</sup> AB 816, Cal. Corps. Code §12253.5.

<sup>3</sup> Cal. Corps. Code §12238(a).

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people who purchase goods from or use the services of the cooperative.<sup>4</sup> Patrons are not necessarily the same thing as members under the Coop Law. Thus a California coop could have patrons who are not members, and vice versa.

AB 816 created three new types of persons under the Coop Law. Primarily, the Act created the categories “worker” and “worker-member.” A worker is a natural person who contributes labor or services to a worker cooperative.<sup>5</sup> Included in the definition of worker is “candidate,” who is a worker being considered for membership in the cooperative. A “worker-member” is a natural person and a patron of the cooperative.<sup>6</sup> Finally, AB 816 created the category of “community investor,” which we discuss in the next section.

AB 816 also expanded the definition of “patron” and “patronage,” by adding a specific subsection for worker cooperatives. Section 12243(b) of the bill states that if a corporation is a worker cooperative, then the patrons are the worker-members, and “patronage” may be measured by work performed, including wages earned and number of hours worked.<sup>7</sup>

Putting together all of these changes, AB 816 created a special sub-category for worker cooperatives in which the members are defined as worker-members who patronize the cooperative by contributing their labor. Patronage can be measured and valued according to the worker-members’ proportionate number of hours worked or wages earned.

## **PART I: THE SECURITIES LAW EXEMPTIONS FOR CALIFORNIA COOPERATIVES**

### *How Capital Raising for Your Worker Cooperative Involves Securities Law*

Anytime you seek to raise capital for your cooperative you need to consider the application of securities laws. Generally, if you give somebody the opportunity to invest money in your enterprise with the expectation of a return it could be considered a security.<sup>8</sup> In California, the definition of a security is even broader-- an investment opportunity *without* the expectation of a profitable return could be considered a security.<sup>9</sup>

If you are offering a security, then your offering must be registered with federal agencies and qualified in the State of California, or you must find an exemption from both sets of laws. Generally, registration and qualification of a securities offering is an expensive process; therefore, finding an exemption from these requirements can significantly reduce the costs associated with raising capital for your cooperative.

In California, the Corporate Securities Law of 1958 regulates the offering and sale of securities. The law provides that it is unlawful to offer or sell any security in the state unless it is exempted or qualified by

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<sup>4</sup> Cal. Corps. Code §12243.

<sup>5</sup> AB 816, Cal. Corps. Code §12238(g).

<sup>6</sup> AB 816, Cal. Corps. Code §12238(e).

<sup>7</sup> AB 816, Cal. Corps. Code §12243(b).

<sup>8</sup> See *SEC v. W. J. Howey Co* 328 U.S. 293 (1946).

<sup>9</sup> See *Silver Hills Country Club v. Sobieski*, 361 P.2d 906 (Cal. 1961).

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permit.<sup>10</sup> The law provides cooperatives an exemption from the qualification requirement under Section 25100(r) of the Corporations Code, which applies to share or memberships issued by a cooperative organized and existing under the Consumer Cooperative Corporation Law. Before AB 816, this so-called “cooperative exemption” was for an aggregate investment not to exceed \$300 per investor. Further, it required that all investors have voting power in the corporation, defined as the power to vote for the board of directors.<sup>11</sup>

### *Changes to the application of the Coop Securities Exemption 25100(r)*

In addition to creating a specific definition of worker cooperative and worker-member, AB 816 made significant changes to the application of the securities exemption in Section 25100(r). First, it increased the aggregate investment amount per member from \$300 to \$1,000, which applies to all cooperatives. Second, it created a new class of investors called “community investors,” which applies only to worker cooperatives. Finally, it revised the definition of the Coop Law’s definition of “voting power.”

As discussed above, the bill created a new class of person, known as “community investor.” The community investor is “a person who is not a worker-member and who holds a share or other proprietary interest in a worker cooperative.”<sup>12</sup> While the law does not specifically state that a community investor is a member, the inclusion of the term “holds a share or other proprietary interest”, likely places community investor in the definition of “member” discussed above.

The California Securities Law requires that in order for an investment to be exempt under the coop exemption, the investor must have voting power. The Coop Law defines voting power as the power to vote for the election of directors.<sup>13</sup> Further, if different classes of members are entitled to vote for different members of the board, then voting power is defined as the percentage of the total number of authorized directors that the membership class has the power to elect.<sup>14</sup>

The Coop Law also requires that voting power “of members having voting rights shall be equal.”<sup>15</sup> This provision is confusing because it implies that a worker cooperative cannot have a community investor class who do not have equal voting rights with the worker-member class to elect the board of directors.

