EXECUTIVE SUMMARY

Cooperatives are facing challenges that differ dramatically from those faced in the long history of cooperation in the United States. Such is the case for agriculture as well as other sectors of the economy. It is a cliche that “cooperatives are at a crossroads.” However, by all objective observations, such is truly the case. In the past the expression was usually used when assessing cooperatives’ economic strength and their ability to survive as businesses. Now, however, the very character of the cooperative form of business enterprise is called into question.

Perceived limitations inherent in cooperative structures and operations have led some to suggest that major changes in fundamental cooperative principles are required if cooperatives are to survive and continue to play important roles in agriculture and rural development. These views have culminated in changes in several organic laws that describe cooperative organizations. These changes are considered by some to undermine the very character of cooperative organizations. Others accept the changes but offer serious cautions if farmer members are to be protected from non-cooperative forces introduced into the cooperative model.

This Background and Discussion Paper describes such perceptions and places them in the perspective of the enormous and sometimes untapped capabilities of cooperatives as they now exist. Ever escalating requirements for change and adaption are an accepted future of any realistic assessment of cooperatives. The Paper outlines changes, adaptations, and responses.

Cooperatives are a form of business organization that operates according to explicit guiding principles, just as principles define sole proprietorships, partnerships of various kinds, corporations of great variety, and companies with mixed characteristics. USDA’s Cooperative Programs has surveyed principles over a century and a half period and developed a practical and solid set of principles statements. Contemporary cooperative principles are:

1. The User-Owner Principle: Those who own and finance the cooperative are those who use the cooperative.

2. The User-Control Principle: Those who control the cooperative are those who use the cooperative.

3. The User-Benefits Principle: The cooperative's sole purpose is to provide and distribute benefits to its users on the basis of their use.

Cooperatives are structured and operated to reflect these principles. The patronage refund system is the main instrument of the User-Benefits principle. A board of directors chosen by members, analogous to the governance structure used by non-cooperative corporations, implements the User-Control principle with the unique attributes of typically one member, one vote rules to select directors who are members of the cooperative.
The User-Owner principle is reflected in the financing methods used by cooperatives with a wide range of adaptations. Two characteristics of cooperative finance differ from that typically found in other types of business organizations. The first is an attempt to balance the amount of equity a patron has invested in the cooperative with the amount of patronage. The appeal of this balance is based on the principle that benefits received are proportional to use so the burden of financing should be similarly balanced. The second, related, difference is that equity invested in a cooperative will be returned at some time to patrons who contributed it. Patronage-based methods such as retained patronage refunds and per unit retails are widely used to obtain capital, both recognized in tax laws. Revolving fund and base capital plans are used to determine when and how equity should be redeemed.

Profound changes in agricultural production, marketing, and all aspects of agricultural supply chains have placed new burdens on existing cooperatives but offer opportunities as well. Such changes have called into question the adequacy of existing cooperative financing methods and related governance issues. Growing involvement in value-added activities by cooperatives is necessary if farmers are to capture the benefits of participating in downstream portions of the supply chain. Cooperatives are abandoning mere commodity sales in favor of value-adding endeavors and pro-active participation in markets.

With this activity comes new requirements for capital. Farmers have responded to the combination of challenges and opportunities by designing cooperatives that have particularly beneficial attributes. One example has been the rapid growth of “new generation cooperatives.” In new generation cooperatives, plant capacity guides the amount of commodity to be supplied by farmer members and farmers are required to commit such delivery. The total capital requirements is determined and related to the amount of product required, with each farmer required to contribute the amount of capital associated with the amount of product delivered. This application of the traditional base capital plan may also include tradeable equity and the opportunity to capture increased cooperative value at the equity’s disposition.

Some capital requirements are or are thought to be beyond the capacity of farmer members to supply in their position as cooperative patrons. In response, cooperatives may consider “outside” capital obtained from investors who have no patronage or other relationship with the cooperative. This may range from preferred stock with no rights to vote on the one hand to actual non-patronage membership and representation on the board of directors on the other. Changes in cooperative governance principles follow.

It is this latter change that has brought about statutory changes. Several States have adopted new “cooperative” statutes that authorize substantial investment by non-farmers, participation in control by voting and election of board of director members, and distribution of benefits according to investment rather than in relation to use. A commission involved in recommending uniform State statutes is considering such a statute to be recommended to all States.
Concerns with the new definitions of cooperative have several bases. Sharing cooperative control may sooner or later undermine the strengths of cooperatives as sole representatives of farmers interests. Conflicts in motivations and objectives between those who wish to benefit from use and those who wish to benefit from returns on investment will make good governance difficult if not impossible. Concerns also exist with the restrictions on true cooperative operations brought about by such major changes. Others believe that well-designed and well-run cooperatives can achieve their goals by other means that do not require fundamental changes in the definitions of cooperatives.

At present, information and analysis is inadequate to assess the implications fully. At the same time, expressions of objections are viewed as obstructionist and non-responsive to the dramatically changing environments in which farmers and their cooperatives exist.

As suggested by this *Paper*, a pro-active approach by a critical number of individuals and institutions, including USDA, is needed to (1) make assessments of implications of the changes on many levels and (2) provide leadership and guidance for cooperatives given results of the assessment. The objective of the thought process is to be sure that cooperatives can be used to their greatest advantage and avoid pitfalls that will be detrimental to farmer members and rural communities in which cooperatives operate.
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Baarda, Current Cooperative Issues, April, 2006

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Many in the cooperative business community are uncertain about the benefit of new statutes allowing non-patron investors to claim governance and financial rights in a cooperative. The cooperative business model is intended to provide goods or services at an affordable rate and maintain the core principle of democratic control. We are concerned that undue manipulation of the cooperative business structure will jeopardize the interests of the members that a cooperative is intended to serve.

– Letter from six major national cooperative associations to the National Conference of Commissioners on Uniform State Laws, June 7, 2005.1

I. Introduction

The above statement is one of several examples of current debates over fundamental cooperative issues and public policy toward cooperatives. Cooperative Programs2 has contributed substantially over many years to a broad and deep understanding of farmer cooperatives by (1) determining the practices that bring success that results in benefits to farmer cooperatives, and by (2) generating critical information needed to address contemporary issues. The two issues emphasized in the letter – cooperative governance and cooperative finance – have

1 The Commission’s role is to recommend new laws that may be considered by the States with the hope that States would enact similar or identical versions to promote uniformity. The Commission recently expanded its cooperative project from farmer cooperatives to all types of cooperatives. The Commission’s work is described further at Section VIII below.

The letter containing the above statement was signed by Daniel A Mica, President & CEO, Credit Union National Association; Fred R. Becker, Jr., President & CEO, National Association of Federal Credit Unions; Douglas Klein, Executive Director, National Association of Housing Cooperatives; Paul Hazen, President & CEO, National Cooperative Business Association; Glenn English, CEO, National Rural Electric Cooperative Association; and Michael E. Brunner, CEO, National Telecommunications Cooperative Association.

been and continue to be the subject of intensive study by Cooperative Programs. Interest in these
two subjects has intensified in recent years. USDA officials have accordingly identified
innovative cooperative finance and cooperative governance as key to continued effectiveness of
adaptive cooperatives in the U.S.

This Paper outlines major issues being addressed by cooperatives as these issues affect
Cooperative Programs’ assistance, research, and outreach functions under the Cooperative
Marketing Act of 1926, the Act guiding Cooperative Programs’ mandates and focus. Discussion
is limited primarily to governance and finance issues and is further limited to farmer
cooperatives.³

The Paper is organized as follows:

The basic characteristics of a cooperative as a business are described as part of the
process of defining what a cooperative is and the characteristics that distinguish a cooperative
from other forms of business enterprise. (Section II). Selected cooperative principles are
identified. Section III describes current methods of cooperative governance including voting
methods, requirements for directors, and the make-up of boards of directors. Current methods of
financing cooperatives are described (Section IV) though by necessity the description is general
and does account for the vast range of methods designed to address special situations. (For
example, “new generation cooperatives” are discussed subsequently in a separate section.)

Major changes in all of the environments in which farmers and cooperatives operate
create challenges as well as opportunities for the cooperative form of business. Pressures and
changes cannot be understood without recognizing the reasons for the pressures and changes.
Section V summarizes changes and challenges to cooperatives relevant to the issues at hand.
Views of cooperatives, including perceptions of limitations, of criticisms and opportunities are
included in Section V. Key topics include capital adequacy, liquidity issues, and difficulties
capturing the value of a cooperative.

Farmers who wish to coordinate their supply, farming, and marketing activities, as well as
cooperatives through whom farmers participate in the supply chain have developed many
innovative business structures and strategies. A number of these have been created to meet the
challenges for which major changes in the characteristics of cooperatives are being suggested.
Section VI is a brief discussion of organizational, structural, and operational responses.
Responses include forming “new generation cooperatives”, restructuring finance, expanding use

³ This is not to suggest that other issues are unimportant nor that Cooperative Programs
does not or cannot continue to engage in a broad spectrum of research on other issues, provide
technical and development assistance, promote cooperative education, or collect and analyze
important data.
of limited liability companies, and creative use of joint ventures, subsidiaries, and strategic alliances used to strengthen farmers’ participation in agricultural supply and marketing.

Attempts are being made by some to change State laws to provide for governance and financing methods not generally used and accepted in cooperatives. These efforts have raised the level of discussion considerably and involve a broad spectrum of cooperative interests. Section VII describes newly enacted cooperative incorporation statutes or major changes in existing statutes in a few states that have resulted in a reassessment of cooperative basics. The following section (Section VIII) describes considerations of a proposed statute that will eventually be recommended to States for adoption as a uniform statute.

Some changes being promoted for cooperative structure and operation are significant for application of other laws pertaining to cooperatives as well. These include taxation, antitrust, securities laws, and other forms of businesses. Possible impacts on other laws and their underlying public policies are discussed in Section IX.

Every response to new environments is not necessarily fully compatible with the cooperative character as currently and generally accepted. Major changes in financing and governance have caused considerable concern with the definition of a cooperative and, more importantly, the position of farmer members when outside investment and control is allowed to become integrated into the cooperative. Concerns, issues and controversies are identified and discussed in Section X. Brief concluding remarks are offered in Section XI.
II. Cooperative Characteristics

Much of the discussion and controversy engendered by several rather drastic changes being touted for cooperatives in the areas of governance and finance grows from the unique character of cooperative businesses in the U.S. economic, business, and legal systems. A background identifying definitions of cooperatives sets the stage for a discussion of the major issues and, indeed, on the significance of the cooperative business form for the future of agriculture and rural communities.

Many definitions of cooperation have been formulated in the substantial history of cooperatives in this country and others. Some are all-inclusive; others emphasize particular aspects of cooperation, such as economic, social, or legal characteristics.

A. General Definitions

Selected representative definitions will help clarify the nature and objectives of farmer cooperatives as they have developed over many years in this country, the focus here being primarily on farmer cooperatives.


An agricultural cooperative is a business organization, usually incorporated, owned and controlled by member agricultural producers, which operates for the mutual benefit of its members or stockholders, as producers or patrons on a cost basis.

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Material on this subject is adapted from a syllabus prepared by James R. Baarda for a one-credit course entitled “The Law of Farmer Cooperatives” given at the LLM program in Agricultural Law at the University of Arkansas School of Law. Various other parts of the Paper are adapted from that material as well. See also Baarda, James R., *Cooperative Principles and Statutes: Legal Descriptions of Unique Enterprises*, U.S.D.A., Agric. Coop. Service, Research Rept. No. 54 (March, 1986).

Cooperatives as business forms developed in the late 18th century in England and France as a reaction to and substitute for actual and perceived hardships and disruptions brought with the industrial revolution and consequent “factorization” of labor. The modern corporate form was not then well defined. In the United States, cooperative and corporate business forms grew concurrently with the major strides toward modern manifestations of both that were occurring from the end of the Civil War to the 1880s. Philosophical underpinnings, at least summary definitions of cooperatives as business forms, are traced primarily to the Rochdale Pioneers in England who listed principles of operation in 1844.
basis after allowing for the expenses of the operation and maintenance and any other authorized deductions for expansion and necessary reserves.


A cooperative enterprise is one which belongs to the people who use its services, the control of which rests with all the members, and the gains of which are distributed to the members in proportion to the use they make of its services.


Cooperation is organized working together for mutual benefits. Economic cooperation is a form of business with democratic ownership and control by member patrons having common needs, serving themselves on a nonprofit basis, and receiving benefits proportional to participation.


A cooperative can be defined for practical purposes as a democratic association of persons organized to furnish themselves an economic service under a plan that eliminates entrepreneur profit and that provides for substantial equality in ownership and control.

*Schaars, Cooperative Principles and Practices*, University of Wisconsin Extension (1973)⁶:

...A cooperative is a business voluntarily owned and controlled by its member-patrons and operated for them and by them on a nonprofit or cost basis.


---

A cooperative is a voluntary contractual organization of persons having a mutual ownership interest in providing themselves a needed service(s) on a nonprofit basis. It is usually organized as a legal entity to accomplish an economic objective through joint participation of its members. In a cooperative, the investment and operational risks, benefits gained, or losses incurred are shared equitably by its members in proportion to their use of the cooperative's services. A cooperative is democratically controlled by its members on the basis of their status as member-users and not as investors in the capital structure of the cooperative.

Definitions vary, naturally, according to backgrounds and viewpoints of those making them. They do, however, present a general idea of what a cooperative is and how such organizations are set up and operate.

**B. Development of Cooperative Principles**

Cooperatives can best be described as business enterprises operated according to certain principles distinguishing them from other forms of business enterprise. This section describes sets of principles developed over a period of years that are still of interest and importance in assessing the "cooperative character" of a business entity.

1. **Corporate Principles**

Corporations, of which most cooperatives are a subset, operate according to principles that have, as cooperative principles, developed over a period of time. Corporate principles are sometimes listed as are cooperative principles, although not with the focus and attention devoted

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8 Partnerships and noncooperative corporations in particular. Some writers on cooperative issues have begun to use the term "investor oriented firm," or "IOF," to refer to corporations that are not cooperative in function. The more descriptive term "non-cooperative corporation" is used in this discussion paper.
to cooperative principles. While formulations differ widely, a list of seven characteristic
describes most corporations.

1. Shareholders are not personally liable for the obligations of the corporation other
than to the extent they can lose the value of the equity owned. The implications of
limited liability in the financing context for cooperatives is noted below.

2. The corporate entity has perpetual existence that does not depend on changes in
the makeup of its shareholders.

3. Corporations have centralized management implemented through the authority
and actions of the board of directors.

4. Shares of stock or other interests in the corporation are generally freely
transferable. This applies to publically held corporation but less so to close
corporations. Close corporations restrict ownership and transferability for a
number of reasons primarily through contractual agreements.

5. The corporate business has access to debt and equity capital in a great variety of
forms and in many markets. This capability to garner financing from many
sources is one of the main advantages of the corporate business form and accounts
for the growth of corporations, particularly in the latter part of the 19th century as
business enterprise size and financial needs outstripped the capacity of
individuals, families, or small consortia to provide adequate financial resources.

6. The corporate entity has most of the legal rights of an individual. It acts as a
single unit to hold property, to contract, and to resort to the legal system to
enforce its rights.

9 Corporate characteristics are important for a number of reasons such as Federal income
taxation, limited liability, or financing purposes, among many others. This leads to specialized
formulations that depend on the purpose for which principles are being used. This note on
corporate principles is from James R. Baarda, *Current Law & Economics Debates: Tools for
Assessing Fundamental Cooperative Changes?*, paper presented at the NCR-194 Conference,
Kansas City, Missouri (October 28, 2003).


11 Cooperatives may have some of the characteristics of close corporations such as limited
transferability. Implications of this are being studied elsewhere.
7. Many of the relationships among stakeholders are standardized by operation of corporate statutes giving stability and predictability to corporations, stakeholders, and those dealing with corporations. This standardization includes institutional stockholder and creditor protections.

As in the case of cooperative principles, several formulations of corporate characteristics are offered as summary descriptions of the corporate entity. For example, a list of four may include:

1. A corporation is a separate entity with perpetual existence. It exists apart from those who provide risk capital or who manage its business.
2. Liability for corporate debts is limited to the assets the corporation owns and does not extend to owners’ assets.
3. The power to manage the corporation’s business is centralized by delegation to the board of directors.
4. Stockholders can transfer their ownership interests to others without terminating the corporation’s existence.

Given these few fundamental principles, an enormous variety of organizational characteristics can fit within the corporate fold. The importance of each principle is largely dependent on the circumstances that bring the principle into question.

2. Cooperative Principles

Cooperative principles are an overlay on corporate principles, with some corporate principles being directly applicable but with others modified or eliminated by cooperative principles. Contemporary formulations of cooperative principles vary, but do not differ fundamentally from traditional principles.

The first set of rules commonly identified as cooperative principles was a combination of true cooperative principles and business practices thought desirable in a well-run cooperative. Developed by a consumers' cooperative of flannel weavers in England in 1844, these rules, now

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outdated in many respects, are still considered first expressions of modern cooperative principles. This group of weavers is commonly referred to as the "Rochdale Pioneers."

The principles developed by the Rochdale pioneers, or formulated by others in following years to describe how the Rochdale pioneers wanted their Society to work, were:

1. The store is open to all.
2. The store charges ordinary market prices.
3. The store receives only ready money and gives no credit.
4. The store gives dividends in proportion to purchases.
5. Every member must have a share or shares and receive good interest on them.
6. All are equal in voting power, whether they have few or many shares.
7. The store sells genuine articles that are what they profess to be.
8. The store has an honest manager and active committee (board of directors).
9. The Society insists on an efficient and intelligent audit and stocktaking.

In the United States, the Patrons of Husbandry (the "Grange") developed a statement of cooperative principles in 1876 in response to widespread misunderstanding about what cooperatives were and what they could and could not do for farmers, and frequent failures of newly formed cooperatives. Grange principles described the way most cooperatives in the United States now operate, although some original Grange principles, too, have been discarded by most cooperatives.

The 1876 Grange principles were:

1. One member, one vote.
2. Limitation of interest on invested capital.
3. Payment of dividends on patronage.

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5. "Neither fear nor court competition."  

The most recent statement of general cooperative principles on a broad-based scale was developed by the International Cooperative Alliance (ICA). ICA’s original statement of principles was developed in 1937 and restated in 1966. The principles stated in 1966 were:

1. Open membership.
2. Democratic control.
3. Distribution of surplus to the members in proportion to their transactions.
4. Limited interest on capital.
5. Political and religious neutrality.
6. Cash trading.
7. Promotion of education.

The International Cooperative Alliance, in connection with the 150th year celebration of the Rochdale Pioneers, devised a new set of cooperative principles. The statement of the ICA was adopted in Manchester (UK) September 23, 1995, following.  

DEFINITION

A cooperative is an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise.

VALUES

Cooperatives are based on the values of self-help, self-responsibility, democracy, equality, equity, and solidarity. In the tradition of their founders, cooperative members believe in the ethical values of honesty, openness, social responsibility, and caring for others.

PRINCIPLES

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16 Scroggs, Claud, "Cooperative Principles--and How They Grew," in Cooperatives--Keystone of Agriculture, 1980-1981, American Institute of Cooperation, Washington, D.C. (1981). Many arguments and much motivation associated with early cooperation related to farmers' poor competitive position with respect to buyers, middlemen, bankers, landowners, etc. Such arguments have been couched in somewhat more neutral "economic" terms but are still of fundamental importance. They are also still part of the "cooperative movement" theme, especially in some sectors outside of agriculture.

17 http://www.coop.org
The cooperative principles are guidelines by which cooperatives put their values into practice.

1st PRINCIPLE: VOLUNTARY AND OPEN MEMBERSHIP

Cooperatives are voluntary organizations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political, or religious discrimination.

2nd PRINCIPLE: DEMOCRATIC MEMBER CONTROL

Cooperatives are democratic organizations controlled by their members, who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership. In primary cooperatives members have equal voting rights (one member, one vote) and cooperatives at other levels are organized in a democratic manner.

3rd PRINCIPLE: MEMBER ECONOMIC PARTICIPATION

Members contribute equitably to, and democratically control, the capital of their cooperative. At least part of that capital is usually the common property of the cooperative. They usually receive limited compensation, if any, on capital subscribed as a condition of membership. Members allocate surpluses for any or all of the following purposes: developing the cooperative, possibly by setting up reserves, part of which at least would be indivisible; benefitting members in proportion to their transactions with the cooperative; and supporting other activities approved by the membership.

4th PRINCIPLE: AUTONOMY AND INDEPENDENCE

Cooperatives are autonomous, self-help organizations controlled by their members. If they enter into agreements with other organizations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain their cooperative autonomy.

5th PRINCIPLE: EDUCATION, TRAINING AND INFORMATION

Cooperatives provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of their cooperatives.
They inform the general public -- particularly young people and opinion leaders -- about the nature and benefits of cooperation.

6th PRINCIPLE: CO-OPERATION AMONG CO-OPERATIVES

Cooperatives serve their members most effectively and strengthen the cooperative movement by working together through local, national, regional, and international structures.

7th PRINCIPLE: CONCERN FOR COMMUNITY

While focusing on member needs, cooperatives work for the sustainable development of their communities through policies accepted by their members.

In 1965, the U.S. Department of Agriculture studied criteria commonly used to describe characteristics of a business enterprise unique to cooperatives. The criteria listed in Cooperative Criteria give a concise description of cooperative business enterprise operation.

The criteria listed in the U.S.D.A. publication are:

1. The basis purpose of a cooperative is to render economic benefits to its members.
2. Cooperatives are organized around the mutual interests of members.
3. Cooperatives are essentially nonprofit enterprises in the sense that they are not organized to make monetary gains for cooperatives as legal entities or for their members as investors, but primarily for all patrons as users of their services.
4. Cooperatives are democratically controlled.
5. Risks, costs, and benefits are shared equitably among members.
6. Members have an obligation to patronize their association.
7. Cooperatives do business primarily with members.

Contemporary formulations of cooperative principles vary, but do not differ fundamentally from traditional principles. Combining summary statement of principles with the descriptive formulation of Agricultural Cooperative Service gives four principles for modern farmer cooperatives:

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1. Cooperatives are owned and democratically controlled by those who use their services.
2. Net margins are distributed to users in proportion to their use of the cooperative.
3. Returns on investment are limited.
4. Cooperatives are financed substantially by those who use their services.

The first three principles are "traditional" and considered of prime importance by most writers as fundamental principles of a truly cooperative business enterprise. An organization operating according to the three principles will be cooperative in nature, but an organization deviating from one or more principles will not necessarily be a cooperative. The three principles are common factors in statement of principles, whether the lists are condensed to only three or expanded to several. The fourth principle is a restatement of the ownership feature of the first principle. It is stated separately because of current interest in member-financing techniques, particularly the equity redemption process unique to cooperative enterprises financed on an as-needed basis by owner-users.

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C. Contemporary Principles

The most definitive set of principles was developed in 1987 by USDA. Modern principles are:

1. The User-Owner Principle: Those who own and finance the cooperative are those who use the cooperative.

2. The User-Control Principle: Those who control the cooperative are those who use the cooperative.

3. The User-Benefits Principle: The cooperative's sole purpose is to provide and distribute benefits to its users on the basis of their use.

A summary definition of a cooperative enterprise incorporates all essential principles. As defined in the 1967 USDA publication *Cooperative Criteria*:

A cooperative is a voluntary contractual organization of persons having a mutual ownership interest in providing themselves needed service(s) on a nonprofit basis. It is usually organized as a legal entity to accomplish an economic objective through joint participation of its members. In a cooperative the investment and operational risks, benefits gained, or losses incurred are shared equitably by its members in proportion to their use of the cooperative's services. A cooperative is democratically controlled by its members on the basis of their status as member-users and not as investors in the capital structure of the cooperative.

Comparison of corporate principles and cooperative principles leads to several observations. For the most part, cooperatives have all of the essential characteristics of a corporation, the exceptions being unincorporated cooperatives or cooperative organizations using a limited liability company (LLC) legal form. Thus, the first five Cox formulation corporate principles are the same for cooperatives as for cooperatives. Two distinctions remain. The first

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is that cooperative corporations do not share corporate principles six and seven – corporations have a broad range of capital sources available to them and interests in the corporation are freely transferable. Neither of these differences is total, however. Cooperative corporations can, in fact, draw upon a wide range of capital sources in that they can borrow capital from a multitude of sources and can obtain equity capital from a broad range of individuals and businesses, their member-patrons. Sources of equity capital are not as extensive as those available to non-cooperative corporations, but cooperative corporations can access capital from multiple sources outside the firm and use it as a single entity, the same characteristic that defines a critical feature of the modern corporation. The pool of equity for cooperatives is simply more limited. This limitation is the impetus for the call for more outside equity.

Transferability carries a somewhat clearer distinction between a cooperative and a non-cooperative corporation because equity capital in a cooperative is limited to those who have an additional relationship with the cooperative. To maintain this requirement, cooperative membership is typically not transferable, although this is not an unvarying rule. In any case, the transferee must meet cooperative requirements such as a patronage relationship with the cooperative that collects multiple interests in the stakeholder transferee. To the extent that the free transferability of equity in a non-cooperative corporation emphasizes the continued existence of the corporate body regardless of the precise identity of equity holders, cooperatives, too, carry this key corporate feature of ownership transferability.
A closer focus on cooperative principles indicates that little direct conflict exists between non-cooperative corporate principles and cooperative principles. Some of the essential organizational and operational characteristics defined in cooperative principles are simply not addressed in corporate principles as generally summarized. The user concept, for example, so essential to cooperative definition, does not appear in corporate principles. Users have no relationships to the corporate entity that require special recognition in general principles. A second group of relationships, those relating to control, are found in the centralized management corporate principle, but the actual specification of control through voting power, for example, comes only in more detailed organizational descriptions by statute and corporate documents.

Corporate principles, at least as summarized above, differ most from cooperative principles, also as summarized above, in the subject covered by the user-benefits principle. Nowhere in the corporate principles is the objective of the corporation specified, unlike the objective description in cooperative principles. By nearly universal practice, corporate benefits inure to the sole benefit of equity owners in proportion to their ownership. This is a clear and total distinction from the benefits distribution defined in cooperative principles.

**D. Principles and Practices in Operation**

Each cooperative association has its own operating method. Patentation refund mechanics depend upon specific circumstances. Though generalization is difficult, three questions focus on how cooperative principles are implemented. First, what is the net margin available for distribution or retention by the cooperative? Second, to whom is the margin distributed? Third, how are eligible margins apportioned among eligible recipients? These questions are frequently not answered directly by statutes describing how a cooperative operates.

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27 The patronage relationship, including patronage-based financing, is integrally tied to Federal income taxation rules and definitions. Patronage refunds (“patronage dividends” in the tax Code) for which “single tax” treatment is afforded to “any corporation operating on a cooperative basis” are defined clearly and succinctly in the Internal Revenue Code. The term "patronage dividend" is defined in I.R.C. §1388(a) (26 U.S.C. §.1388(a));

Definitions; special rules
(a) Patronage dividend

For purposes of this subchapter, the term "patronage dividend" means an amount paid to a patron by an organization to which part I of this subchapter applies--
It is helpful to organize the patronage refund process into several steps somewhat more closely resembling statutory approaches to the net margins distribution process.

Generation and disposition of net margins by a cooperative using the patronage refund method to return benefits to patrons can be divided into four steps, each of which may be described by statute.

1. Net margins available for distribution to patrons are determined in two stages. The total excess of income over expenses (including advances to patrons for product delivered) is first found, then the portion determined to be patronage related income available for distribution may be separated for special treatment. Subtractions from net margins may be permitted or required, reducing amounts available for distribution to patrons in proportion to business done with the association. For example, common permission to distribute some net margin in proportion to equity ownership (dividends on capital stock, for example) rather than patronage is usually described by statute in the net margin calculation description. Other required uses or reserve establishment may be contained in statutes.

2. Not all cooperative users may be eligible to receive part of the net margins as patronage refunds. A typical example is a cooperative dealing with nonmembers on a non-patronage basis, returning no net margins to nonmember patrons. After disqualifying this group of users, the cooperative has a determined amount of funds to distribute to a defined group of patrons.

3. The proportion of net margins distributed to each patron depends on two factors. The cooperative must decide how operating results (margins or losses) will be segregated or combined if the cooperative has multiple operations serving separate groups of farmers and the operations have different margins or losses. Secondly, the proportion of each patron's business with the cooperative is determined, and each patron's portion of eligible refunds is determined. Step three thus determines allocation of margins to eligible recipients.

(1) on the basis of quantity or value of business done with or for such patron,
(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and
(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.
4. The final step in the refund process is distribution. Form of distribution (cash or notices evidencing retention of refund amounts as contributions to capital) does not affect implementation of the cooperative distribution principle.

Patronage refunds may be described by statutes under which cooperatives are incorporated. One of the most detailed descriptions is found in the Wisconsin statute.28

**Wisconsin Provisions on Earnings Distribution**

**Section 185.45. Apportionment and distribution of proceeds**

At least once annually the directors shall determine and distribute net proceeds as follows:

1. There shall be deducted from total proceeds:
   a. All operating expenses and costs.
   b. The cost of supplies, commodities, equipment and other property or services procured or sold for patrons.
   c. The cost of services performed for patrons.
   d. All taxes and all other expenses.
   e. Reasonable and necessary reserves for depreciation, depletion and obsolescence of physical property, doubtful accounts and other valuation reserves, all of which shall be established in accordance with usual and customary accounting practices.

2. The remainder of the total proceeds are net proceeds and shall be distributed and paid as follows:
   a. An amount not to exceed 5 percent thereof may be set aside as an educational fund to be used in teaching or promoting cooperative organization or principles.

28 It is ironic indeed that Wisconsin is currently considering major changes to the cooperative law that would negate the key principles of the user-benefits principle in cooperatives. See Section VII for discussion.
Such funds shall for all purposes except the computation of net proceeds be deemed an expense of operation of the cooperatives.

b. A share of the net proceeds may be set aside for or paid to officers or employees, or both. Such amount shall for all purposes except the computation of net proceeds be deemed an expense of operation of the cooperative.

c. In a cooperative organized with capital stock such dividend may be paid upon capital stock as is authorized by the articles. No dividend may be paid if the capital is impaired or if payment of such dividend would result in an impairment of capital.

3. Unless the articles or bylaws otherwise expressly provide, none of the remainder of the net proceeds shall constitute income of the cooperative but all thereof shall be distributed and paid to patrons, whether members or not, as follows:

a. Reasonable reserves for necessary purposes may be created, which shall be credited to patrons in accordance with the ratio which their patronage bears to total patronage.

b. All the remainder of the net proceeds shall be distributed and paid to patrons in accordance with the ratio which their patronage bears to total patronage.

c. There shall be no distinction between the persons entitled thereto, but such reserves and distributions may be based upon business done with particular departments or in particular commodities, supplies or services, or upon classification of business according to the type or nature thereof.

4. If the articles or bylaws so provide:

a. Any of the net proceeds may be credited to allocated or unallocated surplus or reserves of the cooperative.

b. None of the remainder shall constitute income to the
cooperative, but all thereof shall be distributed and paid in accordance with the ratio which individual patronage bears to total patronage, either to member patrons only, or to all patrons with nonmembers receiving a lower proportion than members, as the bylaws may provide. There shall be no other distinction between members and nonmembers, but distribution may be based on business done with particular departments, or in particular commodities, supplies or services, or upon classification of business according to type or nature thereof.

5. The distribution and payment of net proceeds under sub. (3) or (4) may be in cash, credits, stock, certificates of interest, revolving fund certificates, letters of advice, or other certificates or securities of the cooperative or of other associations or corporations, in other property, or in any combination thereof.

6. All or any part of the net proceeds may be applied to losses incurred in prior years, and the bylaws may also include any reasonable provisions for the apportionment of losses.

A sample bylaw provision on patronage refunds follows:

**Operation at Cost.** The association shall at all times be operated on a cooperative service-at-cost basis for the mutual benefit of its member patrons.

**Margin Allocation.** In order to induce patronage and to assure that this association will operate on a service-at-cost basis in all its transactions with its members, the association is obligated to account on a patronage basis to all member patrons on an annual basis for all amounts received from business conducted with members on a patronage basis, over and above the cost of providing such services, making reasonable additions to reserves, and redeeming capital credits. Such allocation shall be on the basis of the volume (or dollar value) of product marketed through (and/or purchased from) the association.

The association is hereby obligated to pay all such amounts to the patrons in cash or by credits to a capital account of each member patron.

This brief discussion does not capture the immense variation in how cooperatives operate to ensure that benefits are generated for patrons and are allocated on the basis of use. It merely suggests that all events within the cooperative are focused on the cooperative’s patrons.
III. Cooperative Governance Descriptions

Several concerns about cooperative governance are currently being discussed among cooperatives and those who study cooperatives. These include the quality and training of cooperative directors, the various techniques used to identify and select directors, and perceived defects in the way cooperatives are governed that lead to a decision-making process that is too slow to respond to rapidly-changing conditions. Another subject of interest is directors who are neither members nor patrons of the cooperative. These individuals can either represent the “public interest” as permitted in some cooperative incorporate statutes or who bring expertise to the board of directors. Some of these are perennial issues represented in cooperatives and educational programs since the beginnings of organized cooperatives.

Considerable effort studying effective cooperative governance is undertaken on a continued basis. For the most part, cooperatives have found ways to achieve directorship and management capabilities comparable to and often exceeding those found in non-cooperative business firms. Indeed, some cooperative governance practices described as ineffective means to govern a business have been inserted into evolving principles of business governance generally.

29 It should be emphasized that “outside” directors who represent investments are very different from “outside” directors representing the public’s interest or who bring only expertise to the board but represent exclusively farmer members’ interests.

30 As only one current example, Professor Jennifer Keeling (now Bond) at Colorado State University (formerly University of California at Davis) has been engaged in research relating selected characteristics of cooperative governance practices to financial strength and performance. Examples are: Keeling, Jennifer, An Empirical Investigation into Performance and Governance Linkages in Agricultural Cooperatives, paper presented at AAEA Annual Conference, Providence, Rhode Island (July 26, 2005); and Bond, Jennifer, Cooperative Financial Performance and Board of Director Characteristics, paper to be presented at NCERA-194 conference, Minneapolis, Minnesota (November 9, 2005). Similarly, the cooperative regulatory body of Nova Scotia collects data on cooperative governance in an effort to predict cooperative performance and identify troubled cooperatives.
The Paper focuses on governance issues associated with new capitalization methods. In particular, new laws and other organizational structures may allow investment in the cooperative by those who do not use the cooperative, the so-called “outside” investment. The governance issue is couched in terms of cooperative “control.” What is the impact on farmers of this partial investment and partial control by non-farmers whose interest in the cooperative is primarily or exclusively to receive return on invested capital?

Principles and methods of cooperative “control” are based on the User-Owner Principle: Those who own and finance the cooperative are those who use the cooperative. This principle is a critical modification of the general corporate principle that the corporate entity is controlled by those who own it. It is an modification only in the sense that the primary focus is on the control-use relationship. However, it is not a modification in the sense that those who use the cooperative also own it. One distinct difference is voting power – in a cooperative voting power is typically democratic with a one member, one vote rule whereas in a non-cooperative corporate entity voting power is usually assigned on the bases of stock ownership.

As an introduction to the cooperative principle and the manner in which members control their cooperatives, current methods of governance are summarized.

A. Common Governance Structure and Methods

The User-Control principle of cooperatives is expressed generally in two requirements in a farmer cooperative. The first is a requirement that only those who will use the cooperative may be members entitled to the right to vote in the cooperative’s affairs. The second is the method by which directors are chosen and qualified to be a director.

1. Membership Qualification

The following typical statutory provision specifies membership requirement:31

(a) Under the terms and conditions prescribed in the bylaws adopted by it, an association may admit as members, or issue common stock to, persons only engaged in the production of the agricultural products to be handled by or through

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31 For more details see Baarda, James R., *Cooperative Principles and Statutes: Legal Descriptions of Unique Enterprises*, U.S.D.A., Agric. Cooper. Service, Research Rept. No. 54 (March, 1986); and Baarda, James R. *State Incorporation Statutes for Farmer Cooperatives*. U.S. Dept. of Agriculture, Agricultural Cooperative Service, Cooperative Information Report No. 30 (October 1982). Many statutes have been changed to some degree in the 20 years since the publication of these reports. The exact numbers given in this Paper may have changed as well. This caveat applies for all subsequent references to these two publications.
Examples of bylaw and articles of incorporation provisions may be found in Frederick, 32 Donald A. Sample Legal Documents for Cooperatives. U.S. Dept. of Agriculture, Agricultural Cooperative Service, Cooperative Information Report No. 40 (May 1990). Most of the examples in this Paper are drawn from that publication.

the association, including the lessees and tenants of land used for the production of such products and any lessors and landlords who receive as rent all or part of the crop raised on the leased premises.

(b) If a member of a non-stock association be other than a natural person, such member may be represented by any individual, associate, officer or manager or member thereof, duly authorized in writing.

(c) One association organized hereunder may become a member or stockholder of any other association or associations organized hereunder.

Bylaw provisions, a sample of which follows, tailor membership requirements to each cooperative. 32

Qualifications. Any person, firm, partnership, corporation or association, including both landlord and tenant in share tenancies, who is a bona fide producer of agricultural products in the territory in which the association is engaged in business, and who agrees to be a patron of the association, signs a marketing agreement with the association, purchases one share of common stock, and meets such other conditions as may be prescribed by the board of directors, may become a member of the association.

All applications for membership must be approved by the board of directors. Member status is effective as of the time the board approves the application for membership.

Membership qualification and restrictions on transfer of membership are typically couched in terms of the common stock carrying membership rights. A sample provision in articles of incorporation states:

In the event the board of directors of the association shall find, following a hearing, that any of the common stock of this association has come into the hands of any person who is not eligible for membership, or that the holder thereof has ceased to be an eligible member, such holder shall have no rights or privileges on account of such stock, or vote or voice in the management or affairs of the association other than the right to participate in accordance with law in case of dissolution. The association shall repurchase such stock for par value. If such

32 Examples of bylaw and articles of incorporation provisions may be found in Frederick, Donald A. Sample Legal Documents for Cooperatives. U.S. Dept. of Agriculture, Agricultural Cooperative Service, Cooperative Information Report No. 40 (May 1990). Most of the examples in this Paper are drawn from that publication.
holder fails to deliver any certificate evidencing the stock, the association may cancel such certificate on its books and records, and the certificate is thereby null and void.

The common stock of this association may be transferred only with the consent of the board of directors of the association and on the books of the association, and then only to persons eligible to hold it. No purported assignment or transfer of common stock shall pass to any person not eligible to hold it, nor the rights or privileges on account of such stock, nor a vote or voice in the management of the affairs of the association.

The objectives and consequences of restricted membership provisions are that “membership” is limited to those who stand in the relationship of user, owner, and use-based beneficiary to the cooperative. Members have the right to control their own cooperative. Therefore the cooperative’s array of control mechanisms is oriented solely to members.

2. Directors

Selection of directors is one of the most significant of members’ duties. The relationship between use and control is implemented by two general provisions. The first is director eligibility, the second is the method of choice.

Generally, directors in a cooperative must be members of the cooperative. In a farmer cooperative this means, of course, that directors are farmers. Exceptions exist. It is not uncommon for cooperative incorporation statutes to allow a director to be selected to represent primarily the interests of the “public.” Other exceptions may exist as well. Some cooperatives and those studying governance have advocated a limited number of directors who bring expertise not necessarily possessed by farmer directors. The most commonly mentioned are financial expertise and marketing knowledge in cooperatives that participate in complicated and sophisticated product market systems.

In an exception to the producer-director requirement, many statutes permit the cooperative to select an "outside" director. A typical statement says:

The by-laws may provide that one or more directors may be appointed by any public official or commissioner by the other directors selected by the members or their delegates. Such directors shall represent primarily the interest of the general public in such associations. The director or directors so appointed need not be members or stockholders of the association; but shall have the same powers and rights as other directors. Such directors shall not number more than one-fifth of the entire number of directors.
One of the most common subjects of member voting is director selection. A typical statute states, “The affairs of the association shall be managed by a board of not less than five directors, elected by the members or stockholders from their own number.” A typical statute further adds:

Section 1. Number and Qualification of Directors. The association shall have a board of directors of ___( ) members. Each director elected shall be a member of this association in good standing.

No person shall be eligible to be a director if that person is in competition with, or is affiliated with any enterprise that is in competition with, the association. If a majority of the board of directors of the association finds at any time following a hearing that any director is so engaged or affiliated that person shall thereupon cease to be a director.

No director after having served for ___( ) consecutive full term(s) shall be eligible to succeed himself or herself, but after a lapse of ___( ) year(s) shall again be eligible.

3. Member Voting Power

Voting in cooperatives is typically, though not exclusively, based on a “democratic” foundation rather than one of investment. Generally, cooperative members may cast only one vote on an issue regardless of either the amount of business done with the cooperative or the amount of equity investment in the cooperative. Members’ voting power is commonly found in statutes. The usual statement is:

No member or stockholder shall be entitled to more than one vote, regardless of the number of shares of common stock owned by him.

A cooperative may use several methods of limiting voting to one per member. One method is to assign one vote regardless of the number of shares owned as in the previous statutory statement. Another method is to simply restrict ownership of common (voting) stock to one share per member. A sample articles of incorporation provisions follows:

Each member shall hold only one share of common stock and each eligible holder of common stock shall be entitled to only one vote in any meeting of the stockholders upon each matter submitted to vote at a meeting of the stockholders.

Bylaws usually reaffirm statutory voting powers and describe certain voting situations in more specificity. A sample follows:
Voting. Unless otherwise stated in the articles of incorporation, or these bylaws, or required by applicable law, all questions shall be decided by a vote of a majority of the members voting thereon.

Each member shall be entitled to only one vote. Voting by mail shall not be permitted. Proxy voting shall be allowed. Each proxy shall be in writing, and no member shall vote more than one proxy. Cumulative voting is not permitted.

If a membership is held by a partnership, corporation, or other legal entity, the member shall designate in writing the person who shall vote on behalf of the member. That designation shall remain in effect until written notice of a properly authorized change in the designated voter shall be received by the association.

Quorum. _____ (%) members or _____ percent (%) of the membership, whichever is a larger number, shall constitute a quorum at any properly called annual or special membership meeting.

The preceding bylaw sample prevents voting by mail and permits proxy voting. State cooperative incorporation statutes are split on voting by mail and voting by proxy, and bylaws must conform to the applicable rule. State incorporation statutes are also split on voting power. Although most require one vote per member, a significant number permit voting on other bases, typically with some relation to the amount of business done with the cooperative.

B. Current Research and Information Base

Cooperative Programs has had three substantial roles in cooperative governance, directly and indirectly. Cooperative Programs has analyzed, in various ways, the bases for governance by investigating voting methods and the role of the board of directors. A second focus has been to provide information and engage in activities to assist in cooperative’s governance processes through training, publications, and other information. A third role has been to investigate practices actually used by cooperatives at various stages of the governance process.

Following is a mere suggestion of the knowledge and information base existing on cooperative governance.

1. Governance Basics

As mentioned above, cooperative governance has been the subject of enormous amounts of study for as long as cooperatives have existed. The “basics” range from the essential character of cooperative user-control to the finer points of director and management performance. Studies also range from the practical to the theoretical. The point to be made is that substantial
2. Governance Improvement

A pro-active use of the considerable information on cooperative governance focuses on director training and programs for cooperative management. Most information on cooperative governance is aimed ultimately at improvement. Programs range from national programs (almost none have survived over the years), to regional programs involving two or more state activities, to director programs conducted at the state level. A listing of such programs is not possible. Much of the responsibility for director training has devolved to two groups – academic institutions particularly through extension structures, and state cooperative councils, often coordinated and presented in cooperation with universities.

One form of improvement efforts is through publications that can be used by directors and management or by advisors and trainers. Another form is through general conferences and programs attended by directors, among others, that present general information about business and markets. Such programs expand the scope of directors’ knowledge. They introduce directors to new ideas that can be adopted or modified for application to directors’ own cooperative.

Cooperative Programs has been actively involved in governance improvement for many years. Such activities range from direct participation in director training programs; development of published information on governance practices; published or presented information on director roles, responsibilities, and liabilities; and active support to other institutions such as state cooperative councils and educational institutions as they produce their own programs and materials.

3. Governance Practices

Cooperative leaders including directors, management, and advisors, find descriptions of what cooperatives actually do to govern themselves to be very useful. A subset of the kinds of


34 Both the National Council of Farmer Cooperatives (NCFC) and the National Cooperative Business Association (NCBA) are engaged in large projects to discern more about cooperative governance structure and practices. Cooperative governance is of interest to other trade associations as well. The Farm Credit Administration (FCA) has a direct interest in
information produced as described in the previous two items focuses on describing actual governance practices. The most recent examples are articles and presentations by Cooperative Programs’ Bruce Reynolds.35

4. Relevant Policy Issues

Few of the above mentioned sources focus directly on the critical governance issues addressed in this Paper – challenges to user-member cooperative control presented when new forms of equity ownership are introduced. Analysis of the broader issues of governance and control is one form of badly needed response to changes and challenges. Narrower questions include those relating to new make-up of boards of directors and to obligations that boards have to recognize the rights of investors who stand in a different position with respect to the cooperative than member-patrons. Finally, when the cooperative’s members consider new financing methods, leadership by informed directors is needed to predict the implications for the cooperative and make wise decisions.

Selected governance issues raised among cooperatives, advisors, academics, and government officials are discussed further in Section X.
IV. Cooperative Finance Descriptions

The following discussion summarizes some typical methods of cooperative financing.36 Growing needs for capital investment are noted as an introduction to the challenges facing cooperatives and the innovative methods some cooperatives are using to respond effectively.

A. Common Cooperative Financing Methods

While current methods of cooperative finance are frequently criticized in the abstract, fundamental methods of cooperative finance have been generally successful for raising capital appropriate for most types of cooperatives in numerous circumstances. Only by clearly identifying unmet needs can alternative and creative financing methods be placed in perspective and measured for their advantages and disadvantages. Several methods commonly used by cooperatives and recognized as particularly appropriate for the cooperative form of business are summarized in the following material.

1. Principles and Finance

Corporate principles of finance are modified for cooperatives in several important ways. The User-Owner Principle states, “Those who own and finance the cooperative are those who use the cooperative.” Cooperatives have established many methods to apply this principle in practice.

Two distinctions between cooperatives and non-cooperatives are clear. The first is that equity investments by members are made for the purpose of providing capital for the cooperative, the benefits of which are received through the patronage relationship. Just as a farmer receives no direct return on an investment in a tractor but rather on income received from what that tractor contributes to the farming operation, so a farmer receives no direct return on investment in a cooperative except as the cooperative contributes to the farmer’s income. Cooperative members do not seek a return on investment through dividends based on ownership of stock or a return on investment from sale of appreciated equity interests. This premise is increasingly challenged as discussed further below.

The second distinction is in the amount of investment in the cooperative relative to other investors. Generally, relative investment levels by investors in a corporate entity are governed

36 Much of this discussion is drawn from material on this subject adapted from an unpublished syllabus prepared by James R. Baarda for a one-credit course entitled “The Law of Farmer Cooperatives” given at the LLM program in Agricultural Law at the University of Arkansas School of Law.
only by an investor’s desire and ability to place money in the corporation. In a cooperative, on the other hand, investment is a burden on farmers. Because they receive returns from their investment in proportion to their use of the cooperative, logic and fairness suggest that the relative levels of investment in a cooperative should be correlated with the level of use.