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<sup>10</sup> Cal. Corps. Code §25110.

<sup>11</sup> Cal. Corps. Code §12253.

<sup>12</sup> AB 816, Cal. Corps. Code § 12238(f).

<sup>13</sup> See Cal. Corps. Code § 12253, providing that voting power means “the power to vote for the election of directors at the time any determination of voting power is made and does not include the right to vote upon the happening of some condition or event which has not yet occurred. In any case where different classes of memberships are entitled to vote as separate classes for different members of the board, the determination of percentage of voting power shall be made on the basis of the percentage of the total number of authorized directors which the memberships in question (whether of one or more classes) have the power to elect in an election at which all memberships then entitled to vote for the election of any directors are voted.”

<sup>14</sup> *Id.*

<sup>15</sup> Cal. Corps. Code §12404, “Except as permitted in Section 12314 [section related to a central organization which is a corporation whose membership is composed, in whole or in part, of other corporations organized under this part], the voting power of members having voting rights shall be equal.”

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In order to correct this ambiguity in the Coop Law, and also to provide a pathway to include community investors under the Securities Law cooperative securities exemption, AB 816 changed the Coop Law's definition of voting power. The new Section 12253(c) provides that community investor voting power is completely different from that given to regular voting members. A community investor's voting power must be provided in the articles or bylaws, and it is limited to approval rights only over the following major decisions: merger, sale of major assets, reorganization, or dissolution.<sup>16</sup> The bill further limits approval rights to voting rights that "shall not include the right to propose any action."<sup>17</sup> Therefore, a worker coop that wants to include community investors in the 25100(r) securities exemption, must give any community investor approval rights only over the decisions enumerated above. Such approval rights must be stated in the articles or bylaws. However, it shall not give the right to propose any of these decisions because that is the exclusive right of the worker-member class.

By creating a governance system in which community investors have approval rights over major change of control and change of entity decisions, AB 816 sought to balance the interests of investors in protecting their investment against the interests of maintaining cooperative principles of democratic member control and worker-member governance.

## **PART II: PAIRING THE COOP SECURITIES EXEMPTION WITH THE FEDERAL INTRASTATE EXEMPTION**

A cooperative corporation seeking community investors will also want to find an exemption from federal securities laws. Using California's securities law exemption for cooperatives along with the federal Intrastate Exemption will likely be the least expensive way to comply with state and federal securities laws when offering shares in the worker cooperative to community investors.

### ***What is the Federal Intrastate Exemption?***

The federal Intrastate Exemption is available under Section 3(a)(11) of the Securities Act of 1933 and exempts "any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory."

In other words, if a cooperative is offering shares or memberships in California and is doing most of its business in California then the offering is likely eligible for the exemption. The SEC, however, has adopted a safe-harbor rule (Rule 147)<sup>18</sup> that if complied with ensures eligibility for the exemption.

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<sup>16</sup> AB 816, Cal. Corps. Code §12253(c).

<sup>17</sup> *Id.*

<sup>18</sup> 17 C.F.R. § 230.147.



### *Safe Harbor Rule 147*

Failure to comply with Rule 147 does not necessarily mean that an offering is ineligible for the Intrastate Exemption. However, compliance with Rule 147 provides peace of mind that the offering squarely fits within the exemption.

For an offering in California to comply with Rule 147, the following requirements must be met:

1. The cooperative is incorporated or organized in California.
2. The cooperative derives at least 80 percent of its gross revenues and those of its subsidiaries on a consolidated basis from California. How this is determined depends on when the offering is made. This provision does not apply, however, if the cooperative has had gross revenues of \$5,000 or less in its most recent 12-month fiscal period.
3. The cooperative had, at the end of its most recent semi-annual fiscal period prior to the first offer of any part of the issue, at least 80 percent of its assets and those of its subsidiaries on a consolidated basis located within California.
4. The cooperative intends to use and uses at least 80 percent of the net proceeds from sales made pursuant to the rule in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within California.
5. The principal office of the cooperative is located within California.
6. No part of the issue may be offered or sold to non-residents for a period of nine months from the date of the last sale of an issue under the rule.
7. During that nine-month period, all resales of any part of the issue, by any person, shall be made only to persons resident within California.
8. The cooperative shall, in connection with any securities sold by it pursuant to the rule:
  - a. Place a legend on the certificate or other document evidencing the security stating that the securities have not been registered under the Securities Act of 1933 and setting forth the limitations on resale contained in the rule;
  - b. Issue stop transfer instructions to the cooperative's transfer agent, if any, with respect to the securities, or, if the cooperative's transfers its own securities make a notation in the appropriate records of the cooperative; and
  - c. Obtain a written representation from each purchaser as to his or her residence.
9. The cooperative shall, in connection with any offers, offers to sell, offers for sale or sales by it pursuant to this rule, disclose, in writing, the limitations on resale contained in the rule.