Though not stated explicitly in the principle, another desirable characteristic of cooperative financing suggests that member investment should be in proportion to business conducted with the cooperative to the extent possible. This desirable relationship reflects the belief that:

1. Financial contributions are a burden upon farmer members;
2. Members can only receive benefits from the cooperative by using it to enhance their farm income;
3. A greater financing burden should be borne by those who use the cooperative more and are thus able to realize more benefits form the service their investment supports.

The financing techniques described following reflect the above two distinctions.

Every cooperative has a financing system and structure tailored to its needs and the wishes of its farmer members. Because of this, a great variety of financing methods exists. Some cooperative financing has attributes of systems used by any non-cooperative corporation, other methods are quite unique to cooperatives.

Financing methods unique to cooperatives may be classified two ways -- methods used to get capital from patrons and systems developed to determine how much capital should be contributed and returned. The method used to add capital based on the patronage relationship can, in turn, be of two types. Patronage refunds may be paid in certificates, notices, or other evidences of the patron's capital contribution rather than being paid to the patron in cash. Patronage refunds are determined by reference to cooperatives' net margins. In the alternative, per unit retain allocations are patron contributions based on an established amount per unit of product.

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37 A typical investment transaction is not between an investor and the corporation but between the buyer of the investment document and a seller. No money changes hands between investor and the corporate entity after the initial corporate offering. Any increase in value following the initial sale is not recognized by the corporation itself, only by the selling investor.
A second division relates to the system cooperatives may use to determine how much capital is required from each patron and how such capital can be returned to patrons. Two financing methods unique to cooperatives are the revolving fund financing system and the base capital financing system. These two may also be related to each other depending on the particular method a cooperative uses to implement its capital structure.

Some financing methods typical for non-cooperative corporations are found in cooperatives. Some are used in a very similar fashion but, for the most part, even those superficially similar methods have a somewhat different application in cooperatives than in non-cooperative corporations.

2. General Capital Structure

A cooperative's overall financial "structure" may look quite similar to other businesses. The balance sheet will reflect assets on the one side and current liabilities, long-term liabilities, and owners' equity on the other. The primary distinguishing feature of a cooperative's structure is the members' equity section.

Cooperatives may rely on borrowed capital if it is necessary and profitable to do so. The very high cost of borrowed capital when interest rates are high is balanced against severe limitations on what farmers are able to add to equity capital, especially in early years when the cooperative has not had time to build member patronage through special cooperative financing techniques.

i) Debt Capital

Debt capital may be divided into two general kinds with differing implications for the cooperative and its member-patrons:

1. Debt owed to financial institutions or obligations evidenced by market-based debt instruments.

2. Debt owed to members or patrons, whether free-standing obligations or debt arising from the patronage relationship.

Figure 3. General Financial Structure of a Cooperative
At first impression, debt capital is so traditional that it might be considered “neutral” in any implications for cooperatives. However, debt capital and associated debt servicing carry with them numerous specific obligations that affect not only the behavior of the cooperative but the cooperative’s business objectives. Debt cannot be systematically separated from equity because of the integrated nature of a total financing system. Debt considerations affect the totality of a cooperative’s obligations to sources of capital and cooperative objectives. Cooperative governance is affected as well, and policies may be heavily influenced by the combination of capital supplied by member producers and others.

ii) Equity Capital

Equity capital is “traditionally” contributed by member-patrons in the amounts needed by the cooperative. The contribution is often based on a system that ties the contribution to patronage, a method that has historically suited cooperative principles well under most circumstances. Changes in equity capital systems raise the most concern about new systems because of perceived incompatibility with cooperative principles. The following set of financing types summarizes a range of traditional and proposed “innovative” equity financing systems.

1. Direct investment from member-patrons;
2. Patronage-based equity plans;
   A. Equity generation
      i) Per-unit retains
      ii) Retained patronage refunds
   B. Retention and determination of equity amounts
      i) Revolving fund system
      ii) Base capital plans
      iii) Use-rights based plans
3. Patronage-based capital, conversion to permanent capital in the hands of producers;
4. Conversion of patronage-based or directly invested member-patron capital to tradeable equity;

Figure 4. Investment and Debt Distribution for Cooperatives
5. Other unusual internal capital structures that incorporate characteristics of non-cooperative financing systems;

6. Non-member, non-patron equity investment (“outside investors”) with no voting rights;

7. Non-member, non-patron equity investment (“outside investors”) with voting rights.\(^{38}\)

3. Determining Cooperative's Needs

The cooperative (with the board of directors making the decisions) must determine how much capital it needs to finance its operations. This process requires analysis:

1. The cooperative's purposes and what specific business it will conduct to achieve its purposes;

2. What equipment, facilities, and operating methods will be needed to carry out its business efficiently and successfully;

3. Financial needs to acquire and use physical and all other assets;

4. The structure used to meet the financial needs in a most cost-effective manner;

5. Sources and methods used to acquire the required capital.

The first such analysis is conducted at the cooperative's organization and results are contained in the first business plan. Thereafter the board of directors constantly monitors

\(^{38}\) This is the type of “outside” equity capital of particular interest. It is addressed in more detail below.
financial performance and the cooperative's business and, in addition, continues the planning process to reflect changing needs and cooperative growth.

4. Methods of Membership Capital Contribution

Ways farmer members can meet the financial needs of their cooperative so it can benefit them by its operations are varied. However, they can be divided into three types:

1. Members make investments in the cooperative by direct payment;

2. Members contribute as part of the patronage relationship through patronage refunds paid in equity interests rather than in cash;

3. Members contribute as part of the patronage relationship through per unit contributions.

i) Membership and Equity Ownership

Cooperatives require a membership fee from farmers who become cooperative members, usually evidenced by a share of membership stock or a membership certificate. The membership fee is not usually an amount great enough to add significantly to the cooperative's total capital. Rather, it is the means by which farmers become members and owners with rights to vote in the cooperative's affairs. However, it is usually an amount great enough to show the seriousness of the member-financing relationship between cooperative and member.

The use of stock is common among cooperatives, which are sometimes divided into "stock cooperatives" and those not using stock, called "nonstock cooperatives" or sometimes "membership cooperatives." The Stock cooperatives issue common stock to evidence "membership." The stock carries with it the right to vote in the cooperative's affairs. Two differences emphasize the characteristically cooperative use of common stock. The stock is generally nontransferable and it is typically restricted in voting power it carries so the cooperatives' control system is preserved. Common stock is not usually issued as a main source of financing.

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40 Some cooperatives issue different classes of common stock and the exact character of each class is defined by the cooperative.
Common stock\textsuperscript{41} is an evidence of ownership in a corporation that carries with it rights to participate in the benefits (and losses) of the corporation, as well as control rights. Common stock is the foundation financing method for all corporations. Many if not most corporations have no other type of directly-contributed equity capital.

Because common stock establishes the fundamental relation between the stockholders and the corporate entity, it establishes the principle features of the entity, whether a non-cooperative corporation or a cooperative. The distinctions between non-cooperative and cooperative corporations begin with common or membership stock. Analysis of the law and obligations associated with common stock provides the basis for distinguishing the rights and obligations of holders of common stock in a non-cooperative corporation and a cooperative.

The common stock/membership stock evidence of ownership is in itself a relatively simple and well-defined instrument, as is the process of purchase by stockholder members.\textsuperscript{42} However, the implications of ownership diverge sharply once the structure and operations of the entities are compared. That distinction establishes much of the foundation for defining cooperative finance and principles. For that reason, the major characteristics and distinctions are addressed separately, first for non-cooperative corporations and then for cooperatives.

ii) Corporate Common Stock

Common stock is issued by corporations pursuant to the incorporation statute and the terms of its its article of incorporation. Formal terms are relatively simple as are the processes by which common stock is issued by the corporation. Once a share of common stock is issued and sold to a stock purchaser, the corporation has little to do with subsequent transfers, markets, or dispositions of that stock.\textsuperscript{43} In most cases, absent a buy-back action or certain kinds of

\textsuperscript{41} The Revised Model Business Corporation Act (”RMCBA”) does not use the terms “common” or “preferred” stock. However, the usage is established and this \textit{Paper} will use the terms commonly understood.

\textsuperscript{42} Owners of common stock in non-cooperative corporations are typically called “stockholders” or “shareholders” while owners of common stock in cooperatives are typically called “members.” Members are stockholders (in stock cooperatives) but the additional relationship between a cooperative member and the cooperative justify the different terminology. In this \textit{Paper} traditional terminology will be preserved to the extent possible but in some contexts assiduous distinctions would be excessively clumsy and other terms will be used as appropriate.

\textsuperscript{43} Absent, of course, many ways a corporation may deal in its own stock or otherwise use its stock in reorganization or merger situations. Substantial restrictions on transfer may be imposed by a close corporation and other transfer restrictions may be found in special
restricting or mergers, common stock is as perpetual as the existence of the corporation. This is not to say that the value of stock in the hands of current owners is irrelevant to the corporation even through the organization does not receive any part of the gain on a stockholder’s profitable sale of the corporation’s stock. Indeed, as is discussed below, the corporation’s objectives are directly related to stock valuation.

Common stock possesses the characteristics of equity that would be expected of the most basic equity in the corporation. Holders of common stock have exclusive control of the corporation through the right to elect the board of directors. The indicia of ownership giving the shareholders ownership enables the shareholders to exercise control as established by the statutory specification of the board of directors and the bylaws. Voting power is on a one vote per share basis, shareholders have defined powers to remove directors, and shareholders may have statutory rights to participate directly by vote on matters affecting the corporation through fundamental transactions such as mergers and dissolution.

Stockholders have a claim on the corporation’s income after the corporation satisfies its obligations to more senior investors such as debt-holders and holders of senior equity. The owners of common stock may be considered “owners” of residual income. Whether the income is actually distributed to holders of common stock or retained as additional equity is a matter of business judgment on the part of the corporation. Whatever decision is made, the corporation’s obligations to common shareholders include assignment of residual values to common stockholders who will realize benefits of ownership by receiving dividends on their stock in proportion to the number of shares owned as well as increase in the market value of the stock. Stock valuations by markets is the most recognizable characteristic of common stock ownership. Holders of common stock also have a right to the residual assets of the corporation upon dissolution.

Several characteristics of corporate common stock distinguish it from the common stock representing membership in a cooperative. Common stock is generally not restricted to particular holders or those who have defined relations with the corporation other than the stock ownership. The corporation need not approve ownership or stock trading. Just as there is no limit on the number of votes that can be accumulated with the purchase of common stock, there is no limit on the amount or proportion of common stock owned by one shareholder. No limits are placed on the returns paid as dividends on capital stock. Returns, whether paid or retained for circumstances.

44 Implications of the dividend decision are noted below.

45 This is not necessarily true for close corporations. The close corporation characteristics of a cooperative are being investigated as a means to understand the cooperative-equity owner relationship, particularly obligations of the cooperative to such owners.
investment in the corporation, depend completely on the residual income available after all other obligations are satisfied for the accounting period.

iii) Stock Purchase and Redemption

Membership stock is normally issued after application and approval by the board of directors. Because the common stock evidences membership, its issuance and duration is also related to membership. Ownership of common stock is therefore limited to those who are eligible for membership in the cooperative. For farmer cooperatives the limitation is primarily based on status as farmer and patron of the cooperative, although cooperatives can place further restrictions on ownership of common stock. A typical statute46 states:

Under the terms and conditions prescribed in the bylaws adopted by it, an association may admit as members, or issue common stock to, persons only engaged in the production of the agricultural products to be handled by or through the association, including the lessees and tenants of land used for the production of such products and any lessors and landlords who receive as rent all or part of the crop raised on the leased premises.

Several terms are usually defined in more detail. For example, statutes may state that the term “association” means any corporation organized under this [cooperative incorporation] act” and “person” shall include individuals, firms, partnerships, corporations and associations.” Federated cooperatives are explicitly recognized in the membership provision. “One association organized hereunder may become a member or stockholder of any other association or associations organized hereunder.”

Bylaws can be used to refine definitions and procedures and statutes typically assign certain definitions to the cooperative’s bylaws. A typical provision on member qualifications states:

Qualifications. Any person, firm, partnership, corporation or association, including both landlord and tenant in share tenancies, who is a bona fide producer of agricultural products in the territory in which the association is engaged in business, and who agrees to be a patron of the association, signs a marketing agreement with the association, purchases one share of common stock, and meets such other conditions as may be prescribed by the board of directors, may become a member of the association.

A corollary of restricted common stock ownership is restricted disposition and transfer. A sample provision in a cooperative’s articles of incorporation states:

The common stock of this association may be transferred only with the consent of the board of directors of the association and on the books of the association, and then only to persons eligible to hold it. No purported assignment or transfer of common stock shall pass to any person not eligible to hold it, nor the rights or privileges on account of such stock, nor a vote or voice in the management of the affairs of the association.

Unlike common stock issued by a non-cooperative corporation, common stock evidencing cooperative membership is redeemed upon termination of membership. The event triggering redemption may be voluntary termination of membership or mandatory suspension or termination when membership conditions are no longer met by the holder of a share of common stock evidencing membership.

Statutory permission for bylaw provisions on termination are broad, stating that the bylaws may provide for:

The number and qualification of members or stockholders of the association and the conditions precedent to membership or ownership of common stock; the method, time and manner of permitting members to withdraw or the holders of common stock to transfer their stock; the manner of assignment and transfer of the interest of members and of the shares of common stock; the conditions upon which and time when membership of any member shall cease; the automatic suspension of the rights of a member when he ceases to be eligible to membership in the association; and the mode, manner and effect of the expulsion of a member; the manner of determining the value of a member's interest and provision for its purchase by the association upon the death or withdrawal of a member or stockholder, or upon the expulsion of a member or forfeiture of his membership, or, at the option of the association, the purchase at a price fixed by conclusive appraisal by the board of directors. In case of the withdrawal or expulsion of a member, the board of directors shall equitably and conclusively appraise his property interests in the association and shall fix the amount thereof in money, which shall be paid to him within one year after such expulsion or withdrawal.

In response, bylaws may outline conditions for suspension or termination

**Suspension or Termination.** In the event the board of directors of the association shall find, following a hearing, that any of the common stock of this association has come into the hands of any person who is not eligible for membership, or that the holder thereof has ceased to be an eligible member, or that such holder has not marketed through the association the products covered by a marketing agreement with the association, or not otherwise patronized the association for a period of ____(_ ) year(s), or otherwise violated
the articles of incorporation, bylaws, or other agreements made with the association, the association may suspend such holder's rights as a member and terminate the membership.

and articles of incorporation and bylaws may establish redemption rules accordingly:

In the event the board of directors of the association shall find, following a hearing, that any of the common stock of this association has come into the hands of any person who is not eligible for membership, or that the holder thereof has ceased to be an eligible member, such holder shall have no rights or privileges on account of such stock, or vote or voice in the management or affairs of the association other than the right to participate in accordance with law in case of dissolution. The association shall repurchase such stock for par value. If such holder fails to deliver any certificate evidencing the stock, the association may cancel such certificate on its books and records, and the certificate is thereby null and void.

iv) Control

Common stock plays the same fundamental role in non-cooperative corporations and cooperatives regarding control. It gives shareholders the right to control the organization by selection of the board of directors which establish corporate policies on behalf of shareholders. Voting power in cooperatives, however, is oriented towards a different overall objective and view of the cooperative organization.

While return to equity investment in a cooperative by farmers is limited but not prohibited, most cooperatives do not pay any compensation in dividends on such capital. The reason for this practice is that to the extent the cooperative pays dividends on equity it reduces the amounts of net income available for distribution to farmer users. While getting compensated for use of capital, the farmer receives less patronage refund. Cooperatives usually weight distribution of net income on a patronage basis rather than on an investment basis because it is in more direct keeping with the benefits distribution cooperative principle.

v) Other Direct Investment

Other than the direct investment with a membership fee or purchase of a share of membership stock, direct investment is not usually a major source of member capital in cooperatives. An exception applies at the initial stage of financing a new cooperative when a

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47 USDA’s most recent financial survey of all cooperatives found that only 1.5 percent of net income was paid as dividends on capital stock. Rathbone, Robert C., and Roger A. Wissman. Farmers’ Cooperative Financial Profile, 1997. U.S. Dept. of Agricultural, RBS Research Report 171 (April 2000).
cooperative is created. No capital exists through which to add to capital. Therefore a direct capital contribution may be required.

Some cooperatives with sophisticated financial structures may provide for direct investment by selling special equity interests to members, or sometimes others, such as non-voting preferred stock. Cooperatives may issue preferred stock, also in different classes if so desired. Preferences and other characteristics of a cooperative's preferred stock are defined by the cooperative.

vi) Patronage-Based Equity Investment

The bulk of a cooperative financing comes from members through the patronage relationship.

The unusual features of cooperative financing are systems used to relate financial obligations of members and patrons to their use of the cooperative rather than to their direct investment with a view toward returns on investment. Because cooperatives are intended to provide benefits to owners as users rather than as investors and because cooperatives are owned and controlled by those who use them, the obligation to provide finance falls unequally upon members. In addition to the desired goal of financing related to use, the patronage refund system of returning net margins to users has become a convenient and important mechanism by which cooperative financing goals are achieved.

Patronage-based financing is the most common way cooperative members and patrons meet their obligation to their cooperative. The concept of patronage-based financing is comprised of several parts. First, the proportion of financial contribution made to the cooperative by each member or patron is important. Second, two overall methods are available to achieve the balance of financing required. The first is through direct contribution and the second is based on the fact cooperatives generate net margins from which the patron may contribute the required share.

The second method, more directly related to patronage-based financing, can be divided into two parts -- how the financial obligations are contributed to the cooperative by the cooperative's users and how they are returned by redemption. The combination of contribution and redemption yields the cooperative's final capital structure.

Patronage-based contribution may be made in two ways. \(^{48}\) A portion of the patronage refund paid to patrons out of the cooperative's net margins may be paid in a form other than cash. That is, the refund is made but in a certificate of some kind evidencing capital contribution. The

\(^{48}\) Classification into only two for summary purposes should not obscure the multitude of variations actually found.
system operates as if the patronage refund were paid in full and the patron reinvested part or all of it in the cooperative. This system is recognized in tax law.\textsuperscript{49}

A second method in which cooperative patrons contribute their share of the financing is based on units of product handled by the cooperative rather than on the cooperative's return of net margins. The system has become known as the per unit retain system. The cooperative typically retains a set portion per unit of product sold on behalf of the patron as the patron's capital contribution.

As is clear from the above descriptions, capital contributions will continue to build as time passes and patronage occurs. Without redemption an undesirable amount and balance of capital would result both from the cooperative's and patron's perspective. Two systems have been devised to give the cooperative the kind of capital structure it wants. One is the "revolving fund financing system" and the other is the "base capital plan system." Although the two systems are often viewed as a dichotomy, they may, in fact, operate together.

A relatively "painless" method of members capital contribution is through patronage refunds. The method relies on the form of patronage refund payment, although it is sometimes incorrectly called "retained" patronage refund.

Patronage refunds, as discussed last session, may be paid in cash. In addition, however, part of the total amount paid to a patron may be paid not in cash but in the form of some evidence of investment in the cooperative.

The amount not paid in cash is credited directly to the member's equity account in the cooperative and will be part of that individual member's equity until it is "redeemed" (paid back), a process discussed later.

Each year in both the patronage refund certificate and per unit retain system each farmer doing business with the cooperative will add equity to the cooperative capital structure. At some point the cooperative will have the amount needed.

Two systems can be used to regulate the total amount of equity each member has in the cooperative:

\footnote{This is a traditional system and was recognized by Courts and the Internal Revenue Service long before it received Code authorization, discussed further below.}
1. The revolving fund method in which equity added to the cooperative in past years is "redeemed" and replaced by new equity being added by either of patronage related equity contribution systems;

2. The base capital plan in which each members’ desirable share of total cooperative capital is determined and redemption or addition is adjusted so each member has that amount of equity in the cooperative.

These two systems are not entirely independent and can, if the cooperative wishes, be made to work together.

5. Revolving Fund Methods

The revolving fund equity system determines how much total capital the cooperative needs, then begins to "redeem out" the oldest equities in such amounts that new equities being added will maintain the needed capital levels. The cooperative:

1. Pays a portion of a patronage refund in cash or collects a per unit contribution;

2. Totals its member equity after current additions;

3. Determines its current equity needs;

4. Determines the excess equity capital;

5. Redeems earliest equities proportionally so total equity redemption brings member equity to current equity need levels.

"Revolving fund financing" is a term used for numerous systems. Generally, revolving funds are systems in which patrons make capital contributions on a regular basis, typically through retained patronage refunds or per unit retain allocations. The cooperative redeems such capital contributions on a regular basis. Redemption is usually on a first in, first
out basis. The cooperative determines what its total capital requirements are and the excess is redeemed each year, the earliest or "oldest" equity being revolved out first.

One result of this method is a "revolving period" representing the period of time equity is held before redemption. A second result is that contributions are based on use, as suggested by cooperative principles. However, as the revolving period lengthens (the cooperative keeps equity for a longer period of time), the difference between the proportion of current business done with the cooperative and the proportion of total equity contributed by the patron may increase.

Most incorporation statutes do not describe a revolving fund system of financing. Revolving fund financing systems may be described in various ways, typically in the cooperative's bylaws.

6. Base Capital Plans
"Base capital plan" is a general term

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Figure 7. Three-year Pattern for Hypothetical Cooperative, Additions to Equity Based on Patronage Proportion Each Year.

given to a financing system that focuses more carefully on the current proportion of capital a patron should have in the

Figure 8. Total Addition to Cooperative Equity by Year
cooperative at any particular time, typically based on the degree of use. The cooperative determines first what its total capital needs are. It then allocates the capital needs among its patrons based on various factors, with emphasis on current, average, or projected patronage. Each patron's contribution and redemption is adjusted to achieve the total equity goal. The desired balance can be achieved either by adjusting the amounts contributed, either by direct contribution, retained patronage refunds or per unit retain allocations, or by selected redemption methods.

The base capital plan is a method some cooperative use to better match current patronage with current total equity each member has in the cooperative. The procedure is generally as follows:

1. The cooperative determines its capital needs;
2. It determines each patron's share of the capital needed;
3. Each member's actual capital in the cooperative is compared with the amount the member should have;

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4. It then adjusts each member's equity to meet its needs.

Total capital needed does not differ from that estimated in the revolving fund method as described before.

Each member's share is related to patronage levels. This can be done in several ways. Examples are: Each farmer's share of business with the cooperative averaged over the three most recent years, or an estimate of business each patron expects to do with the cooperative in the following year. The cooperative determines a workable method.

Most cooperatives have articles of incorporation or bylaw provisions describing the basic principles of their equity redemption system. These are, of course, an integral part of the overall financing program. The following sample is that of a bylaw provision. Two options are given for the method of determining amounts.

Section 1. Regular Redemption. (two options presented)

(Revolving Fund)
If at any time the board of directors determines that the financial condition of the association will not be impaired thereby, capital credited to members' accounts may be redeemed in full or in part. Any such redemption of capital shall be made in order of priority according to the year in which the capital was furnished and credited, the capital first received by the association being the first redeemed.

* * * * * * * * * * *

(Percent of All Equities)
It shall be the policy of the association, when other redemption priorities set forth herein have been met, and when funds are available, to redeem in cash a percentage of each member patron's capital credits, rather than ratably by year. The time and method of any such redemption shall be determined by the board of directors.

Section 2. Discretionary Special Redemptions. Notwithstanding any other provision of these bylaws, the board, at its absolute discretion, shall have the power to retire any capital credited to members' accounts on such terms and conditions as may be agreed upon by the parties in any instance in which the interests of the association and its members are deemed to be furthered thereby and funds are determined by the board to be available for such purposes.
Section 3. Specified Special Redemptions. The association shall give priority to redemption of members' capital credits held by deceased persons for the settlement of their estate. The association shall thereafter grant priority redemption to capital credits of former members who have attained their 65th birthday and are no longer actively engaged in agricultural production as actual producers or landlords in share tenancy. The time and method of such redemption shall be determined solely by the board of directors, dependent upon the financial condition of the association. In the case of redemption of the equities of those persons who have attained age 65 and retired from farming, preference may be given to the oldest retirees in establishing the order of priority among those eligible.

In the case of a corporation or partnership holder of members' capital credits, such corporation or partnership shall be considered eligible for priority treatment to the same extent as the individual stockholders of such corporation or partners of the partnership would have qualified, if each individual stockholder or partner were an individual member-patron of this association. Any redemption shall be made to the corporation or partnership, and not to the individual stockholder or partner thereof.

Each corporation or partnership shall report to the association the percentage of ownership interest in the corporation or partnership of each of its stockholders or partners. Failure to report accurately the percentage of individual ownership interest shall disqualify any allocations made to the corporation or partnership by this association from redemption priority. If a corporation or partnership should dissolve, its capital credits in this association shall be prorated among, and transferred to, the individual stockholders or partners and considered for redemption on an individual ownership basis. The amount of any redemption or prorate related to a corporate or partnership member shall be determined by the percentage of ownership interest as reported by the corporation or partnership.

When two or more persons are holders of capital credits as tenants in common, without a designation of rights of survivorship, they shall be deemed by this association to be acting as partners and shall be subject to the same requirements as a partnership.

Capital credits held in joint tenancy with rights of survivorship shall be considered for priority of redemption according to the qualifying status of the youngest member of the joint tenancy or, in the event of death of one of the joint tenants, of the survivor.
7. Innovation and Flexibility

Summary descriptions of cooperative financing methods suggest variations and flexibility but do not capture the full range of adaptations possible. Only a few variations are noted below in Section VI, Subsection B. At this point it is only necessary to point out the danger of assigning restrictive financing methods to “traditional” cooperatives and concluding that drastic changes are needed in the fundamentals of cooperative finance if cooperatives are to play vital roles in agriculture and rural development.  

B. Current Research and Information Base

A complete review of the information available on cooperative finance is not possible. The sources of information exemplify the kind of work available. Cooperative financial studies and publications range from the basic practicalities of finance, both from descriptive and proscriptive perspectives, to theory, with all levels between represented. A survey of existing materials would provide the foundation for further analysis and the further development of the information and knowledge base required to explore the issues raised in this Paper.

As an example, the essential characteristics of new generation cooperatives are merely applications of a base capital plan combined with product delivery contracting, both of which have been used extensively by cooperatives for many years.

V. Changes and Challenges

The issues noted in this Paper exist only because the economic, business, and social environments in which cooperatives typically exist are changing dramatically. Cooperatives, farmers, and others are responding. One type of response is essentially defensive in which cooperatives are designed, organized and used to stave off unwelcome consequences to farmers. Another is offensive in which farmers use cooperatives to take aggressive and pro-active roles in the new environments.

The following material is only a brief outline of changes that are either forcing cooperatives to change for their own survival or that are offering new opportunities for cooperative enterprise. Ideally, each change could be associated with a cooperative response, or vice versa. However, at this point only a survey is offered.

A. Changes Facing Cooperatives in Agriculture

There is no way that all changes that have an impact on cooperatives and their members can be surveyed, and certainly no method by which such changes are related to their impacts on cooperatives. However, a brief note on some of the more important changes in the economic, business, and policy environments in which cooperatives operate suggests why it is natural to expect changes in cooperatives in response as well as changes in attitudes toward cooperatives.

The following list is divided into three parts. Market-focused changes are those that affect cooperatives because the markets, broadly defined, in which cooperative operate are changing. This includes not only specific agricultural markets but the market-place for goods and services world-wide, all of which affect cooperatives in one way or another. Member-based changes reflect those that are occurring among members themselves. The character of members are in a continual state of flux. Because cooperatives are entirely member based, when members change, cooperatives change as well. Cooperatives, for a number of reasons, may engage in new and different strategies as they represent their members’ interests in markets. Innovation, market niches, and participation in new levels of the supply chain are examples of how cooperatives themselves structure themselves appropriately in response.

1. Market-Focused Changes

The impacts of many changes are felt primarily through changes in the markets in which cooperatives exist. A limited number out of many are listed here.\(^{53}\)

i) Globalization

Globalization is the expansion of influences and economic activities with diminished barriers from political, economic, and social distinctions. The impacts of globalization are felt in three major ways. At market levels, world market forces are reflected directly back to all levels of agribusiness and to U.S. farmers. Demand, supply, pricing and all other economic forces that determine farm income and affect farming decisions are now world issues, not local, regional, national or even hemispheric issues. At the farmer level, individual U.S. farmers do not produce for limited or well-defined markets. Every farmer is part of a competitive world system in production choices and costs, governmental support programs, market delivery systems, sources and pricing of inputs. Production trends may be inexorable on a world scale, leaving individual farmers unable to make meaningful production decisions.

53 Baarda, James R., “Major Changes in Agriculture Raise Big Questions for Nation’s Cooperatives,” U.S. Dept. of Agriculture, Rural Cooperatives, November/December 2002, p. 21. Each observer has his or her own list of such forces and preferences for their ranking in importance.
Farmers are also now exposed to world financial markets where the economic systems are far different from the U.S. system. They also face international and transnational political forces, fluctuating exchange rates and new communications systems and technologies, all of which can change rapidly. These environments are ever more important to agriculture, and at the same time, are less and less sensitive to agriculture. Almost any production activity in any sector is expendable if “economics demands it.”

ii) Competition

Competition has always been a factor that drives innovation in agriculture as well as most other economic activities. Cooperatives are no exception. The character of competition is changing, however, with new challenges and opportunities following. Forces of competition, micro-economic and macro-economic, impinge on every aspect of the farming and marketing process. The forces are not only more pervasive but in some regards more volatile than ever before. Stability and predictability are rare commodities.

An ever increasing number of forces that drive agriculture and affect cooperatives lie outside of the control of farmers or even the general agricultural sector. They may lie even outside of the ability of a nation to control. The agenda is being set by others, not necessarily by design, but more by impersonal economic forces that are neutral in some sense, but not at all neutral toward those who cannot exert power.

Concerns about the environment, food safety, animal health and treatment, conservation, odor and pest management, land use, food costs and labor conditions are among forces that are finding their way into laws and regulations that impose social interests on farmers and the agriculture sector. This ever increasing network of prohibitions and directives are part of the competitive environment in which farmers and cooperatives exist.

iii) Concentration

Concentration in the agriculture supply chain is increasing at the point in which farmers participate in the market place as sellers of commodities. The use of cooperatives to combat the effects of concentration has been and continues to be an important part of traditional cooperative formation and use. Bargaining power, or lack thereof, has almost always been of concern to farmers. But it is an ever-increasing problem because of the increasing concentration of buyers and suppliers.

An increasing number of pricing systems are “closed” due to the decline of both the number of participants in the market place and in the reduction of number of farms. Reduction in transparency and open price discovery methods arise from the increase in private agreements between producer and buyer. Complete industry integration is the culmination of the process, leaving farmers and their cooperatives to determine the best or perhaps only means of survival.
Concentration at the retail level has not only added to problems of bargaining power balance, it has also reduced the opportunities for farmers to participate at all. The national scope of retailing concentration, with giant food chains charging for shelf space and continued concentration of an already concentrated number of players in many international markets, places U.S. farmers at a distinct disadvantage. At the same time, cooperatives and arrangements among cooperatives are being used creatively to meet the challenge and participate in the economic advantages of size and concentration.

iv) Product Demands

Consumer tastes for food and food products are changing due largely to advertising and marketing. For the most part, advertising and marketing are designed to increase product profitability for processors and retailers. The demand is generated at the retail level and passed back to producers who have little or no input to the process. Farmers are asked to produce what is demanded when the buyer demands it.

Health concerns have made major changes in demand, whether public responses to such concerns are long-lasting changes or the result of fads. Food quality and safety are a major part of driving forces in the supply chain.

The enormous size of the fast food industry and grocery retailers is in many way reducing the variety of foods demanded and offered. In other ways, however, it is increasing variety. More products are becoming homogeneous commodities for which uniformity of size, quality, and taste is absolutely essential. This, in turn, often eliminates the smaller producer from meaningful participation in the supply chain without cooperative effort.

v) Product Identity

One of the major changes affecting markets and the reflection of consumer demand back to producers through market forces, is the increasing importance of product identity. Identity preservation is one example but not the only situation in which product tracing is important. Legal requirements as well as the forces of markets play an increasing role in agricultural production, processing, and distribution. This is demonstrated clearly by international concerns with genetically modified food products and the importance of product identity. Animal disease epidemiology is another example.

vi) Industrialization

Significant increases in contracting and industry integration have totally changed some industries. This trend appears to be making its way into nearly all agricultural sectors. The tradeoffs between rights and obligations inherent in any contracting system often leave the real producer at the bottom when it comes to decision making, influence and profitability.
The industrialization process has resulted in each producer playing an ever-decreasing part of the production process. Decisions are removed from the producer to the point that the term “employee” may best describe many producers.

Perhaps one of the most profound changes brought about by “industrialization” is that the agenda for agriculture is being set outside the farmer/producer system, not by farmers. The driving forces are profitability, returns on equity, growth for growth’s sake, market dominance, reduction of risk and direct depending on financial markets by powerful companies far removed from the production process.

2. Member-Based Changes

The changes described above of course affect farmers. Other changes are somewhat more directly related to farmers and the farming process. These necessarily affect cooperatives where cooperatives are used by farmers to achieve goals that relate back to the farmer.

i) Expectations

The most important forces to consider are those that come from farmers themselves. Farm families have expectations about a desired lifestyle and standard of living, income level and stability, and a decent working environment. Among many other things, this may well influence what farmers want from their cooperative, the kinds of operations the farmers want to establish, and ultimately their willingness to remain in agriculture.

Farmers and other rural residents have observed substantial changes in rural communities, many of which are based on declining income and population. Institutions and amenities are nevertheless required for those remaining, and rural residents have reason to expect that their community will be stable and a rewarding place to live. This, in turn, influences attitudes toward business, the importance of local firms and the impacts of local cooperative facilities on employment and community income.

ii) Size

Increased size and scale of operation is not limited to marketing and processing firms. Farm production units themselves are increasing in size, along with requirements for larger investment, added financial burdens, planning needs and management skills. Dramatic increases in farm size creates new demands for supplies, financial services, land and labor.

iii) Expectations Horizons

Expectations of cooperative members may be shortening. That is, members as farmers, as investors, as those who control the cooperative, and as those who benefit from the cooperative
may expect a more responsive organization able to supply needs with immediacy. The consequence may be that planning horizons may be shortened with a greater demand of short-term payoff at the expense of long-term growth and organizational development. This new attitude may be reflected in a lessened commitment to the cooperative for the sake of membership and a greater willingness to seek out any business or arrangement that will offer a quick satisfaction of demands.

iv) Heterogeneous Interests

Where the members of a cooperative are homogeneous in products produced, investments in the cooperative, level of patronage, and are similar in basic farming character, cooperatives reflect a common goal. This is not always the case for cooperatives, however, and the reconfiguration of farming operations is adding to the problem of heterogeneity. Financial interests offer one example. A growing number of farmer members are older individuals whose farming career is coming to an end. New members have a longer career for planning purposes. The two groups will have very different attitudes toward certain decisions in the cooperative that affects their equity position and the returns they may receive. The older members, for example, may wish to see a smaller portion of a patronage refund paid in cash enabling the cooperative to more rapidly revolve out the equity they have in the cooperative that will soon no longer provide them a benefit through use. Younger members, on the other hand, may have a greater need for cash flow and for investable funds they can invest in the farm itself. These and many other consequences of heterogeneous interests among members influence the character of the cooperative.

v) Return on Investments

As has been describe in various parts of this Paper, investment in the equity of the cooperative is inextricably tied to cooperative patronage, return of benefits on the bases of use instead of investment, and to cooperative control. The combination of these principles is not necessarily compatible with a purely investment view of the cooperative. Cooperative investment is not aimed at returns on investment as if the funds were placed in a financial instrument or share of stock. Rather, returns on the investment are in the nature of income generated by investment in a tool such as a tractor.

It is evident that farmers are beginning to look at their investment in the cooperative as similar to any other kind of financial investment. This means that farmer members expect that investment to have the attributes of a financial investment. This includes not only specific payments of cash out of profits generated by the organization but the ability to capture the value of the organization by liquidity transactions. Sale of cooperative equity by farmer members and realization of gain by selling at a higher price than at which it was purchased are events at the center of the issues discussed in this paper.
3. Strategy-Modifying Changes

Changes in cooperative strategies are evident when surveying modern cooperatives. Several are mentioned only briefly here.

i) From Defense to Offense

Many cooperatives are being created by farmers to take a pro-active role in the market place. This places them in new arenas of competition and may require significant changes in the usual view of cooperatives.

ii) Integration

In some cases cooperatives are taking a more integrated role in the supply chain, tying together various aspects of the supply chain in one, coordinated, more efficient, and hopefully more competitive structure.

iii) Value-Added Activities

Each stage of a supply chain carries with it opportunities to extract profits. Farm production has not been a particularly profitable portion of the supply chain where production is oriented toward mere commodities. Farmers are actively seeking to add value to the commodity they produce and capture the profits from such activities. As noted elsewhere, when farmers use cooperative to add value and capture the benefits, the cooperative itself must be designed and operated to be effective. Expertise, financial resources, and responsiveness to final markets for the value-added product are essential features of such cooperatives.

![Figure 12. Horizontal Coordination of Farmers Through Cooperatives](image-url)
iv) Non-Patronage Ventures

Cooperatives face increasing pressures to engage in activities beyond those associated with member farm production. Demands of the market place often require that an organization supplying a product or set of related products be capable of supplying a stream of product not available from its members. The cooperative is forced to expand its business beyond the patronage relationship as a mechanism to serve it patrons.

v) Variety of Responses to Markets

Cooperatives are also responding to many markets, including national and international markets. This is not necessarily a luxury – in many cases it is an absolute necessity to survive and serve member. For purpose of this Paper it is only necessary to point out that cooperatives are required to be nimble and responsive as they have never been before.

4. “Outside” Influence

Not all impetus for change comes from farmers and their cooperatives. Others also guide and influence. For policy reasons, is it important to identify where forces for change are coming from and how advocacy positions may reflect the agendas of outside influence rather than cooperatives’ long-term interests.

This, however, is not necessarily a critical view. Indeed, governmental and non-governmental entities may be charged with support and advocacy of initiatives is support of innovations in cooperative structure, operation, and finance. Such entities have played important roles in leading cooperatives to change in response to changing times. Outside expertise, leadership, and scholarship can bring vision and ideas that may not come from within cooperatives. In addition, broader ideas may go beyond the particular interest of any individual cooperative but have a significant influence on all cooperatives in a positive manner.

A few sources of outside influence are noted here. Neither individuals, organizations, nor their positions of advocacy are specifically identified. Within any group a wide range of positions and approaches can be identified.
i) Advocacy

Attorneys may play two general roles in cooperative innovations and in the public policy toward cooperatives as reflected in laws. First, as counselors they represented interested parties such as farmers who want to find an organizational structure through which they can actively participate in the market system through supply, services, marketing, bargaining, and engaging in value adding activities. Attorneys will use the full range of existing laws, including cooperative laws, to design the appropriate legal structures whether by incorporation choices, contractual arrangements, or any other means. Part of this process, guided by counsel, will include the choice of business entities that best suit clients’ needs. Where the cooperative form of enterprise is appropriate, counsel will assist the organizers to structure the cooperative appropriately and advise on opportunities as well as restrictions when considering statutes, taxes, antitrust, securities, an other legal aspects of the business entity.

A second role in which attorneys have been actively involved is a change in the laws that define and describe a cooperative. These are primarily the State incorporation statutes that may be used by farmers who wish to form a cooperative. Examples of current activities are discussed below in Sections VII and VIII.

ii) Promoters and Investors

It is expected and appropriate that those who promote economic activities and those who wish to invest in and profit from such activities will address and attempt to challenge perceived or real limitations on the implementation of their ideas. This is certainly the case where farmer groups provide a mechanism by which promoters can create and build capital intensive operations such as ethanol plants. Two obstacles are typical in such circumstances. First, farmers may not be able or willing to provide sufficient capitalization for the promoter to complete the project and receive adequate compensation for the promotion. Second, investors who see an opportunity to profit from the farmers’ organization and the promoters’ contribution are not able to invest in the enterprise and share in the profits.

The consequence of these forces may be that promoters and investors do not fully support the use of a cooperative even though they want the benefits of working with a farmer organization. It may be in their interest to support organizations that are not completely cooperative in substance. The choice is then to advocate and work with an organization that lacks the characteristics of a cooperative disadvantageous to the interests of promoters and investors, while emphasizing those characteristics of the organization that give it the appearance of a cooperative.
iii) Associations

An interesting conundrum faces associations whose membership is made up of cooperatives, and only cooperatives. On the one hand, they are charged with supporting cooperatives and advocating the idea of cooperatives in various forums. On the other hand, as farmers and others increasingly choose non-cooperative options for their business structure, particularly LLCs, such associations lose their membership base.

One way to maintain membership levels in the association is to redefine membership to include organizational forms not previously considered eligible for membership, for example, LLCs that have defined cooperative characteristics. Another choice is simply to redefine what a cooperative is. Eligibility for membership is based in some form on the definition of a cooperative, often based on cooperative laws. Some associations have supported new definitions that call organizations cooperatives that do not have the full complement, or even a majority, of characteristics traditionally defined as a cooperative.

Cooperative supporting organizations may, of course, have reasons to support fundamental changes in cooperative definition that go beyond simply preserving membership. Their advocacy positions are based on a broader view of farmer collaboration than usually encompassed by the definition of a cooperative. At the same time, they are faced with the possibility of supporting forms of organizations that cannot serve the interests of members as unique enterprises but rather adopt non-cooperative characteristics against which cooperatives offered relief.

iv) Advisors

Advisors who assist in the formation of organizations are faced with somewhat the same challenges that face attorneys – how to advise on the best organizational structure for their clientele regardless of its form. One of the disturbing observations of some is that some advisors have initially promoted the idea of a cooperative for the purpose of obtaining investment by farmers in the cooperative, only to advocate conversion to a non-cooperative subsequently for the primary benefit of large investors and management. While advisors may have reasonable beliefs that cooperatives must change dramatically to play a role in a changing economy, unless they are committed to the cooperative idea they may play a role in blurring the distinction between a cooperative and other kinds of business organizations.

v) Financial Institutions

Some financial institutions are limited to providing services to cooperatives. In such cases cooperatives are defined by statutes that may exclude organizations not operating on a statutorily defined cooperative basis but are called cooperatives by some. As farmers and others choose organizational forms that do not conform to the financial institutions’ eligibility
requirements, the institutions lose clientele. Of course, organizations also lose the ability to use the services of the financial institutions as well. It may be in the best interest of financial institutions, at least when measured by the gross amount of services provided and entities served, to promote expansion of the statutory definition of cooperatives upon which eligibility is based.

### B. Limitations, Criticisms, and Opportunities

The underlying question for discussions of issues addressed in this Paper is, “Are cooperative able to respond to changes and maintain their effective service to farmer members?” An associated question is, “If cooperatives are to maintain their roles on behalf of farmers, how must they change?” The questions may be assessed by surveying how cooperatives may be limited in their ability to respond to changes and noting criticisms of cooperatives. Suggestions of these issues have been noted above in different contexts.

The following material makes no effort to assess the validity of limitations and criticisms, nor does it indicate how cooperatives have responded or can respond.\(^{54}\)

#### 1. Size and Scale

Operating efficiency, market power, and ability to respond to markets may depend largely on the size and scale of an operation. A cooperative may be limited in its size and scale because it is dependent on its membership for the products to be processed or moved into the market place. Increased purchases is not a possible response to needs to increase the volume passing through the cooperative. Only additions of new producers to cooperative membership is a permanent solution to volume limitations. Membership additions may be limited by the voluntary nature of membership, by competitors’ ability to purchase product and undermine membership commitment to the cooperative, and by the physical location of production which, if scattered, makes a localized cooperative impossible. Size problems have been most severe where cooperatives’ non-cooperative competitors are very large and cooperatives have been unable to maintain an adequate market share to be effective.

#### 2. Scope

Scope refers to the types of product handled. The problem is presented for cooperatives where demands of the market give advantages to firms that can deliver a variety of products. Limitations can be of two types. A cooperative’s scope of operation is limited to the commodities its members produce. It can only expand its offering by adding members who produce another product or it may make purchases outside of its membership. Scope may also be seasonal. An example is markets for fresh products that may be produced only seasonally by a

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\(^{54}\) Some indication of responses is noted in Section VI below.
cooperative’s members. In the off-season, the cooperative cannot supply the fresh product. The scope problem has caused some cooperatives to change their methods of operation, change their policies on membership, or cease being a cooperative.

3. Capital

Three separate capitalization issues are typically raised regarding farmer cooperatives, though they are related. The first is a common belief or observation that new, value-adding activities by farmers who want to use cooperatives for processing such as ethanol production or livestock slaughter are capital intensive. Capitalization beyond the ability of farmers, even collectively, to provide the financing as is traditionally required in cooperatives. The second is discussion of these inherent drawbacks of cooperative finance such as the “horizon” problem, difficulties matching the amount of capital invested by each member with the member’s participation in the cooperative, and burdens of equity redemption. The third issue is that of the possible role of “outside” finance and its implications for cooperative control and cooperative principles.

Following is a summary of discussions that have taken place in varying circumstances that propose limitations that “traditional” financing methods pose for cooperatives given new challenges for cooperatives. Descriptions of limitations and disadvantages are more recently followed by proposals for major changes as has been discussed. No attempt is made to analyze either the full reasoning and implications of the arguments. Neither are opposing views detailed. The purpose here is simply to articulate the arguments and positions in summary fashion.

i) Undercapitalization

The overarching position leading to current proposals to make major changes in cooperative principles and public policy on cooperatives is that cooperatives cannot raise enough equity using traditional or non-traditional cooperative methods. Limitations on equity capital mean the cooperative form of business cannot be effectively used to serve the needs of farmers who wish to participate in the segments of the supply chain that yield profits, unlike the mere

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55 Capitalization of new generation cooperatives may be termed “non-traditional” because of the combination of investment requirements, delivery, and closed membership. However, the methods are still essentially cooperative because the capitalization comes from farmer members, investment is made solely for the purpose of enabling the cooperative to serve its members on a cooperative basis, and equity requirements are base on patronage. The assertion has been made that new generation cooperatives exhibit nothing new except a new combination of quite traditional practices. New generation cooperatives are described further in Section VI(A). This emphasizes the need to define terms such as “new generation” cooperatives carefully. Some advocates are now referring to organizations formed under the new statutes as “next generation” cooperatives.
marketing of a commodity. Only by finding new sources of equity capital can cooperatives generate the greatest benefit for farmers.

Shortages of cooperative equity can be attributed to several causes. First, farmers may simply not have the kind of capital that enables them to invest in the cooperative to the extent necessary for adequate cooperative performance in the current market climate. Associated with this problem are the relative costs and alternative uses of capital. For farmers with no “excess” capital, any funds invested in the cooperative are funds that cannot be used in the farming operation. The cost to farmers of removing investment in their farms to make investments in the cooperative is too high.

A second limitation on member equity capitalization results from the “horizon” problem. The horizon problem describes the situation where a member’s investment in the cooperative will have a termination period related to equity redemption, preferably corresponding roughly to the period of time the member uses and benefits from the cooperative. However, the cooperative may need to make investments, thus demand the capital, for longer periods of time. This would occur where the cooperative commits to a 30 or 40 year investment in a plant but a farmer may wish to obtain benefits and receive returned equity in a much shorter period. The horizon problem may mean two things for farmer investors. It may mean that farmer equity will be tied up longer if the cooperative faces timely redemption problems. More generally, however, capital investment requirements may be higher because the investment must cover all asset purchases even where the asset will continue to generate income to the cooperative, thus its member patrons, long after the investing farmer receives no benefit from that asset because patronage has ceased.

A third limitation is the inability of an investing cooperative member to fully realize the benefits of the investment because the investment does not reflect an increased value of the cooperative under traditional financing methods. This difficult issue is discussed separately below.