## PART 3: PUTTING IT ALL TOGETHER- BEST PRACTICES FOR ISSUING TO COMMUNITY INVESTORS

### *Voting rights required.*

As stated above, the cooperative securities exemption in the Securities Law requires that the community investors have voting power, as that term is defined in the Coop Law. The new subsection (c) creates a specific voting power definition for community investors. This definition requires that the cooperative provide any community investors with **approval rights only** over the following decisions:

- merger
- sale of major assets
- reorganization; or
- dissolution.

**The community investors' approval rights must be provided in either the articles of incorporation or the bylaws.** This is where a typical investor will first look when analyzing the capital structure and voting rights to protect their investment. Further, it is harder to amend the articles than the bylaws because the articles are filed with the Secretary of State. This can provide more stability, transparency, and ultimately, protection for the community investors, who otherwise have no voting rights for the board of directors or control over the operations of the cooperative.

### *Advertising permitted*

The Securities Law permits securities that are exempt under Section 25100 to advertise the offering of the security.<sup>19</sup> Because the coop securities exemption is under Section 25100, issuers using it may advertise their issuance. These advertisements may include newspapers, the mail, or websites.

However, in order to qualify for the federal intrastate exemption described above, the advertisement must state that it is only available to California residents, and that the cooperative will verify that all potential purchasers are in fact state residents.

### *Cooperative must verify the residency status of all community investors*

Before issuing any community investments, the cooperative should require the potential investor to submit proof of residency, including:

- Current driver's license;
- Most recently filed federal and state income tax returns showing residence address;
- Employment or payroll records showing residence address;

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<sup>19</sup> Cal. Corps. Code § 25300(b)(2).

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- Voters' registration records (showing registration to vote in state); OR
- Utility bills, credit card statements, bank records, showing residence address.

If the cooperative is relying on a website to offer the securities, the website should include a legend and requirement that the potential investor attest to their California residency, for example by clicking a box on the screen, *before* they proceed to read about the offering.

### *Annual meeting and special meetings*

The main purpose of the annual meeting is to elect directors to the board. Community investors have no voting rights to elect directors of the board, so their participation at these meetings will be restricted to observer status. The only time in which they would have voting rights in the cooperative is when their approval rights are required for a decision under 12253(c), or when the Coop Law grants them a voting right under Section 12503, discussed below.

If the community investors are to vote at the meeting, then the cooperative must comply with the notice requirements of Section 12461, which requires that each community investor receive a written notice of the meeting at least 10 days, and not more than 90 days, before the meeting date. The notice should state the matters upon which the community investors are to vote.<sup>20</sup>

AB 816 provided a carve-out for special meetings in a worker cooperative. In a worker cooperative, only worker-members may call a special meeting. Thus, if community investors are in fact members as the Coop Law defines it, then they do not have the right to call a special meeting.<sup>21</sup> If the special meeting is to be attended by only the worker-members, then the cooperative need only give notice to the worker-members, and that too only 48 hours before the meeting, provided that such notice is delivered personally to every worker-member.<sup>22</sup>

### *Voting rights provided by law*

In certain circumstances, the Coop Law grants investors voting rights, regardless of whether the articles of incorporation or bylaws grants them rights. Because community investors are likely to be classified as "members" under the Coop Law, these voting rights apply to them as well. Section 12503 requires that an amendment to the articles of incorporation be approved by members of a class, **if any amendment will materially and adversely affect the rights privileges, preferences, restrictions or conditions of that class as to voting, dissolution, redemption or transfer, or the obligations of that class, in a manner different than such action affects another class** OR materially and adversely affect such class as to voting, dissolution, redemption or transfer by changing the rights, privileges, preferences, restrictions or conditions of another class. In addition, a class has voting rights on an amendment if it will increase the number of

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<sup>20</sup> Cal. Corps. Code § 12461(a)(1)-(2).