The argument that cooperatives cannot obtain capital needed for effective supply chain participation and value-adding activities using existing financing methods, while appealing, has several different facets and has received surprisingly limited research. Some express the opinion that farmer can, in fact, supply needed capital if they are convinced that they will benefit sufficiently to compensate for the investment. In this view, capital exists and no new sources need be tapped. At the same time, cooperatives may be required to be creative in responding to requirements of members for returns and benefits.

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56 This terminology can be confusing because other types of “horizon” problems are sometimes mentioned in connection with cooperatives.
The horizon problem is logical but little is known about its real impact on cooperatives and farmers’ willingness to invest in their cooperative. Some research has been done on the general undercapitalization issue showing that cooperatives may be somewhat undercapitalized.
as compared with non-cooperative businesses. However, much of the commentary on capital

limitations is anecdotal.

ii) Temporary and Permanent Capital

Most cooperative equity is “temporary” in the sense that it is identified with individual members or former members and carries an obligation to redeem it. Cooperative documents are typically written in such a way that a member or former member cannot force repayment to the detriment of the cooperative.\(^{58}\) State incorporation statutes may also establish redemption authority rights and obligations.\(^{59}\) Nevertheless, an obligation exists that does not exist in a non-cooperative corporate entity where the organization has no obligation to redeem equity. This is the essential distinction between temporary and permanent capital.

This situation has led to several criticisms of cooperative finance, or at least to discussions of limitations, three of which are noted here. First, the view is expressed that because the equity structure is not permanent, the cooperative is at a disadvantage when it seeks borrowed capital or engages in any activity where the equity structure of the organization is relevant. A debt/equity ratio tells a somewhat different story for a cooperative than for an organization with no redemption obligations or even the possibility of stock repurchase.

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The second kind of concern with the temporary capital structure is that the cooperative itself is at a disadvantage because it cannot treat its capital as a resource available for all uses that would be beneficial to the cooperative. The cooperative will always be somewhat limited in its commitment to make investments using equity capital that must be returned to investors at some time.

A third argument notes that the members have expectations that not only will they receive the benefits of dealing with the cooperative, they will view the cooperative’s equity accounts as their own rather than the cooperative entities (which, of course, is true). The concern is that the organization will not extend sufficient authority and discretion to management to make decisions on behalf of the cooperative as an independent business entity.

iii) Capital-Patronage Balance

The lag between active patronage and equity redemption is also identified as a reason to make major changes diminishing the principle of cooperative financing based on use.\textsuperscript{60} This is commonly called the “equity redemption” problem. A substantial proportion of member equity is held by those who no longer use the cooperative. In some cooperatives the problem is more severe than in others. The declining number of individuals who are active cooperative members and active farmers – those whose business is the source of funds available to redeem outstanding equity – is seen as an alarm for the future of the cooperative financing system. These arguments are generally based, however, on number of individuals and not on business volume of increasingly large farming operations, the true measure of ability to generate cash for redemption.

This is not to say that the problem is not important. Equity redemption issues have been a perennial concern for cooperatives and have been studied extensively. In 1982 USDA undertook a major study of the equity redemption issue.\textsuperscript{61} Equity redemption and equity-patronage balance continue to be the subject of considerable interest and assessment.\textsuperscript{62}

\textsuperscript{60} Programs for systematic equity capital redemption and replacement were summarized above. These were just simple examples of methods among a wide set of possible practices.

\textsuperscript{61} Results and recommendations were published in Cobia, David W., \textit{et al.}, \textit{Equity Redemption: Issues and Alternatives for Farmer Cooperatives}. USDA, Agricultural Cooperative Service, ACS Research Report No. 23 (October 1982).

iv) Burdens of Redemption

An argument for major shifts away from farmer financing with non-permanent capital is sometimes justified by the burdens of equity redemption. If a cooperative is to redeem its equity, so the argument goes, it must generate more income than a comparable non-cooperative firm that
need not ever redeem its equity. The argument is valid but with significant cautions on reaching proposed conclusions.

One caution against over-emphasizing the redemption effect is that the cooperative is paying its own patrons (or former patrons) and thus the redemption process is a final step in allocating all of its benefits to those who use the cooperative. While the cash flow available for payment of patronage refunds is indeed reduced by cash paid in redemption, the total cash flow nevertheless reaches the hands of patrons. This should also be considered in the context of incoming funds generated by equity additions through the patronage process. Thus, while the cooperative has cash outlays for equity redemption, it also has cash inflows from new equity.

A second caution is that many non-cooperative corporate entities engage in “redemption” through stock repurchases. Instead of distributing net income as dividends on stock, the corporation distributes net income as stock repurchase. One reason for so doing is to increase the value of the remaining stock in the hands of stockholders. This occurs because fewer stockholders (more specifically fewer shares of stock) have a claim to the full net profits of the corporation. Criticisms of cooperative equity redemption practices must take these changes in valuation into account as well to make comparisons with non-cooperative, investor-oriented enterprises.

v) Capital Liquidity

One strong criticism of cooperative’s financing methods is associated with the lack of liquidity. Funds that a farmer member has invested in a cooperative cannot be withdrawn at the farmer’s wish as described previously in the sections on cooperative finance. Exceptions exist, of course, as in the case of a cooperative with a strict base capital plan where capital is returned with the farmer ceases doing business with the cooperative, although the cooperative will certainly protect itself by requiring that the departing farmer find another eligible farmer to purchase the capital and take the departing farmer’s place.

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63 This cogent argument is made by Dahlgren, Joel, “The Challenge of Aligning Ownership with Use – A Commentary,” LVI The Cooperative Accountant 18 (Fall 2003). Dahlgren is an attorney with the law firm of Linquist & Vennam, whose partner Mark Hanson is a leader in advocating major changes in cooperative structure and principles, including major changes in State incorporation statutes for cooperatives. See section on new State statutes below.

64 These practices have become somewhat more common for new generation cooperatives where the required investment is strictly tied to patronage in the form of delivery rights. The obligations run both ways – the members have a right to deliver an established amount of product dependent on the amount of equity in the cooperative and at the same time have an obligation to deliver that amount of product. See the discussion of new generation cooperatives below.
Compounding the liquidity problem is the typical restriction on divestment to non-member, non-patrons at any price. No market exists outside of the cooperative. The liquidity argument is most telling when a comparison is made between cooperative equity and equity in companies whose equity is freely tradeable. If a farmer, for example, invests a certain amount of money in a tradeable security, the farmer can sell that security to anyone else and obtain money in return. If the same money is invested in a cooperative, however, the farmer is neither able to force the cooperative to pay for the certificate nor able to freely sell it to a third party. The former equity is liquid, the second is not. The result is that the overall cost, including the loss of tradeability, is higher for the former. The degree to which cost is increased depends to some extent on the value the farmer places on liquidity.

One of the arguments supporting cooperative’s traditional lack of liquidity (and of longer redemption periods as well) is that the cooperative has made long-term investments for the benefit of members. The cooperative must therefore reduce members’ liquidity to establish stability in its own financial structure as a prerequisite to making returns on farmers’ investment in their cooperative.\textsuperscript{65}

The comparison between cooperative investment and investment in a freely tradeable security should also be tempered by the fact that in many circumstances investment in a firm is not, in fact, completely tradeable and thus the investment is not liquid. Examples would be investment in a close corporation with limitations on transfer, membership in a partnership where transferability will most likely be restricted or non-existent, and investment in the farm itself. So long as the investor maintains some relationship with the company, liquidity is limited. The character of a cooperative in many ways resembles the character of such organizations.\textsuperscript{66}

vi) Capturing Firm Value

A second criticism from the member investors’ perspective is that investment in a cooperative cannot realize any gain in the “value” of the cooperative. Cooperatives’ nearly universal practice is to redeem equity at the same price the farmer purchased the equity – its face value.\textsuperscript{67} Even though the member or former member receives face value, any increase in the

\textsuperscript{65} This may be seen as another view of a “horizon” problem.

\textsuperscript{66} Research is underway that investigates the “close corporation” characteristics of a cooperative and implications of the similarities and differences.

\textsuperscript{67} Equity redeemed at more or less than face value has Federal income tax implications to both the cooperative and recipient.
value of the cooperative cannot be captured.\textsuperscript{68} If during the time the farmer was a member of the cooperative the cooperative’s performance and benefits made it a more attractive subject of use and investment, departing members whose equity is redeemed will not share in the benefits of the cooperative’s success. In some analyses, the argument is made that cooperatives actually “destroy value” by their methods of operating on a cooperative basis.\textsuperscript{69}

Others point out that the “value” of a cooperative is not appropriately measured using criteria applicable to an investment-oriented firm for several reasons. An ongoing inquiry is investigating value concepts applicable to cooperatives.

vii) Expansion and Growth

Limits on cooperative expansion and growth because the cooperative has inadequate access to equity or debt capital have been identified in previous sections in connection with cooperative formation for capital intensive endeavors. Similar concerns accompany cooperative growth and expansion opportunities. It is useful to note here for discussion purposes that capital limitations are a nearly universal issue for all businesses that face capital needs for growth. Before focusing on cooperatives’ issues, it is therefore necessary to consider as well how other businesses generate equity for growth.

Two points are raised. First, despite the publicity surrounding the massive influxes of capital in certain public offerings, most equity increase for corporate businesses comes from retained profits. Cooperatives have methods of using this source as describe above, though with different systems. Systematic additions to cooperative equity are superficially analogous to retained corporate earnings. Ongoing research to compare growth potential for cooperatives and non-cooperatives will take into account similarities and differences. Comparative research on this issue is lacking.

It is also important to address the changes in ownership and behavior when a privately owned company “goes public” to garner public equity capital for expansion. Consequences may be undesirable from a cooperative’s perspective unlike consequences for a non-cooperative business. A careful balancing of interests is needed required for meaningful assessment of cooperative, non-cooperative implications.

\textsuperscript{68} The problem is compounded because discounting makes the redeemed amounts less than when initially purchased. On the other hand, when other equity is retained for a period of time, the time value of money also reduces its value as well.

VI. Organizational, Structural, and Operational Responses

Cooperatives have historically operated successfully within existing legal and policy structures to address many of the issues discussed above. Thousands of cooperatives continue to do so because they have shown flexibility, innovation, and an instinct to survive. New operating procedures have been developed that draw on existing principles and practices, new generation cooperatives and variants being just one example. Farmers also use limited liability companies (LLCs) to engage in joint activities that may or may not operate along cooperative lines. Cooperatives themselves respond effectively to major changes by creating special subsidiaries, joint ventures, and strategic alliances, some of which can alleviate finance problems as well as larger market structure problems.

Following is a brief categorization of how some cooperatives have responded to new or different capitalization needs.

A. “New Generation” Cooperatives

In the last two decades, a number of cooperatives have been formed that combine several principles and practices that respond to significant capital needs for organizations engaging in processing and value-added activities. The term “new generation cooperatives” has been applied to these organizations without assigning particular or uniform attributes to them. The following description is typical, but by no means exclusive, of new generation cooperatives. The innovations of new generation cooperatives on cooperative characteristics are not solely financial. New generation cooperatives are noted here because their financial aspects gain the most attention.

1. Structure

The cooperative creation process typical of new generation cooperative formation begins with a group of farmers who wish to capture the profits of value-added operation that converts their produced commodity into a higher-value product. The needed processing facility is expensive and requires substantial equity investment. It also requires an established and regular amount of commodity throughput to maintain efficiency. To meet both requirements, the incipient cooperative matches the amount of product needed and the amount of equity investment needed.

“Delivery rights” are assigned to equity so that a certain amount of delivery will accompany a certain amount of equity investment. Prospective cooperative members agree to purchase the proportion of equity matching the equity requirement. Not only do delivery rights permit the member to deliver the specified amount of product, the member is required to do so. When that total delivery rights are combined, the efficient product needs are met, and when the total equity investments are combined, the total equity needs are met.
New generation cooperatives also typically require up-front equity investment so that at the initiation of the cooperative it will have sufficient equity capital to build or purchase the plant. Membership is limited because it is directly tied to delivery.

Another typical characteristic of the new generation cooperative is that of tradeable equity. The equity associated with delivery rights may be sold from one producer to another, who purchase the equity and obtains the relevant delivery rights. The rather unique feature of this process is that the value of the equity/delivery rights transferred is a matter of agreement between seller and buyer. Some new generation cooperatives have actively accepted investment by those who are not patrons of the cooperative. However, “outside” equity is not a hallmark of new generation cooperatives.

New generation cooperatives are said to be more market oriented than more traditional cooperatives because they establish a specific structure and strict rules based on what the cooperative can profitably market, what the cooperative can produce in response, and base commodity acceptance on the cooperative’s need rather than the general offering of members.

Several conditions exist that make new generation cooperatives attractive. These include:

1. The desire on the part of producers to capture value-added benefits;
2. High capital requirements;
3. Commitment to an efficient processing system;
4. Response to market signals;
5. Product differentiation – from a commodity to a unique product;
6. Failure of an efficient market chain system.

Examples of some new generation cooperatives include:

Ethanol/biomass
Aquaculture
Speciality cheeses
Swine processing
Bison processing
Cattle feedlots
Soybean processing
Corn processing
Goat/sheep processing
Pasta production
Beer manufacture
Cattle processing
Sugar beet processing
Wine production
2. Issues

Several recurring issues are present in a new generation cooperative. Included are:

1. The “selecting-out” problem where all producers except those with investable funds are excluded from participation and benefits;

2. Limits on governance, particularly where the cooperative engages in processing and marketing far beyond the personal capabilities of the members and the board of directors;

3. A producer portfolio problem because the investing producers are investing in the same industry upon which their farming operation depends, eliminating counter cyclical investment portfolios;

4. The various members may have significantly different motivations for participation, especially where the desire for equity appreciation conflicts with a desire for returns from product delivery;

5. Promoter-driven establishment were those wishing to sell the plant, and perhaps operate it for the cooperative, and the driving force and the cooperative is only a tool to reach promoters’ goals;

6. Outside equity is sometimes obtained introducing obligations to the equity-holders and a mix of entity objectives; and

7. The “growth-at-any-cost” syndrome has caused problems for some new generation cooperatives as they grew beyond the bounds of the original purposes for which they were formed and became more oriented toward the growth objectives of management rather than the income-producing objectives of producers.

3. Experiences

Experiences with new generation cooperatives are growing in number and variety. As such experiences become more numerous and the variety of events expands, study of the examples will lead to lessons not only about such cooperatives but about several aspects of the cooperative character. Existing literature on new generation cooperatives provides a starting point for such lessons.  

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Examples of publications of various kinds on new generation cooperatives include the following: Baarda, James R., “Book review of Merrett, Christopher D., and Norman Walzer (Eds.). A Cooperative Approach to Local Economic Development. Westport, Conn.: Quorum (2001),” 17 J. Cooperatives 49 (2002); Bernardi, Adrienne, and Kimberly Zeuli. A Survey of New
B. Restructuring Finance

Cooperatives may respond to the need to change by restructuring certain aspects of their financial system. For purposes of this Paper, restructuring is not limited to an existing cooperative that changes its method of operations. It includes the use of methods that are sometimes not commonly used by cooperatives or are used in a different way. The purpose of the very brief notes in this subsection is to suggest that cooperatives are able to make significant responses to a wide range of requirements by designing financial systems accordingly.

1. Allocation

As previously described, equity contributed by members is usually allocated to the members based on their additions to capital. This means that the cooperative can identify the contributions of individual members and, depending on the revolving system, redeem equity at some point in the future.

Such is not the case for “unallocated” equity. Unallocated equity is an aggregate indication on the balance sheet that identifies equity that is not identified with a particular member.

Unallocated equity has played varying roles in cooperatives ranging from mere incidental accounts on the balance sheet to a substantial portion of a cooperative’s capital structure. It stands somewhat between member-patron based equity and outside equity for some purposes, though when analyzed some of its characteristics are more closely allied with member-patron equity and some are more akin to non-cooperative corporate equity. Because of this intermediate
status, unallocated equity is treated at this juncture in the continuum of cooperative financing options.

As the case with many financial terms, “unallocated equity” describes a collection of equity types. The central feature for purposes of this analysis is that the interest represented by unallocated equity is not identified as belonging to any specific member or patron. This is in sharp contrast with membership equity or patron-based equity as previously discussed. In addition, unallocated equity is not equity interests contributed by investors who are neither members nor patrons of the cooperative.

i) Generating Unallocated Equity

Unallocated equity\(^{71}\) is generated from margins from cooperative operation. In broad terms, it is retained operating profit, neither paid as patronage refunds, allocated as retained patronage refunds or per unit retains, or paid as dividends on capital stock.

Retained earnings added to unallocated reserves may come generally from three sources. The cooperative may generate income that cannot be allocated to patrons as patronage refunds and receive the tax treatment of patronage refunds. Such “non-patronage sourced” income does not qualify as income that can be distributed as patronage refunds under Subchapter T requirements. Rather than distribute such income to patrons either in proportion to use or as dividends on capital stock, the cooperative retains the income in the unallocated reserve account as unallocated equity.\(^{72}\)

A second general source of income added to unallocated equity is income generated from business with those to whom the cooperative does not pay patronage refunds though it could if it so desired. Rather than distribute the income so generated to those with whom it conducts business, the cooperative retains the margins as unallocated equity. A typical distinction occurs where the cooperative pays patronage refunds to patrons who are members of the cooperative but not to those who are not members, though they deal with the cooperative.

\(^{71}\) Unallocated equity is sometimes referred to a “tax paid equity” or “tax paid reserves” because it does not qualify for deduction by the cooperative as a non-cash portion of a deductible patronage refund or per unit retain. The more general term “unallocated reserve” is sometimes used to describe such equity, as is “permanent capital.” Reasons and implications of the various terms will become clear as features of unallocated equity is described.

\(^{72}\) The cooperative could distribute such amounts after taking them into account as taxable income if it chooses, and some cooperatives do so. For the most part, however, if a cooperative does not wish to add to unallocated equity is will reduce or eliminate its non-patronage sourced income where possible.
A cooperative may also not allocate and pay all of its patronage-sourced income as patronage refunds, setting aside a certain amount for unallocated reserves. In so doing, the cooperative eschews a deduction for such amounts and closes off the opportunity for any future single-tax treatment as well. The cooperative may have specific purposes for such reserves, typically a contingency of some kind.

These three sources of unallocated equity are not the only ones, of course, and cooperatives exhibit great variety and flexibility in their financial structure overall. Implications of the sources from which cooperatives generate unallocated equity are noted in following discussions where appropriate.

The Financial Profile of cooperative for 1997, the most recent set of data available for all cooperatives, records distributions of cooperatives’ net income to unallocated equity. Rathbone and Wissman report that in 1997 15.2 percent of aggregate cooperative income was added to unallocated equity. The report compares additions found in previous financial profile studies, shown in Figure 1.

The authors point out that because additions to unallocated equity are related to the amount of non-member or non-patronage business, in years following those in which cooperatives generally have reduced net income or actual losses in patronage business, unallocated equity reserves are rebuilt in following years, identified as the cause for the dramatic increase for the 1987 survey year. Distribution to unallocated equity comprised 6.1% of net margins in 2001 and 18.6% of net margins in 2002 for the top 100 agricultural cooperatives.

ii) Extent of Unallocated Equity Use

The degree to which unallocated equity makes up cooperatives’ financial structure is

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reported in several surveys of cooperative structure and profiles. The most common sources of such information are from USDA.

The financial profile of cooperatives for 1997 shows that unallocated equity comprised 23.5% of all cooperative equity. The report further describes the variation across principle products and services. Figure 2 shows unallocated equity as a percentage of total equity for product and service breakdowns. Figure 3 shows gives similar data by cooperative size.

More recent research by USDA addresses the extent of unallocated equity among the largest 100 agricultural cooperatives. For the “Top 100” in 2002, unallocated equity comprised 16.5 percent of the cooperatives’ total equity.

It is clear that unallocated equity has played and is continuing to play a significant role in the capital structure of many cooperatives, though the mere presence of unallocated equity does not explain why it exists and how it is used by cooperatives.

iii) Use of Unallocated Equity

Generation of unallocated equity is an intentional action. Where unallocated equity is generated from non-patronage business or from non-members to whom no patronage refund is paid, the decision is part of the method of doing business decided upon by the

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cooperative. The cooperative need not engage in such practices. Even where generation of non-patronage income is a natural and essentially unavoidable part of the cooperative’s business, the resulting income could be distributed to patrons on a patronage basis or distributed as dividends on capital stock after tax payment by the cooperative. At the same time, business and pricing practices that ultimately fund unallocated reserves may be made primarily for other reasons, with the generation of unallocated reserves occurring as a consequence, not a driving force.

Cooperatives may have several reasons for creating and maintaining unallocated equity. Perhaps the most important is as a reserve in case the cooperative suffers an operating loss. Losses present cooperatives with several distinct problems not generally found in non-cooperative corporations. A non-cooperative business generally recognizes a loss by reducing its equity accounts, normally the retained profits account. Income tax law offers methods to carry losses back and forward to lessen tax burdens associated with years in which taxable income was generated.

Cooperatives face additional problems of handling losses generated from patronage business. One set of problems is how to handle the losses for tax purposes, given tax law descriptions of the patronage relationship required for cooperative single tax treatment. Another problem, more serious for principles and practices purposes, is how to account for the losses due to business between cooperative and patron. If cooperative operating principles are followed strictly, the burden of loss for a particular year falls directly on patrons for that year. Cooperatives may opt to reduce unallocated equity reserves to avoid direct and immediate monetary impact on patrons.

A somewhat more general incentive for cooperative unallocated equity relates to the problem of “permanent” capital in cooperatives. Member-patron equity is temporary in the sense that it belongs to the member-patron and will be returned to the member-patron by the cooperative at some point in the financing cycle, whether in a revolving system or base capital plan. This process makes matching obligations incurred from the cooperative investment in long-term assets with finances that support such investments. A cooperative’s obligations may extend well beyond the life cycle of patronage-based investment. Unallocated equity avoids that problem by representing capital that has no termination time or even a process for distribution. In this regard, unallocated equity is the same as retained earnings in a non-cooperative corporation.

2. Revolving Periods

Revolving periods are a problem for cooperatives for a number of reasons. One method of responding to capitalization needs is to reduce the length of the revolving period. At some point this issue blends with the base capital plan.

3. Value and Markets

As has been noted, where the equity investment in a cooperative is treated like an investment in another organization or security, one aspect of the total shareholder return is an increase in the value of the instrument as measured in the market place. The two requirements for realization of total shareholder value is that the equity be tradeable to someone else and that the price of the equity in the transaction is responsive to the market place. Neither is present where transfer is restricted or where the value of the trade is specified such as the price paid in the first instance.

Some cooperatives are avoiding these issues and placing value on the equity through a market mechanism. Many new generation cooperatives are using this method, although it is not a necessary aspect of the new generation cooperative structure. Tradability and market pricing have raised concerns central to the issues addressed in this Paper. Any consideration of such issues must directly address the new practices.

4. Permanent Capital

Cooperatives have combined the need for capital with the desirability of permanent capital and responded by issuing equity interests with no redemption provisions, or at least with no provisions of the kind usually found for cooperative equity based on the patronage relationship.

Cooperatives issue preferred stock in a number of circumstances for varying purposes. Preferred stock may be issued directly to members, may be issued as part of the patronage refund process, may be used as a second-stage equity where the equity began as another form of obligation, or may be issued to non-members. The main concern of this Paper is the distinction between the first three forms of preferred stock creation and the last.

The generation and character of preferred stock is subject to so much variation that no single definition will properly convey the nature of preferred stock. General principles are discussed first, followed by more specific variations that cover preferred stock features of most significance for purposes of this report. A few example cooperative uses are then noted. Central to any discussion of preferred stock is identification of the rights, preferences, and restrictions

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78 See discussion on equity redemption issues in Section V, subsection B.
related to the stock. Preferred stock is distinguished from common or membership stock in important rights, preferences, and restrictions. Preferred stock is not merely a “version” of common stock, it is quite distinct in several critical regards including the nature of the obligations of the corporation to the stockholder discussed further below.\textsuperscript{79}

Preferred stock is issued directly by the firm, whether a non-cooperative corporation or a cooperative, in shares. Preferred stock is investment in the firm evidenced by stock shares. Owners have rights defined by the cooperative, the most evident being rights to receive defined dividends. Preferences in preferred stock give stockholders preference to the net earnings of the corporation and preferences for redemption superior to holders of common stock where corporate assets are insufficient to satisfy all investors. Restrictions apply to preferred stock. Holders of preferred stock have only very limited rights to vote defined by the charter. Holders of preferred stock are also not holders of residual interests in the firm that gives them rights to more than the initial investment

Two generally applicable features of dividends rights in preferred stock define the most important character of the stock. Dividends are typically described in terms of an established and stated rate of return on the investment. This rate is not a residual based on net earnings but is an obligation to be satisfied before dividends are paid on common stock. In the case of cooperatives, dividends are obligations to be satisfied before determining distributions to member/patrons before calculation of amounts available for payment of dividends on capital stock, where used, or for patronage refunds. Dividend rights are often cumulative. If dividends are not paid in some years, all dividends on the preferred stock are cumulated for those years and...

\textsuperscript{79} The Official Comment to § 6.01. Authorized Shares of the Model Business Corporation Act affirms that some terminology is outdated because stock specifications may no longer clearly distinguish between common and preferred stock. It states:

Section 6.01 adopts a new terminology from that traditionally used in corporation statutes to describe classes and series of shares that may be created, but makes only limited substantive changes from earlier versions of the Model Act. Traditional corporation statutes work from a perceived inheritance of concepts of “common shares” and “preferred shares” that at one time may have considerable meaning but that today often do not involved significant distinctions. It is possible under modern corporation statutes to created classes of “common” shares that have important preferential rights and classes of “preferred” shares that are subordinate in all important economic aspects or that are indistinguishable from common shares in either voting rights or entitlement to participate in the assets of the corporation upon dissolution. The revised Model Act breaks away from the inherited concepts of “common” and “preferred” shares and develops more general language to reflect the actual flexibility in the creation of classes and series of shares that exists in modern corporation practice. The words “common shares” or “preferred shares” are no longer used in the revised Model Code...."
must be satisfied in total before common stockholders may receive a dividend. Preferred stock is now seldom issued to the public by corporations but privately placed convertible preferred stock is issued in the start-up stages of small issuers as a form of venture capital.  

Preferred stock is treated by most as an equity investment in the firm but preferred stock has a significant number of debt characteristics. Its debt characteristics include high initial value, regular defined dividends, seniority over common stock at liquidation, and no share of corporate assets beyond redemption at dissolution. Equity characteristics include: Its value represents an equity interest in the cooperative, the payment of dividends are still subject to the board of directors’ declaration and payment, and preferred stock is junior to creditors’ claims at dissolution. Because of the hybrid nature of preferred stock, analysts within the firm need to separately assess the relative position of the holders of preferred stock and the other investors in the firm, including the cooperative’s members.

Preferred stock has traditionally been considered one of the financing options for cooperatives. Most cooperative incorporation statutes specifically authorize preferred stock. Many include reference to member and nonmember stockholders. The exact nature of preferences is not usually detailed in the statute but is typically left to the cooperative in its articles of incorporation.

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80 Mitchell, Lawrence E., and Lewis D. Solomon. *Corporate Finance and Governance.* Durham, N.C.: Carolina Academic Press (1992), p. 545. One of the reasons preferred stock is unattractive for public financing purposes is that the relative costs of capital for preferred stock and for bonds does not overcome the disadvantages imposed on corporations issuing preferred stock because dividends paid on stock are not deductible but payments to bondholders are.

81 Each one of these characteristics is often modified to meet the objectives and requirements of each issue.

82 These, too, can be modified.

USDA’s *Sample Legal Documents*\(^{84}\) gives a somewhat conservative description\(^{85}\) of preferred stock:

*Section 1. Classes and Authorized Amounts.* The capital stock of the association shall consist of shares of common stock with a par value of $____ per share, and _____ shares of preferred stock with a par value of $____ per share.

* * *

*Section 3. Preferred Stock.* The preferred stock of this association may be issued to any person, association, partnership, or corporation.

Preferred stock shall carry no voting rights.

Noncumulative dividends not to exceed _____ percent per year may be paid on preferred stock at the absolute discretion of the board of directors.

Preferred stock may be transferred only on the books of the association. It may be redeemed in whole or in part on a pro rata basis at par, plus any dividends declared and unpaid, at any time on thirty (30) days’ notice by the association, provided said stock is redeemed in the same order as originally issued by years. If the owner fails to deliver any certificate evidencing such stock, the association may cancel the stock on its books.

This association shall have a lien on all of its issued preferred stock for all indebtedness of the holders thereof to the association.

Upon dissolution or distribution of the assets of the association, the holders of all preferred stock shall be entitled to receive the par value of their stock, plus any dividend declared and unpaid, before any distribution is made on the common stock.

Few specific obligations imposed on a firm by issuance of preferred stock are possible because each issue is defined contractually according to the desires and needs of the issuer and purchasing market. Price, dividends, priorities, preferences, and redemption are all defined by terms of the agreement, including the corporation’s charter, that created the stock. Brief


\(^{85}\) More flexible descriptions may (1) reflect the disappearance of “par value” concept in corporate financing, (2) provide more options on the number of shares to be issued, series, and a more open arrangement for timing on issuance, and (3) variations in terms for different series of preferred stock.
discussion of dividends, preferences, and redemption issues suggests the environment in which cooperative-issued preferred stock will exist.

The primary characteristic of dividend payments to holders of preferred stock is that failure to pay dividends will not put the cooperative in default leading to possible dissolution as would failure to make required payments to debt-holders. Under some circumstances, by terms of the stockholding agreement failure to pay dividends for a specified time may give holders of preferred stock the right to select board members.

Cumulative dividends is a peculiar characteristic of preferred stock. However, preferred stock is not required to cumulate dividends and preferred stock may specifically state that it dividends are non-cumulative, as is the situation in the cooperative articles of incorporation sample stated above. Courts have held that where dividends on preferred stock are non-cumulative, the corporation may refuse to pay dividends in years of net earnings and reinvest the funds in the corporation instead.\(^8^6\) The position of holders of preferred stock is that of equity holders, and

When a man buys stock instead of bonds, he takes a greater risk in the business. No one suggests that he has a right to dividends if there are no net earnings. But the investment presupposes that the business is to go on, and therefore even if there are net earnings, the holder of stock, preferred as well as common, is entitled to have a dividend declared only out of such part of them as can be applied to dividends consistently with a wise administration of a going concern.\(^8^7\)

It is true that stockholders are owners of the corporation and expect to share in its profits. ... However, these expectations can be crushed. Stockholders are neither creditors nor money lenders, buy rather investors. ... As investors, the stockholders bear the risk that the company may not make profits in which they can share. ... If the company does make money, the stockholders do have an expectation to share fairly in the corporate fortunes. To share fairly, however, does not mean to share equally if the certificate of incorporation provides that certain stockholders receive preferences over others.\(^8^8\)

In following years, the corporation may pay dividends on common stock without paying arrearages on preferred stock where the preferred stock is non-cumulative. The reinvestments of net earnings that could have been paid as dividends on preferred stock cannot be reversed and

\(^8^6\) Gutmann v. Illinois Central R. Co., 189 F.2d 927 (2d Cir. 1951).


recouped as dividends in subsequent years. Of course, cumulative dividends in arrears must be paid unless the preferred stock is non-cumulative.

Redemption terms are also defined by the preferred stock agreements to varying degrees of specificity. Redemption provisions can be very important for stockholders because the stockholders may have significantly different rights depending on the type of transaction that terminates their interest in the stock. A common dispute involves a merger or reorganization where holders of preferred stock receive either cash or other stock in return for the preferred stock. Courts have frequently found that such termination is not a redemption subject to the terms of the stockholder-corporation agreement regarding either value or dividend payments. Redemption terms are also defined by the preferred stock agreements to varying degrees of specificity. Redemption provisions can be very important for stockholders because the stockholders may have significantly different rights depending on the type of transaction that terminates their interest in the stock. A common dispute involves a merger or reorganization where holders of preferred stock receive either cash or other stock in return for the preferred stock. Courts have frequently found that such termination is not a redemption subject to the terms of the stockholder-corporation agreement regarding either value or dividend payments.

One of the difficulties faced by stockholders in such circumstances is that where corporation statutes authorize several courses of action, the corporation may choose the one most beneficial rather than the one that would lead to stock redemption according to terms of the stockholder arrangement.

The relationship between the corporation and holders of preferred stock is often described as primarily one of contract, unlike the fiduciary relationship with respect to common shareholders. “It is well established that the rights of preferred stockholders are contract rights which the board of directors must respect.” The parties, including the stockholders, depend on the terms of the contract for their rights.

But the preferred stockholders are not – like sailors or idiots or infants – wards of the judiciary. ... To be sure, it is an overstatement that the courts never do more than carry out the intentions of the parties: In the interest of fairness and justice, many a judge-made legal rule does impose, on one of the parties to a contract, obligations which neither party actually contemplated and as to which the language of the contract is silent. But there are limits to the extent to which a court may go in interpolating rights and obligations which were never in the parties’ contemplation.

The relationship, however, is “closer” to that of a fiduciary relationship for preferred stock than for bondholder or other contractual arrangements. In two circumstances courts have been willing to impose fiduciary duties on the corporation. Preferred stock may be convertible to common stock, although this would be unlikely in the case of a cooperative. The redemption right takes the preferred stock toward the position of common stock with attendant fiduciary responsibilities.

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91 Gutmann v. Illinois Central R. Co., 189 F.2d 927 (2d Cir. 1951)
A fiduciary relationship also tends to be imposed when the position of the issuer is one of dominance. As for common stock, in the absence of conflicts of interests the judgment of the majority stockholders and/or the board of directors “is presumed made in good faith and inspired by a bona fides of purpose.” If that presumption is overcome, then the action is measured by an “intrinsic fairness” test.

Generally, under two circumstances holders of preferred stock may vote in the affairs of the corporation. The terms of the stockholder agreement may specify conditions and the extent to which stockholders can cast a vote. Even absent such provisions, statutes may mandate a right to vote upon defined actions by the corporation.

D. Limited Liability Companies

Farmers in many cases have chosen to use a limited liability company (LLC) for joint action rather than a cooperative. This form of organization under described circumstances has become another means to engage in collective action by farmers. While such organizations may have some of the characteristics of a cooperative depending on how it is structured and operated, most are not cooperatives as usually defined.

LLCs are of interest in two situations. The first as just described is where farmers form an LLC for collective action rather than creating a cooperative. The other, noted below, is where two or more cooperatives or a cooperative and another business entity engage in joint activity using an LLC.

One of the concerns expressed by those particularly interested in and committed to the cooperative form of business is that LLCs will be used instead of cooperatives because of their tax advantages and flexibility. Their attractiveness for tax reasons may dominate the attractiveness of cooperatives where the focus is on taxation. This becomes more of a problem where cooperatives are not well understood and where the character of a cooperative is not explained adequately when alternative business forms are being considered.

The following is a brief summary of LLCs with notes on the characteristics relating to their possible use as a means for farmer cooperation. It describes, in order, corporate characteristics, ownership and finance, control and management, allocation and distribution of profits, and tax principles.

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92 Burton v. Exxon Corp., 583 F. Supp. 405 (S.D. N.Y. 1984). Exxon was a majority stockholder of another company, nominated all members of the board of directors, and all members of the board were officers, directors, or employees of Exxon.

1. Structural Characteristics

The first LLC statute was enacted in Wyoming in 1977. The partnership tax treatment so desirable for LLCs was affirmed by the Internal Revenue Service in 1988 and in the following decade most states adopted similar statutes. By 1996, every state had an LLC statute. The National Conference of Commissioners on Uniform State Laws (NCCUSL) promulgated a Uniform Limited Liability Company Act although it was adopted after the first rush of statutes had already been enacted. It appears that the Uniform LLC Act will have added influence as states revisit their LLC statutes. The history explains the variation among states as well as a general trend toward uniformity.

An LLC is a state-authorized, unincorporated association, and is not a corporation. It is a legal structure for organizing a business that provides its owners with the limited liability of a traditional cooperative (and corporation) and the single tax treatment of a partnership. Under a typical state law, an LLC is created by filing articles of organization, comparable to a corporation’s articles of incorporation, with the appropriate state official. Member rights and obligations are set out in a more extensive operating agreement, similar to a partnership agreement or corporate bylaws. The operating agreement covers issues such as management, voting rights, allocation of income and losses, transfer of interest, and member withdrawal.

LLCs are very flexible. The statutes usually establish default rules for structure and operating methods but allow the members themselves to modify the rules, with certain exceptions. Modifications are described in the operating agreement.

The key element for LLCs is the limitation on liability for its members. Without limitation of liability the LLC would offer few, if any, advantages over partnerships. If properly formed and if the necessary formalities are observed, LLC members are not liable for the debts of the LLC entity. As in the case of corporate entities, the limited liability protection for owners

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may be lost under some circumstances. Principles of liability protection are still being developed in law for LLCs but the general trend seems to be that corporate principles are the best guide.

2. Ownership and Finance

Owners of an LLC are called “members”, as in a cooperative. However, unlike in a cooperative the members’ relationship with the LLC only need be that of ownership and control. Use of the LLC is not part of the ownership and finance formula. LLCs do not issue stock and different terminology may be used to refer to member investments such as units or percentages of ownership. Members themselves determine the proportion of total financing contributed by each member. It is presumed that an LLC wanting to adopt essentially cooperative features could establish investment proportions along the lines of patronage, or vice versa.

3. Control

Member control of the LLC can be described in two parts – management structure and voting power. LLCs have two options for management structure depending on the statutes and especially on members’ own desires as expressed in the operating statement. The most common statutory model, if not modified by members, creates a “member-management” system. Members have direct management power in the LLC and, more interestingly, each member has the authority to bind the LLC in obligations to other parties. The powers and processes are analogous to a general partnership.

Members may in the alternative choose to use a “manager-management” model in which authority is assigned to one or more managers. This is closer to the familiar board-management system for corporations but no formal board of directors stands between members and management. The operating statement will describe the managers, methods of selection, and the assignment of authority. The LLC’s inherent flexibility makes possible hybrid management systems as well.

Members, of course, carry the right to vote as their means to exercise control over the organization they own. Statutes are split on the default rules to apply to member voting power but in any circumstance the LLC can determine its own system. Some states use a one-member, one-vote rule as a default, others establish voting power based on financial contribution as the default. In either case, the LLC can establish its own system of voting power. It is presumed that LLCs can tailor voting to be similar to that for various cooperative systems as well. The one vote per member is natural. Modifications to vote on a basis related to the amount of business done with the LLC are probably possible given the flexibility exhibited for many LLC decisions.

LLC statutes may prescribe requirements on voting proportions that the LLC cannot change. Requirements for a unanimous vote of members or a supra majority vote for certain
events and decisions may be required. Such voting requirements may have significant impacts on the LLC’s decision-making process especially in the big decisions.

4. Benefits Allocation and Distribution

Some state LLC statutes presume as a default that profits or losses will be allocated to LLC members on an equal basis. Others establish as a default allocation profit or loss allocation in proportion to investment. In either case, members may establish other plans for profit distribution. It is presumed that an LLC has the flexibility to base allocations of profit to members in proportion to their use of the cooperative.

Actual distribution of the allocated profit is particularly important for careful consideration. Generally, when profit is allocated to an LLC membership it will be taxed to the member regardless of any cash received. If an allocated amounts are not actually distributed to the members in a timely manner, or are not distributed at all (retained as additions to capital), members will not receive cash sufficient to meet their tax obligations.96

5. Taxation

Earnings and losses pass through an LLC to the owners for federal income tax purposes under IRS administrative rules. The LLC itself incurs no taxes as a separate business entity. Rules established by the LLC for allocation of profits and losses will generally determine the allocations under the tax rules although certain restrictions may apply. The tax code does not contain any provisions for LLCs comparable to Subchapter T for cooperatives and the LLC is actually less flexible than a cooperative in balancing member-entity needs.97 Single tax treatment is generally available at the state level although exceptions exist.

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96 This is analogous to a cooperative’s qualified written notice of allocation paid to patrons instead of cash. Subchapter T requires that to be a qualified written notice of allocation deductible by the cooperative and taxed to the patron recipient, the cooperative must pay at least 20 percent of the total allocation in cash. Non-qualified written notices of allocation allow cooperatives to absorb the taxable income until actually distributed to patrons, an option not available to an LLC.

97 See previous footnote. As another example from the perspective of a member, if a cooperative generated net margins from non-patronage sources, the cooperative will recognize the profit for tax purposes in the year generated. Members, however, will not recognize any income until the cooperative actually pays the amount to members.
6. Use by Farmers

The actual use of LLCs by farmers either as a form of cooperative or as a clear substitute for cooperatives has not been documented. Anecdotal evidence raises concerns about the continued use of cooperatives if cooperative laws are not changed to apply essential LLC principles to a form of cooperative. However, more information is needed to address this issue.98

7. Challenge to Cooperative Form

Observations and opinions are being expressed that unless cooperatives adopt some of the desirable characteristics of an LLC, cooperatives will no longer be used for activities commonly justifying cooperatives.

D. Joint Ventures, Subsidiaries, Alliances

A major but sometimes unexplored or underestimated business organization that allows cooperatives to continue to serve farmer members in the face of massive changes in markets is ancillary organizations such as a jointly owned subsidiary, a joint venture, or a strategic alliance. Cooperatives may use these structures for three purposes related to the subjects noted in this Paper.

Limitations on the scope of cooperative operations may be alleviated by making arrangements with those who can engage in the restricted activity and coordinating operations so that the cooperative can offer goods and services seamlessly. A growing use of special arrangements is responding to demands for non-seasonal supply of seasonal products and demands for full complement services. For example, a cooperative whose producers grow a product only harvested in the Fall may form a joint arrangement with growers or a growers’ association in localities where the harvest for that product occurs in the off-season in another hemisphere. Similarly, a cooperative whose growers produce one variety of a product may joint venture with another organization, whether a cooperative or not, to obtain product that will allow the cooperative to provide a full complement of that product with different varieties. This is frequently demanded by large retail purchasers.

Cooperatives can use various arrangements to grow where size is an important factor in continued success in changing markets. One such practice is for a cooperative to purchase a controlling interest in an existing business that complements the cooperative’s ongoing business. The cooperative thereby obtains access to bricks and mortar facilities, processing capacity, brands and trademarks, expanding markets, and existing expertise without the need to build the

facilities and markets from zero. It may obtain everything needed for strategic expansion without fully committing its financial resources while at the same time investing in endeavors that are already proven and successful. Expansion may be vertical into processing, horizontal with the addition of more capacity and markets, or mixed by entering new or niche markets.

Farmers may respond to the challenge of obtaining the use of equity capital for a new venture by establishing an organization, separate from but controlled by the cooperative, whose sole purpose is to build facilities needed by the farmers. The farmers create a cooperative whose members are the farmers and that has no outside investment or control. An ancillary business is created that builds and owns the needed facilities. The cooperative and individual farmers may invest in the organization but the major source of investment is from others. The business is contractually obligated to the cooperative to provide services to the cooperative and its members, while the cooperative is obligated to provide compensation adequate to allow competitive returns to investors. In this way the cooperative captures the benefits of investor money but maintains its character as a farmer-owned, financed, and controlled cooperative.

This subject is extremely important but cannot be discussed further at this point. Such arrangements are a major consideration when investigating the capabilities of cooperatives to participate effectively in modern agricultural market places. Evidence points to important opportunities to maintain the cooperative form of business yet overcome many of the perceived limitations on cooperatives as noted elsewhere in this Paper.

E. Two Examples

Farmers have also developed ways to maintain a cooperative form for certain purposes but obtain the benefits of other kinds of organization through coordinated efforts. Two examples show how such systems may be used for various purposes.

1. Investment Vehicle for Non-Farmers

The structure of what comprises a system is made up of five groups and business entities.

1. A Joint Venture through which equity capitalization “will be accomplished.” Equity capital are obtained from two sources – Cooperative and the group of “accredited investors.

2. Accredited investors, individuals who provide equity directly to Joint Venture.

99 Subsidiaries and strategic alliances, with similar overall purposes, have been noted.
3. *Cooperative* that obtain equity investment from member-producers and invest in Joint Venture.

4. *New Markets Investment LLC* used to obtain benefits of Federal new market tax credits.

5. *Operating LLC*, the entity that owns and operates the processing plant.

The total equity capitalization is estimated to be from between $10 million and $12 million. Equity capitalization for Joint Venture is obtained from two sources.

Certain types of investors may purchase equity interests without triggering the full registration and other requirements of Federal securities laws. According to the U.S. Securities and Exchange Commission:

Under the Securities Act of 1933, a company that offers or sells its securities must register the securities with the SEC or find an exemption from the registration requirements. The Act provides companies with a number of exemptions. For some of the exemptions, such as rules 505 and 506 of Regulation D, a company may sell its securities to what are known as "accredited investors."

The federal securities laws define the term accredited investor in Rule 501 of Regulation D as:

- a bank, insurance company, registered investment company, business development company, or small business investment company;
- an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of $5 million;
- a charitable organization, corporation, or partnership with assets exceeding $5 million;
- a director, executive officer, or general partner of the company selling the securities;
- a business in which all the equity owners are accredited investors;
- a natural person who has individual net worth, or joint net worth with the persons spouse, that exceeds $1 million at the time of the purchase;
a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year; or

a trust with assets in excess of $5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

– http://www.sec.gov/answers/accred.htm

Only investors meeting those requirements are allowed to participate.

The second source of equity capital for Joint Venture is the Cooperative. In turn, the Cooperative’s investable funds come from producer members.

Producers invest in the Cooperative in two ways.

a. A membership fee is charged for each member. The membership fee is a set amount but the same amount of credit is given for those who have previously invested. These fees are used to “offset development costs.”

b. Shares of “common stock” are issued at a set amount per share. A specified number of shares are available for the total equity capitalization assuming all shares are purchased by eligible producers. Each member must purchase at least a set number of shares for a determined minimum investment.

Common stock purchase is tied to delivery. Each share of common stock gives the producer the right and obligation to deliver a set amount of product per year depending on plant capacity and market conditions.

Total system requirements are also determined based on plant capacity and market conditions.
Equity capital contributed by the Cooperative members is passed through to the Joint Venture by the Cooperative’s purchase of common stock in the Joint Venture. The Joint Venture invests the equity capital it obtains from the Cooperative and from the accredited investors in two ways.

a. A “portion” of the equity is invested in New Markets Investments, LLC. Through this mechanism tax credits are made available to accredited investors. New Markets Investment, LLC in turn invests proceeds in the Operating LLC.

b. The remainder of the Joint Venture’s equity is invested directly in the Operating LLC.

As a consequence of this system, the Operating LLC, the owner and operator of the packinghouse, ultimately receives the equity capital of producer members of the Cooperative and of the accredited investors.

The total equity capital investment stream is summarized in Figure 17.

The financing system describes returns to the various parties, with ultimate returns to the accredited investors and to the Cooperative member patrons.

Accredited investors receive payments giving them 21% return to their investment in cash, payable in monthly cash installments beginning in year three. These payments are preferred and are limited for tax reasons only subject to net cash flow being available from operations. The Joint Venture, in which they own the preferred stock, is not an operating entity so the operations referred to are those of the Operating LLC. Required payments to accredited investors are not appear to be related to the profitability of the system, only to availability of cash. The
arrangement emphasizes the hybrid character of the equity capital with significant elements of debt obligation characteristics.

Accredited investors receive two benefits in addition to cash payments. They have their equity capital redeemed in seven years (again for tax reasons) at a fixed price based on a target Internal Rate of Return (IRR) on a cash basis. This is not based on the equity value of the Operating LLC nor on the Joint Venture. Thus, even if the capital has diminished during the seven year period, the accredited investors will not suffer any diminution of their returns. In addition, upon redemption and realization of the preferred IRR on their investment, accredited investors will receive a small share in the Joint Venture at no additional cost.