<sup>21</sup> Cal. Corps. Code § 12460(e).

<sup>22</sup> Cal. Corps. Code § 12461(a).



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memberships authorized for the class; increase the number of memberships authorized for another class; effect an exchange, reclassification or cancellation of all or part of the memberships of the class; or authorize a new class of memberships. As we can see, if the community investor class is deemed to be a “member class” with the rights of membership, this can be potentially problematic for the worker cooperative, and can restrict its future ability to authorize new shares for any class in the cooperative, including the worker-member class, if it cannot get approval from the community investors.

In some ways this is a good thing for the community investors- because it broadens their approval rights to categories other than those directly provided in AB 816. However, it also means that a worker cooperative will need to do a lot more upfront planning (with its attorney) *before* issuing any community investor shares. The questions that the worker cooperative should settle before any community investor issuance include:

- What is the maximum number of classes? Usually this will only be two classes- the worker-member class and the community investor class.
- What is the maximum authorized numbers of shares *per class*? Remember, even an increase in the authorized shares for the worker-member class will likely trigger a vote requirement for the community investors.
- What are the rights, privileges, preferences, restrictions of the worker coop and community investor classes?

### *No Filing Requirements*

Both the federal Intrastate Exemption and California’s exemption for shares and memberships of cooperatives are self-executing, meaning that the cooperative does not need to file anything with the federal Securities and Exchange Commission or California’s Department of Business Oversight, respectively, to take advantage of the exemptions.

### *Anti-fraud provisions still apply*

Although the community investor shares are issued under exemptions from both federal and state securities laws, anti-fraud provisions still apply to protect investors from misleading statements made by issuers. California’s anti-fraud provisions are in Section 25401 of the Corporations Code. The federal anti-fraud provisions are found in U.S. Securities and Exchange Commission's Rule 10b-5, promulgated under Section 10(b) of the Securities Exchange Act of 1934. Both laws make it unlawful to make an untrue statement of a material fact in connection with the offer, sale or purchase of a security.

### *Note About Out-of-State Investors*

If the cooperative intends to offer shares or memberships to even just one out-of-state individual or investor, the cooperative will be ineligible for the federal Intrastate Exemption. While the offering may

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qualify for other exemptions from federal securities law, we would recommend that the cooperative consult an attorney to determine the most appropriate exemption to use.

Similarly, if the cooperative intends to offer shares or memberships to out-of-state individuals or investors then the cooperative will also need to comply with that state's securities law. And therefore, we would also recommend that the cooperative consult an attorney licensed in that state regarding securities law compliance relevant to that state.

### *Integration*

There are certain situations under which two or more securities offerings may be treated as one single offering. The rules governing integration are primarily intended to prevent enterprises from conducting more than one offering in an effort to get around requirements of an exemption. However, a cooperative may have legitimate reasons for wanting to conduct more than one offering in a short period of time. For example, a cooperative may begin offering shares to community investors under California's Coop Securities Exemption and the federal Intrastate Exemption, but later determine that excluding out-of-state investors prevents the cooperative from accessing available capital. Under this example, the cooperative would have to wait at least six months to conduct another offering (under different securities law exemptions) to reach those out-of-state investors, otherwise the two offerings would be integrated (deemed to be a part of a single offering).<sup>23</sup>

Whether there has been an offering can sometimes be unclear. In those situations, the particular facts and circumstances will help determine whether there has been an offering, which include 1) whether the sales are part of a single plan of financing; (2) whether the sales involve issuance of the same class of securities; (3) whether the sales have been made at or about the same time; (4) whether the same type of consideration is being received; and (5) whether the sales are made for the same general purpose.

In short, if the cooperative intends to conduct more than one offering in a short period of time, the cooperative should consult an attorney about whether the rules of integration will be triggered.

### **CONCLUSION**

On January 1, 2016, the changes made to California's Coop Law and related state securities law will go into effect. These changes will make it easier for cooperatives in California to raise capital, and worker cooperatives in particular will encounter fewer burdens when raising capital from the general community. Although cooperatives will still need to carefully navigate these new laws, this guide provides a roadmap to the key considerations cooperatives need to address when raising capital under this new framework.

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<sup>23</sup> 17 C.F.R. § 230.502; 10 C.C.R. § 260.102.12.