Accredited investors also receive the full benefit of the tax credits as passed through New Market LLC. They are spread over seven years and the seven-year holding period for preferred stock held by accredited investors matches that time period.

Producers who are to invest in the system through their purchase of common stock in the Cooperative are given no described nor specified rights to any returns on their equity investment.

Specified returns on equity are shown in Figure 18.

**Specified Income Streams**

The system must describe where profits and income are generated and how they are allocated and distributed.

The only income stream that is specified is that of the returns on equity capital, but only to the accredited investors. Its only relation to actual earned income and profitable operations is that of a preference.
specification. The operating expenses and generation of gross income are positioned in the Operating LLC. How profit at that level is allocated is not clear.

The farmers’ sole connection with this system is as producers delivering product to the Operating LLC and as beneficiaries of any income generated and returned through the Cooperative. Its position in the system, its structure, and its relationship to farmer members and others is therefore determinative of the farmers position and the character of the benefits farmers themselves receive from this business system. To the extent that the cooperative is in a disadvantageous position in the system, farmer producers are placed in a poor position as well.

The Cooperative is somewhat similar to so-called “new generation” cooperatives but with some variations that are of interest. Producer member investment requirements have been mentioned previously. Investment is tied to delivery rights and obligations. However, the delivery rights and obligations can be “leased” to others who can deliver to the cooperative. This causes a distinct separation of investment and patronage. The concerns are best demonstrated by comparing this with our general understanding of what makes a cooperative unique.

Applying the basic cooperative principles noted above leads to some concerns with this arrangement.

1. The User-Owner Principle: Those who own and finance the cooperative are those who use the cooperative.

2. The User-Control Principle: Those who control the cooperative are those who use the cooperative.

3. The User-Benefits Principle: The cooperative's sole purpose is to provide and distribute benefits to its users on the basis of their use.

No single structure is required to meet the principles as outlined. However, investigation of the “economic realities” of an organization gives a good idea of its cooperative character as long as the emphasis is on the position of members. A summary of the principles in application is shown diagrammatically in Figure 19. The key feature is the inseparability of ownership, control, benefit, and use.

To the extent that farmers provide equity capital to the cooperative (finance) and

Figure 19. Cooperative Principles
transfer their use of the cooperative to others, the bond between ownership and patronage is broken. When this is coupled with a poorly defined method of generating and returning benefits in proportion to patronage, the bond between use and benefit is likewise broken. Whether the organizational system described here meets the principles of cooperative operation is to be determined and may lead to differences of opinion.

2. Organizational Combinations for Product and Market Development

It may be beneficial to use a combination of organizational types to achieve an overall goal that extends somewhat beyond individual farmers’ interests. In the example given here, crucial involvement of the public sector created the need to form different kinds of organization. Goals extended to revitalize agriculture in an urbanizing area, obtain the support of the community both through public funding and private investment, and provide opportunities for farmers to become an integral part of the overall mission.

The structure is comprised of three organizations.

1. A Nonprofit organization with public purposes, access to funds available only to a non-profit organization, and with access to the services of a university’s research arm to develop new commodities to be grown in the region as well as new market development.

2. An Operating LLC that purchases farm commodities, processes commodities into innovative products, develops markets for those products, and generates profits.

3. A Cooperative financed by farmers that handles the farmer commodities, sells the commodities to the Operating LLC or independently, provides selected services to farmer members, and allocated income to farmers on a cooperative basis.

The Nonprofit organization represents a wide range of interests. These include plans to develop facilities designed to inform the public about agriculture and food, promote agriculture in the region, and develop commodities and products. The latter is achieved by close connections with the local university to develop new varieties of several important crops that may be of higher value than traditional crops in the area. In addition, the Nonprofit works with various institutions to develop new processes for adding value to farm commodities. The Nonprofit establishes relationships with State and regional promotional arms with special interest in developing international markets for products.

As a nonprofit organization, the Nonprofit has access to a variety of public funds from Federal, State, and local sources. It works closely with other nonprofit organizations with analogous purposes.
The Operating LLC processes commodities into value-added products, many of which are marketed at the retail level with brand names. The products are both commodities and specialty products.

The Operating LLC is financed by a limited number of substantial investors for securities laws purposes. Initial investment is encouraged partly as a means to obtain returns on equity but also as a vehicle that local individuals with substantial wealth can invest in preserving the communities and way of life they find desirable.

The Cooperative is made up of farmer members who agree to participate in the cooperative according to certain protocols. Specified investment is required that will vary depending on the level of the Cooperative’s services and capital needs. Identity preservation and quality control are paramount. The Cooperative provides certain services not appropriate for the LLC.

The Operating LLC purchases product from the Cooperative or in some circumstances directly from farmers. Its margin is allocated among its investors and the cooperative by agreement. Cooperative margins are allocated to farmers on a cooperative basis.

**Figure 20. Organization Combination for Multiple Purposes**
VII. New Statutes – State Developments

A. Development of Contemporary Statutes

Cooperative principles, originally formulated as self-governing rules, have found their way into the legal structures by which cooperatives are organized and operated. Cooperative businesses, whose taxation is described in this publication, are corporate bodies and look to States for authorization. States, through incorporation laws, create corporate existence and extend benefits and restrictions to corporate entities. This is also true for cooperative corporations, but because they differ in important ways from non-cooperative corporations, statutes giving cooperative corporations authorizations differ from non-cooperative business corporation statutes.

1. Primary Cooperative Characteristics

All States have recognized cooperatives' special characteristics by enacting statutes specifically designed for incorporating cooperatives. The 50 States have approximately 85 such statutes at the present time. These statutes, taken as a whole, supply the single most comprehensive description of the cooperative form of business enterprise. Universal existence of special cooperative incorporation statutes, along with their descriptions of cooperative rules, structure, and operation make State cooperative incorporation statutes a useful source of information about cooperatives. They also, of course, are first sources of law to which practitioners turn.

Cooperative incorporation statutes address the important principles, although there is wide variation among statutes about what is an appropriate subject of statutory law and how the issue is handled. When statutes and principles coincide, some features of the cooperative are

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100 This section relies on Baarda, James R., *Cooperative Principles and Statutes: Legal Descriptions of Unique Enterprises*, U.S.D.A., Agric. Coop. Service, Research Rept. No. 54 (March, 1986). Numerous changes have occurred in statutes in the last 20 years so the exact numbers of statutory provisions identified for each issue may not be accurate.

reduced from general principles of structure, finance, and operation to specific rules. Which are important depends upon the issue being addressed.

Many statutes make broad statements about overall cooperative purposes that clearly indicate the nature of cooperatives. Three formulations of cooperative principles are reflected in these broad statements:

1. The basic purpose of a cooperative is to render economic benefits to its members.
2. Cooperatives are organized around the mutual interests of members.
3. Cooperatives are essentially nonprofit enterprises in the sense that they are not organized to make monetary gains for cooperatives as legal entities or for their members as investors, but primarily for all patrons as users of their services.

Twenty-nine statutes in 27 States contain a statement that "[a]ssociations organized hereunder shall be deemed 'nonprofit' inasmuch as they are not organized to make profit for themselves, as such, or for their members, as such, but only for their members as producers." Seven additional statutes describe cooperative associations as nonprofit, giving as reasons cooperatives' primary object is "not to pay dividends on invested capital but render and provide means and facilities by or through which producers of agricultural products may receive a reasonable and fair return for their products."

Many other statutes simply say a cooperative is nonprofit without the reasons given above. Frequently included in State cooperative incorporation statutes is a provision that producers may form a "nonprofit, cooperative association." Forty-one statutes representing 34 States emphasize the nonprofit character of cooperatives by direct statement, while operation for the mutual benefit of members is described as characteristic of cooperatives by other statutes in summary descriptions of a cooperative or in statements about the general character of an organization to which the act applies. Sixty-four statutes include "nonprofit" or "mutual benefit" (or both) descriptions of cooperatives.

The simplicity of mutual benefit and nonprofit statutory descriptions of cooperatives is deceptive. The differences such statements draw between a cooperative and noncooperative corporation are fundamental. The very justifications of the two types of corporate enterprises' existence are basically opposed. Noncooperative corporations' desire to create wealth for

102 This analysis is based on Baarda, James R., Cooperative Principles and Statutes: Legal Descriptions of Unique Enterprises, U.S.D.A., Agric. Coop. Service, Research Rept. No. 54 (March, 1986). Citations to each relevant statutory provision for all States are given in that report.

investors contrasts sharply with cooperative corporations' objects to benefit the users as producers of agricultural products.\textsuperscript{104}

The three principles of member control, distribution of cooperative benefits in proportion to use rather than capital ownership, and limited returns on capital stock have all found their way into the incorporation statutes, although they are not treated uniformly among State laws.

The principle that cooperatives are "democratically controlled\textsuperscript{105}" and "cooperatives are owned and democratically controlled by those who use their services" find its clearest expression in the voting rights assigned to cooperative members.

This principle is seen in incorporation statutes requirement either that each member have only one vote or that voting the based on the amount of business done with the cooperative.\textsuperscript{106} "In either case, universal stock-based voting rules of business corporations are sharply modified to accommodate the 'democratic control' principles of cooperative operation."

Fifty-five statutes in 36 States limit each member to only one vote regardless of how many shares of stock or how much other equity the member holds in the cooperative. The other statutes allow some variations to the one member, one vote rule. The most common is that for voting power based on the amount of business done with the cooperative. A dozen States specifically mention patronage-weighted voting, and if statutes referring specifically to patronage-based voting are added to those giving cooperatives power to use voting based on other than a one member, one vote rule, 28 States have one or more statements under which patronage based voting power is permissible.

The principle that cooperative benefits or surpluses are shared by users on the basis of use rather than capital ownership is fundamental. It is also the principle associated with that part of cooperative structure and operation most closely associated with the things about a cooperative related to income taxation--generation and disposition of revenues -- incorporation statutes noted above pertaining to the "nonprofit" nature of a cooperative and its purposes of mutual benefit to patrons are expressions of this principle. However, many statutory provisions are more specific. A few such provisions are summarized here.


Allocation and distribution of a cooperative's net margins to patrons in proportion to their business with the cooperative can be defined in three parts.

1. Net margins are distributed rather than retained by the cooperative business entity.

2. Net margins are distributed to patrons of the cooperative as users, not investors.

3. Refunds are allocated in proportion to patrons' use of the cooperative.

Fifty-five statutes in 43 States discuss procedures by which net margins are distributed rather than retained as profit by the cooperative. Fifty-two statutes in 41 States give some description of the apportionment process.

Twelve statutes say net margins available for distribution to patrons be apportioned on a "patronage" basis. Twenty describe apportionment on the basis of purchases, sales, business, or other similar terms. Eight statutes include apportionment based on labor or wages.

Twenty-one statutes say apportionment must be made in proportion prorated according to the ratio of an individual patron's business to total business. Allocation on a patronage basis required in other statutes would be calculated similarly. Contract provisions in many statutes also incorporate the patronage based allocation principle.

Forty-six statutes in 40 States permit cooperatives to do business with nonmembers as well as member. In most cases there is no requirement a cooperative deal with nonmembers on a cooperative basis. In all statutes in which a cooperative may do business with nonmembers, cooperatives are required to do at least 50 percent of their business with members.

Analysis of statutory descriptions of net margin distribution processes, and both specific and general rules cooperatives with net margins must follow, leave no doubt cooperative mutual benefit and net margin return principles are clearly incorporated in law. Statutes show considerable variation on how specific or detailed requirements are, and in fact many statutes contain no direct reference to net margins distributions.107

The third of the major cooperative principles is a limitation on the amount of dividends paid on capital stock, distributions of net margins based on ownership rather than use. Fifty-five

statutes place a definite maximum limit on dividends paid on capital stock. Although there are exceptions, most limitations apply equally to common or membership stock and preferred stock.

Stock dividends limitations make up the third and final major traditional principle... This principle has been clearly incorporated into fundamental cooperative law. Dividend limitations complement the overall cooperative nonprofit and mutual benefit rules, and give separate specific rules of conduct easily recognized and applied by corporations operating on a cooperative basis.

2. Cooperative Statutes' Growth

Historical development of cooperative incorporation statutes left its mark upon patterns of present statutes. Cooperative formation and growth, especially in the late teens and early 1920's, created demand for incorporation authority equal to that available to noncooperative corporations, but which formally recognized peculiar characteristics of cooperative enterprise.

The first incorporation statute generally recognized as specifically designed for a cooperative form of business enterprise was enacted in Michigan in 1865. The most influential statute of general application was Wisconsin's 1911 Act permitting persons to "associate themselves as a cooperative association, society, company, or exchange, for the purpose of conducting any agricultural, dairy, mercantile, mining, manufacturing or mechanical business on the cooperative plan." A similar law was adopted by 16 States.

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112 1911, ch. 368, 1911 Wisc. Laws. Except for direct quotes, citations to original acts will not be given.

113 Nourse, The Legal Status of Farmer Cooperation, 46, n. 23 (1927). Hanna, Law of Cooperative Marketing Associations (1931) lists only 13. The 16 listed by Nourse were:
In the same year Nebraska enacted a similar law, followed within a few years in four States.\textsuperscript{114} Vestiges of the Wisconsin Act remain in a significant number of contemporary statutes.

Several nonstock incorporation statutes were adopted during the same period. The California Act of 1909 was such a nonstock act, and was followed in four other states.\textsuperscript{115} A second nonstock law was suggested in 1917 by the U.S. Department of Agriculture.\textsuperscript{116} It was used as a model in six States.\textsuperscript{117}

Nonstock statutes' influence, as well as the relative importance of all other statutes existing in 1920, was overwhelmed by rapid and almost universal adoption of a law drafted by Aaron Sapiro of California.\textsuperscript{118} Sapiro was a dynamic promoter of cooperative marketing efforts. The lasting influence, as well as the relative importance of all other statutes existing in 1920, was overwhelmed by rapid and almost universal adoption of a law drafted by Aaron Sapiro of California.\textsuperscript{118} Sapiro was a dynamic promoter of cooperative marketing efforts. The lasting

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\textsuperscript{114} Colorado and Indiana in 1913, North Dakota in 1915, and Florida in 1917. Nourse, \textit{Legal Status}.

\textsuperscript{115} Florida in 1909, Colorado and New Mexico in 1915, and Nevada in 1921.

\textsuperscript{116} The bill was promoted to meet the requirements of Section 6 of the Clayton Act of 1914 (15 U.S.C. §6 (1982)) for "labor, agricultural, or horticultural organizations, instituted for the purpose of mutual help, and not having capital stock or conducted for profit...." Antitrust protection was extended to stock associations by the Capper-Volstead Act of 1922, Ch. 57, 42 Stat. 388 (codified at 7 U.S.C. §§291, 292)


\textsuperscript{118} This does not mean, however, that other statutes and ideas were simply replaced. Most still exist, usually alongside a Sapiro type statutes, and many are actively used by cooperatives today.
impact of his law was due to its appropriateness to the times,\textsuperscript{119} the need for cooperative incorporation legislation,\textsuperscript{120} and vigorous personal efforts by Sapiro himself.\textsuperscript{121}

With many cooperatives' failure to fulfill hopes held out by Sapiro and his followers, and with changing concepts about what the "cooperative movement" should do, Sapiro's personal influence among cooperatives waned. The laws, however, proved resilient.

So great was the stature of the law Sapiro designed,\textsuperscript{122} it was quickly labelled the "Standard Act."\textsuperscript{123} The statute usually identified as an example of the Standard Act was the Bingham Act in Kentucky,\textsuperscript{124} partly because it incorporated improvements over previous examples of the Standard Act and was the subject of constitutional challenge, the results of which gave an imprimatur of legitimacy to cooperative associations throughout the United States.\textsuperscript{125}

\textsuperscript{119} As an example, many associations were organized to coordinate marketing for a large proportion of a commodity in hopes bargaining power would enhance prices to farmers. A strong marketing agreement between farmer and cooperative was needed to get product commitment for the commodity. Sapiro insisted on strong contract terms in the law, though their "iron clad" characteristics proved weak given economic circumstances and were, in fact, in some ways incompatible with concepts of voluntary cooperatives in the U.S.

\textsuperscript{120} Though incorporation authority was badly needed and provided by Sapiro type laws, almost equal importance was given at the time to legitimizing cooperatives under antitrust and anti-competition laws.

\textsuperscript{121} For comments on Sapiro and his activities see Nourse, \textit{Legal Status}, and Knapp, \textit{The Advance of American Cooperative Enterprise: 1920-1945} (1973).

\textsuperscript{122} Of course, Sapiro did not ignore all existing statutes and write a totally unique law on a clean slate. Most features can be traced to existing laws in some fashion.

\textsuperscript{123} Both Nourse (Nourse, \textit{Legal Status}) and Hanna (Hanna, \textit{The Law of Cooperative Marketing Associations} (1931)) used "Standard Act" to describe the Sapiro formulation. See also Evans and Stokdyk, \textit{The Law of Agricultural Co-operative Marketing}, (1937)

\textsuperscript{124} Adopted in 1922.

\textsuperscript{125} \textit{Liberty Warehouse Co. v. Burley Tobacco Growers' Co-operative Marketing Ass'n}, 276 U.S. 71 (1928).
The Standard Act was adopted rapidly. In 1921, 13 States adopted the Standard Act as the model for their own cooperative incorporation statute.¹²⁶ Five States adopted it in 1922,¹²⁷ fourteen in 1923,¹²⁸ two in 1929,¹²⁹ three in 1925,¹³⁰ and one each in 1927 and 1928.¹³¹ If variations are included in the Standard Act count of States, a total of 46 had adopted some form of the Standard Act by 1930.¹³²

Despite widespread adoptions of similar versions of the Standard Act, a number of scholars encouraged adoption of a truly uniform act in the mid-1930's. In 1936, a draft of a uniform law was approved by the National Conference of Commissioners on Uniform Laws¹³³ and was approved by the American Bar Association.¹³⁴ Though the Uniform Agricultural Cooperative Association Act was touted as an "epochal development"¹³⁵ in cooperative

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¹²⁶ Alabama, Arizona, Arkansas, Georgia, Idaho, Kansas, Montana, North Carolina, North Dakota, Oregon, South Carolina, Texas, and Washington.

¹²⁷ Kentucky, Louisiana, Maryland, Mississippi, and Virginia.

¹²⁸ California, Colorado, Florida, Illinois, Maine, Minnesota, Mississippi, Ohio, Oklahoma, South Dakota, Tennessee, Utah, West Virginia, and Wyoming.

¹²⁹ New Jersey and New York.

¹³⁰ Indiana, Nebraska, and New Hampshire.

¹³¹ New Mexico and Rhode Island, respectively.

¹³² For example, variations not counted by Hanna were Pennsylvania, Iowa, Michigan, Nebraska, Wisconsin, Connecticut, and Massachusetts. Hanna, The Law of Agricultural Co-operative Marketing Associations (1931), p. 46, n. 35.


marketing law, it was ultimately adopted in only three States\textsuperscript{136} and was withdrawn in 1943 for lack of significant acceptance.\textsuperscript{137}

The most recent group of related incorporation statutes for cooperatives was initiated in Wisconsin in 1955. The Wisconsin law was followed rather closely by several other States\textsuperscript{138} and has influenced other statutes.\textsuperscript{139} Several other patterns of development are evident from statutory research, patterns whose thorough description must await further statutory and historical research. Valid comparisons of statutes by aggregation of specific provisions characteristics will require application of statistical analytic techniques.\textsuperscript{140}

\textbf{B. History and Status of New Statutes}

Major changes in the statutory recognition of fundamental cooperative principles have challenged current views of cooperatives and have raised the concern of many, some of whom view the statutes as a death knell for “true” cooperatives. Currently, three statutes (in Wyoming, Minnesota, and Tennessee) incorporate the controversial approach and other states are considering similar changes. Iowa has adopted a similar statute. Wisconsin is currently considering legislation along the same lines.

\textit{1. The Wyoming-Minnesota Model}

The first statute of this style was enacted in Wyoming in 2001 without meaningful debate and with little understanding of its implications. At present, it appears that no organizations have incorporated under the act.

\begin{footnotes}
\item[136] Utah in 1939, Maine in 1945, and Hawaii in 1949.
\item[138] North Dakota, Oregon, and South Dakota.
\item[139] Alaska and Hawaii.
\item[140] Of course, for the practicing attorney in search of language in other jurisdictions identical or similar to the local jurisdiction, analysis of statutes will require more than identification of patterns across jurisdictions. It may require nothing less than a search for identical language among statutes on a specific topic.
\end{footnotes}
The most significant of this class of statutes became effective August 1, 2003, in Minnesota. It is significant not only because of the degree to which its content deviates from existing cooperative statutes, but because it was adopted in Minnesota, one of the most important states for agricultural cooperative activity.\textsuperscript{141} Brief notes on its key provisions, those most controversial, are listed following.

1. A cooperative organized under the new statute may have “investor-members” who invest in and own the cooperative but do not patronize it. A key feature of this provision is the amount of outside investment permitted – it appears that a “cooperative” organized under this statute can be almost 100 percent owned by non-farmers, non-producers, or those who have no patronage relationship with the cooperative.

2. As would be expected, such outside investor-owners have a right to the cooperative’s profits, margins that would otherwise be distributed to patrons on a patronage basis. The statutes permit up to 85 percent of the “cooperative’s” profits to be distributed to non-patron investors, distributed, of course, in a manner not reflecting any use of the cooperative.

3. Outside investors may hold up to 85 percent of the voting rights in the cooperative.

4. With respect to the board of directors of such an organization, the law provides that at least 50 percent of the voting power will be held by patron-members, as opposed to non-patron-member directors, but the limit only applies to “general matter of the cooperative.” Thus it appears that the investor-members can effectively control the outcome of key or special matters.

5. The statute provides that members may establish a “bloc” voting system where the patron-members vote as a group and the non-patron-members vote as a group, applicable either to board of director voting or to membership voting.

\textsuperscript{141} CHAPTER 105-H.F.No. 984; An act relating to cooperatives; authorizing businesses to organize as cooperative associations; providing penalties; amending Minnesota Statutes 2002, sections 80A.14, subdivision 17; 80A.15, subdivision 2; 322B.70, subdivision 1; proposing coding for new law in Minnesota Statutes, chapter 322B; proposing coding for new law as Minnesota Statutes, chapter 308B.

308B.201. Organizational purpose. A cooperative may be formed and organized on a cooperative plan for any lawful purpose, including (1) to market, process, or otherwise change the form or marketability of products, including crops, livestock, and other agricultural products, the manufacturing and further processing of those products, other purposes that are necessary or convenient to facilitate the production and marketing of products by patron members and others, and other purposes that are related to the business of the cooperative; (2) to provide products, supplies, and services to its members; and (3) for any other purposes that cooperatives are authorized to perform by law.
6. The “cooperative” can elect to be treated as a partnership for income tax purposes, thus obtaining the advantages of a limited liability company.

7. The statute, a long statute with numerous provisions, contains material on a number of other issues.

2. The Iowa Statute

The most recent statute redefining cooperatives was signed into law May 20, 2005, in Iowa. The law is an act “Relating to the Establishment of a Form of Business Association Referred to as a Cooperative,” adding the “Iowa Cooperative Associations Act” as part 501A.

C. Finance Provisions

Following are selected statutory provisions from the Minnesota statute that relate to financing the organization.

308B.241. Bylaws. Subdiv. 2. Contents. (a) If not stated in the articles, the bylaws must state. ... (2) The capital structure of the cooperative to the extent not stated in the articles, including a statement of the classes and relative rights, preferences, and restrictions granted to or imposed upon each class of member interests, the rights to share in profits or distributions of the cooperative, and the authority to issue membership interests, which may be designated to be determined by the board.

501A.501. ORGANIZATIONAL PURPOSE. A cooperative may be formed and organized for any lawful purpose for the benefit of its members, including but not limited to any of the following purposes:

1. To store or market agricultural commodities, including crops and livestock.
2. To market, process, or otherwise change the form or marketability of agricultural commodities. The cooperative may provide for the manufacturing or processing of those commodities into products.
3. To accomplish other purposes that are necessary or convenient to facilitate the production or marketing of agricultural commodities or agricultural products by patron members, other patrons, and other persons, and for other purposes that are related to the business of the cooperative.
4. To provide products, supplies, and services to its patron members, other patrons, and others.
5. For any other purposes that a cooperative is authorized by law under chapter 499 or 501.
308B.601. Membership interests. Subdiv. 1. Amounts and divisions of membership interests. The authorized amount and divisions of patron membership interest and, if authorized, nonpatron membership interests may be increased, decreased, established, or altered, in accordance with the restrictions in this chapter by amending the articles or bylaws at a regular members’ meeting or at a special members’ meeting called for the purpose of the amendment.

308B.611. Nature of membership interest and statement of interest owned. Subdiv. 6. Specific terms. Without limiting the authority granted in this section, a cooperative may have membership interests of a class or series: (1) subject to the right of the cooperative to redeem any of those membership interests at the price fixed for their redemption by the articles or bylaws or by the board; (2) entitling the members to cumulative, partially cumulative, or noncumulative distributions; (3) having preference over any class or series of membership interests for the payment of distributions of any or all kinds; (4) convertible into membership interests of any other class or any series of the same or another class; or (5) having full, partial, or no voting rights, except as provided in section 308B.555.

Following are selected statutory provisions from the Iowa statute that relate to financing the organization.

501A.506. BYLAWS. Subsec. 2. CONTENTS. (a) If not stated in the articles, the bylaws must state all of the following. ... (2) The capital structure of the cooperative to the extent not stated in the articles, including a statement of the classes and relative rights, preferences, and restrictions granted to or imposed upon each class of member interests, the rights to share in profits or distributions of the cooperative, and the authority to issue membership interests, which may be designated to be determined by the board.

501A.901. MEMBERSHIP INTERESTS. Subsec. 3. AMOUNTS AND DIVISIONS OF MEMBERSHIP INTERESTS. The authorized amount and divisions of patron membership interest and, if authorized, nonpatron membership interests may be increased, decreased, established, or altered, in accordance with the restrictions in this chapter by amending the articles or bylaws at a regular members’ meeting or at a special members’ meeting called for the purpose of the amendment.

501A.903. NATURE OF A MEMBERSHIP INTEREST AND STATEMENT OF INTEREST OWNED. Subsec. 3. TERMS OF MEMBERSHIP INTERESTS. All the membership interests of a cooperative are subject to all of the following: a. membership interests shall be of one class, without series, unless the articles or bylaws establish or authorize the board to establish more than one class or series.
within classes. b. Ordinary patron membership interests and, if authorized, non-
patron membership interest subject to this chapter are entitled to vote as provided
in section 501A.810, and have equal rights and preferences in all matters not
otherwise provided for by the board and to the extent that the articles or bylaws
have fixed the relative rights and preferences of different classes and series.

501A.903. NATURE OF MEMBERSHIP INTEREST AND STATEMENT OF
INTEREST OWNED. Subsec. 6. SPECIFIC TERMS. Without limiting the
authority granted in this section, in regulating the membership interest of a class
or series, a cooperative may do any of the following: a. Subject to the right of the
cooperative to redeem any of those membership interests at the price fixed for
their redemption by the articles or bylaws or by the board. b. Entitle the members
to cumulative, partially cumulative, or noncumulative distributions. c. Provide a
preference over any class or series of membership interests for the payment of
distributions of any or all kinds. d. Convert into membership interests of any other
class or any series of the same or another class. e. Provide full, partial, or no
voting rights, except as provided in section 501S.810.

D. Governance Provisions

Following are selected statutory provisions from the Minnesota statute that relate to
governance:

308B.005. Definitions. Subdiv. 6. Board. “Board” means the board of directors of a
cooperative.

308B.005. Definitions. Subdiv. 15. Member. “Member” means a person or entity
reflected on the books of the cooperative as the owner of governance rights of a
membership interest of the cooperative and includes patron and nonpatron
members.

means a member’s interest in a cooperative consisting of a member’s financial
rights, a member’s right to assign financial rights, a member’s governance rights,
and a member’s right to assign governance rights.

membership interest” means a membership interest that does not require the
holder to conduct patronage business for or with the cooperative to receive
financial rights or distributions.
308B.005. Definitions. Subdiv. 23. Patron membership interest. “Patron membership interest” means the membership interest requiring the holder to conduct patronage business for or with the cooperative, as specified by the cooperative to receive financial rights or distributions.

308B.241. Bylaws. Subdiv. 1. Required. A cooperative shall have bylaws governing the cooperative’s business affairs, structure, the qualifications, classification, rights and obligations of members, and the classifications, allocations, and distributions of membership interests, which are not otherwise provided in the articles or by this chapter.

308B.241. Bylaws. Subdiv. 2. Contents. (a) If not stated in the articles, the bylaws must state. ... (3) a provision designating the voting and governance rights, to the extent not stated in the articles, including which membership interests have voting power and any limitations or restrictions on the voting power, which shall be in accordance with the provisions of this chapter; (4) a statement that patron membership interests with voting power shall be restricted to one vote for each member regardless of the amount of patron membership interests held in the affairs of the cooperative or a statement describing the allocation of voting power allocated as prescribed in this chapter.

308B.401. Board governs cooperative. A cooperative shall be governed by its board, which shall take all action for and on behalf of the cooperative, except those actions reserved or granted to members. Board action shall be by the affirmative vote of a majority of the directors voting at a duly called meeting unless a greater majority is required by the articles or bylaws.

308B.411. Election of directors. Subdiv. 2. Generally. ... (b) A majority of the directors shall be members and a majority of the directors shall be elected exclusively by the members holding patron membership interests unless otherwise provided in the articles or bylaws. (c) The voting authority of the directors may be allocated according to allocation units or equity classifications of the cooperative provided that at least one-half of the voting power on general matters of the cooperative shall be allocated to the directors elected by members holding patron membership interests, or in the alternative, the directors elected by the members holding patron membership interests shall have an equal or shall not have a minority voting power on general matters of the cooperative.

308B.535. Act of members. Subdiv. 2. Class or series of membership interests. In any case where a class or series of membership interests is entitled by this chapter, the articles, bylaws, a member control agreement, or the terms of the membership interests to vote as a class or series, the matter being voted upon must also receive
the affirmative vote of the owners of the same proportion of the membership interests present of that class or series; or of the total outstanding membership interests of that class or series, as the proportion required under subdivision 1, unless the articles, bylaws, or the member control agreement require a larger proportion.

308B.545. Member voting rights. Subdiv. 1. Member has one vote; or patronage voting. A patron member of a cooperative is only entitled to one vote on an issue to be voted upon by members holding patron membership interest, except that if authorized in the articles or bylaws a patron member may be entitled to additional votes based on patronage criteria in section 308B.551. On any matter of the cooperative, the entire patron members voting power shall be voted collectively based on the vote of the majority of the vote cast unless otherwise provided in the bylaws. The bylaws may not reduce the collective patron member vote to less than 15 percent of the total vote on matters of the cooperative. A non-patron member has the voting rights in accordance to his nonpatron membership interest as granted in the bylaws, subject to the provisions of this chapter.

308B.551. Patron member voting based on patronage. Subdiv. 1. Patron members to have an additional vote. A cooperative may authorize by the articles or the bylaws for patron members to have an additional vote for: (1) stipulated amount of business transacted between the patron member and cooperative; (2) a stipulated number of patron members in a member cooperative; (3) a certain stipulated amount of equity allocated to or held by a patron member cooperative in the cooperative’s central organization; or (4) a combination of methods in clauses (1) to (3).

308B.555. Voting rights. Subdiv. 2. Voting power. Unless otherwise provided in the articles, bylaws, or member control agreement, members have voting power as provided in section 308B.545.

308B.555. Voting rights. Subdiv. 3. Nonmembers. The articles or bylaws may give or prescribe the manner of giving a creditor, security holder, or other person a right to vote on patron membership interests under this section.

308B.601. Membership interests. Subdiv. 5. Nonpatron membership interests. If authorized by the articles, the cooperative may solicit and issue nonpatron membership interests on terms and conditions determined by the board and disclosed in the articles, bylaws, or by separate disclosure to the members. Each member acquiring nonpatron membership interest shall sign a member control agreement or agree to the conditions of the bylaws, either of which shall describe the rights and obligations of the member as it relates to the nonpatronage interests,
the financial and governance rights, the transferability of the nonpatron membership interest, and division and allocations of profits and losses among the membership interest and membership classes, and financial rights upon liquidation.

Following are selected statutory provisions from the Iowa statute that relate to governance:

501A.102. DEFINITIONS. Subsec. 5. BOARD. “Board” means the board of directors of a cooperative.

501A.102. DEFINITIONS. Subsec. 15. MEMBER. “Member” means a person or entity reflected on the books of the cooperative as the owner of governance rights of a membership interest of the cooperative and includes patron and nonpatron members.

501A.102. DEFINITIONS. Subsec. 17. MEMBERSHIP INTEREST. “Membership interest” means a member’s interest in a cooperative consisting of a member’s financial rights, a member’s right to assign financial rights, a member’s governance rights, and a member’s right to assign governance rights. “Membership interest” includes patron membership interests and nonpatron membership interests.

501A.102. DEFINITIONS. Subsec. 20. NONPATRON MEMBERSHIP INTEREST. “Nonpatron membership interest” means a membership interest that does not require the holder to conduct patronage for or with the cooperative to receive financial rights or distributions.

501A.102. DEFINITIONS. Subsec. 24. PATRON MEMBERSHIP INTEREST. “Patron membership interest” means the membership interest requiring the holder to conduct patronage for or with the cooperative, as specified by the cooperative to receive financial rights or distributions.

501A.506. BYLAWS. Subsec. 1. REQUIRED. A cooperative shall have bylaws governing the cooperative’s business affairs, structure, the qualifications, classification, rights and obligations of members, and the classifications, allocations, and distributions of membership interests, which are not otherwise provided in the articles or by this chapter.

501A.506. BYLAWS. Subsec. 2. CONTENTS. (a) If not stated in the articles, the bylaws must state all of the following. ... (3) A provision designating the voting and governance rights, to the extent not stated in the articles, including which
membership interests have voting power and any limitations or restrictions on the voting power, which shall be in accordance with the provisions of this chapter; (4) A statement that patron membership interests with voting power shall be restricted to one vote for each members regardless of the amount of patron membership interests held in the affairs of the cooperative or a statement describing the allocation of voting power allocated as prescribed in this chapter.

501A.701. BOARD GOVERSNS COOPERATIVE. A cooperative shall be governed by its board, which shall take all action for and on behalf of the cooperative, except those actions reserved or granted to members. Board action shall be by the affirmative vote of a majority of the directors voting at a duly called meeting unless a greater majority is required by the articles or bylaws.

501A.703. ELECTION OF DIRECTORS. Subsec. 2. GENERALLY ... b. A majority of the directors shall be members and a majority of the directors shall be elected exclusively by the members holding patron membership interests unless otherwise provided in the articles or bylaws. c. The voting power of the directors may be allocated according to equity classifications or allocation units of the cooperative. If the cooperative authorizes nonpatron membership interests, one of the following must apply: (1) At least one-half of the voting power on matters of the cooperative that are not specific to equity classification or allocation units shall be allocated to the directors elected by members holding patron membership interests. (2) The directors elected by the members holding patron membership interests shall have at an least equal voting power or shall not have a minority voting power on general matters of the cooperative that are not specific to equity classifications or allocation units.

501A.705. REMOVAL OF DIRECTORS. Subsec. 3. REMOVAL BY MEMBERS. Any one or all of the directors may be removed at any time, with or without cause, by the affirmative vote of the holders of a majority of the voting power of membership interests entitled to vote at an election of directors, provided that if a director has been elected solely by the patron members or the holders of a class or series of membership interests as stated in the articles or bylaws, then that director may be removed only by the affirmative vote of the holders of a majority of the voting power of the patron members for a director elected by the patron embers or of all membership interests of that class or series entitled to vote at an election of that director.

501A.808. ACT OF MEMBERS. Subsec. 2. CLASS OR SERIES OF MEMBERSHIP INTERESTS. In any case where a class or series of membership interests is entitled by this chapter, the articles, bylaws, a member control agreement, or the terms of the membership interests to vote as a class or series,
the matter being voted upon must also receive the affirmative vote of the owners of the same proportion of the membership interests present of that class or series; or of the total outstanding membership interests of that class or series, as the proportion required under subsection 1, unless the articles, bylaws, or the member control agreement require a larger proportion.

501A.810. MEMBER VOTING RIGHTS. Subsec. 1. MEMBER HAS ONE VOTE OR PATRONAGE VOTING. A patron member of a cooperative is only entitled to one vote on an issue to be voted upon by members holding patron membership interest. However, if authorized in the cooperative’s articles or bylaws, a patron member may be entitled to additional votes based on patronage criteria in section 501A.811. If nonpatron members are authorized by the patron member and granted voting rights on any matter voted on by the members of the cooperative, the entire patron members voting power shall be voted collectively based on the vote of the majority of the vote cast unless otherwise provided in the bylaws. The bylaws shall not reduce the collective patron member vote to less than fifteen percent of the total vote on matters of the cooperative. A nonpatron member has the voting rights in accordance to the nonpatron member’s nonpatron membership interest as granted in the bylaws, subject to the provisions of this chapter.

501A.811. PATRON MEMBER VOTING BASED ON PATRONAGE. Subsec. 1. PATRON MEMBERS TO HAVE AN ADDITIONAL VOTE. A cooperative may authorize by the articles or the bylaws for patron members to have an additional vote for all of the following: a. A stipulated amount of business transacted between the patron member and cooperative; b. A stipulated number of patron members in a member cooperative; c. A certain stipulated amount of equity allocated to or held by a patron member cooperative in the cooperative’s central organization. d. A combination of methods provided in this subsection.

501A.812. VOTING RIGHTS. Subsec. 2. NONMEMBERS. The articles or bylaws may give or prescribe the manner of giving a creditor, security holder, or other person a right to vote on patron membership interests under this section.

501A.901. MEMBERSHIP INTERESTS. Subsec. 2. NONPATRON MEMBERSHIP INTERESTS. a. In order for a cooperative to have nonpatron membership interests, the patron members must approve articles or bylaw provisions authorizing the terms and conditions of the nonpatron membership interests, which may include authorizing the board to determine the terms and conditions of the nonpatron membership interests. b. If nonpatron membership interest are authorized, the cooperative may solicit and issue nonpatron membership interests on terms and conditions determined by the board and
disclosed in the articles, bylaws, or by separate disclosure to the members. Each member acquiring nonpatron membership interest shall sign a member control agreement or agree to the conditions of the bylaws. The control agreement or the bylaws shall describe the rights and obligations of the member as it relates to the nonpatronage interests, the financial and governance rights, the transferability of the nonpatron membership interest, and division and allocations of profits and losses among the membership interest and membership classes, and financial rights upon liquidation.

E. Benefits Allocation Provisions

Following are selected statutory provisions from the Minnesota statute that relate to the distribution of benefits generated by the enterprise, generally referred to as profits.

308B.241. Bylaws. Subdiv. 2. Contents. (a) If not stated in the articles, the bylaws must state: ... (6) if nonpatron membership interests are authorized, a statement as to how profits and losses will be allocated and cash will be distributed between patron membership interests collectively and nonpatron membership interests collectively to the extent not stated in the articles, a statement that net income allocated to reserves shall be distributed on the basis of patronage, and a statement that the records of the cooperative shall include patron membership interest and, if authorized, nonpatron membership interests, which may be further described in the bylaws of any classes and in the reserves.

308B.601. Membership interests. Subdiv. 3. Patron member interests. The patron membership interest collectively shall have not less than 60 percent of the cooperative’s financial rights to profit allocations and distributions. If authorized in the original articles as filed, or articles or bylaws adopted by an affirmative vote of the patron members, or the articles or bylaws are amended by the affirmative vote of patron members, then the cooperative’s financial rights to profit allocations and distributions to patron members collectively may be not less than 15 percent.

308B.601. Membership interests. Subdiv. 5. Nonpatron membership interests. ... If the articles or bylaws do not otherwise provide for the allocation of the profits and losses between patron membership interests and nonpatron membership interests, then the allocation of profits and losses among nonpatron memberships individually and patron membership interests collectively shall be allocated on the basis of the value of contributions to capital made according to the patron membership interests collectively and the nonpatron membership interests individually to the extent the contributions have been accepted by the cooperative.
Distributions of cash or other assets of the cooperative shall be allocated among the membership interests as provided in the articles and bylaws, subject to the provision of this chapter. If not otherwise provided in the articles or bylaws, distributions shall be made on the basis of value of the capital contributions of the patron membership interests collectively and the nonpatron membership interests to the extent the contributions have been accepted by the cooperative.

308B.721. Allocation and distributions to members. Subdiv. 1. Allocation of profits and losses. The bylaws shall prescribe the allocation of profits and losses between patron membership interest collectively and any other membership interests. If the bylaws do not otherwise provide, the profits and losses between patron membership interests collectively and other membership interests shall be allocated on the basis of the value of contributions to capital made by the patron membership interests collectively and other membership interests and accepted by the cooperative. The allocation of profits to the patron membership interests collectively shall not be less than 50 percent of the total profits in any fiscal year, except that if authorized in the original articles as filed or in articles or bylaws that are adopted by an affirmative vote of the patron members or the articles or bylaws are amended by the affirmative vote of the patron members, the allocation of profits to the patron membership interests collectively may not be less than 15 percent of the total profits in any fiscal year.

308B.721. Allocation and distributions to members. Subdiv. 2. Distribution of cash or other assets. The bylaws shall prescribe the distribution of cash or other assets of the cooperative among the membership interests of the cooperative. If not otherwise provided in the bylaws, distribution shall be made to the patron membership interests collectively and other members on the basis of the value of contributions to capital made and accepted by the cooperative, by the patron membership interests collectively, and other membership interests. The distributions to patron membership interests collectively shall not be less than 50 percent of the total distributions in any fiscal year, except that if authorized in the articles or bylaw adopted by the affirmative vote of the patron members, or the article or bylaws are amended by the affirmative vote of the patron members, the distributions to patron membership interests collectively shall not be less than 15 percent of the total distributions in any year.

308B.725. Allocations and distributions to patron members. Subdiv. 1. Distribution of net income. A cooperative may set aside a portion of net income allocated to the patron membership interests as the board determines advisable to create or maintain a capital reserve.
308B.725. *Allocations and distributions to patron members.* Subdiv. 2. *Reserves.* In addition to a capital reserve, the board may, for patron membership interests: (1) set aside an amount not to exceed five percent of the annual net income of the cooperative for promoting and encouraging cooperative organization; and (2) establish and accumulate reserves for new buildings, machinery and equipment, depreciation, losses, and other proper purposes.

308B.725. *Allocations and distributions to patron members.* Subdiv. 3. *Patronage distributions.* Net income allocated to patron members in excess of dividends on equity and additions to reserves shall be distributed to patron members on the basis of patronage. A cooperative may establish allocation units, whether the units are functional, divisional, departmental, geographic, or otherwise and pooling arrangements and may account for and distribute net income to patrons on the basis of allocation units and pooling arrangements. A cooperative may offset the net loss of an allocation unit or pooling arrangement against the net income of other allocation units or pooling arrangements.

308B.725. *Allocations and distributions to patron members.* Subdiv. 5. *Form of distribution.* A cooperative may distribute net income to patron members in cash, capital credits, allocated patronage equities, revolving fund certificates, or its own or other securities.

Following are selected statutory provisions from the Iowa statute that relate to the distribution of profits.

501A.506. *BYLAWS.* Subsec. 2. CONTENTS. (a) If not stated in the articles, the bylaws must state all of the following: ... (6) if nonpatron membership interests are authorized, all of the following: (a) A statement as to how profits and losses will be allocated and cash will be distributed between patron membership interests collectively and nonpatron membership interests collectively to the extent not stated in the articles. (b) A statement that net income allocated to a membership interest as determined by the board of directors in excess of dividends and additions to reserves shall be distributed on the basis of patronage. (c) A statement that the records of the cooperative shall include patron membership interest and, if authorized, nonpatron membership interests, which may be further described in the bylaws of any classes and in the reserves.

501A.901. *MEMBERSHIP INTERESTS.* Subsec. 1. PATRON MEMBERSHIP INTERESTS. Patron membership interests shall be the only membership interest of a cooperative unless nonpatron memberships are authorized under subsection 2. If nonpatron interests are authorized, the patron membership interests collectively shall have not less than fifty percent of the cooperative’s financial rights to profit
allocations and distributions. However, the cooperative’s articles or bylaws may be amended by the affirmative vote of patron members to allow the cooperative’s financial rights to profit allocations and distributions to patron members collectively to by a lesser amount but in no case less than fifteen percent.

501A.901. MEMBERSHIP INTERESTS. Subsec. 2. NONPATRONAGE MEMBERSHIP INTERESTS. a. In order for a cooperative to have nonpatron membership interests, the patron members must approve articles or bylaw provisions authorizing the terms and conditions of the non-patron membership interests, which may include authorizing the board to determine the terms and conditions for the nonpatron membership interests. b. ... If the articles or bylaws do not otherwise provide for the allocation of the profits and losses between patron membership interests and nonpatron membership interests, then the allocation of profits and losses among nonpatron memberships individually and patron membership interests collectively shall be allocated on the basis of the value of contributions to capital made according to the patron membership interests collectively and the nonpatron membership interests individually to the extent the contributions have been accepted by the cooperative. Distributions of cash or other assets of the cooperative shall be allocated among the membership interests as provided in the articles and bylaws, subject to the provision of this chapter. If not otherwise provided in the articles or bylaws, distributions shall be made on the basis of value of the capital contributions of the patron membership interests collectively and the nonpatron membership interests to the extent the contributions have been accepted by the cooperative.

501A.1005. ALLOCATION AND DISTRIBUTIONS TO MEMBERS. Subsec. 1. ALLOCATION OF PROFITS AND LOSSES. If nonpatron membership interests are authorized by the patrons, the bylaws shall prescribe the allocation of profits and losses between patron membership interests collectively and any other membership interests. If the bylaws do not otherwise provide, the profits and losses between patron membership interests collectively and other membership interests shall be allocated on the basis of the value of contributions to capital made by the patron membership interests collectively and other membership interests and accepted by the cooperative. The allocation of profits to the patron membership interests collectively shall not be less than fifty percent of the total profits in any fiscal year, except if authorized in the articles or bylaws that are adopted by an affirmative vote of the patron members, or the articles or bylaws as amended by the affirmative vote of the patron members. However, the allocation of profits to the patron membership interests collectively shall not be less than fifteen percent of the total profits in any fiscal year.
501A.1005. ALLOCATION AND DISTRIBUTIONS TO MEMBERS. Subsec. 2. DISTRIBUTION OF CASH OR OTHER ASSETS. A cooperative’s bylaws shall prescribe the distribution of cash or other assets of the cooperative among the membership interests of the cooperative. If nonpatron membership interests are authorized by the patrons and the bylaws do not provide otherwise, distribution shall be made to the patron membership interests collectively and other members on the basis of the value of contributions to capital made and accepted by the cooperative, by the patron membership interests collectively, and other membership interests. The distributions to patron membership interests collectively shall not be less than fifty percent of the total distributions in any fiscal year, except if authorized in the articles or bylaw adopted by the affirmative vote of the patron members, or the article or bylaws are amended by the affirmative vote of the patron members. However, the distributions to patron membership interests collectively shall not be less than fifteen percent of the total distributions in any fiscal year.

501A.1005. ALLOCATIONS AND DISTRIBUTIONS TO PATRON MEMBERS. Subsec. 1. DISTRIBUTION OF NET INCOME. A cooperative may set aside a portion of net income allocated to the patron membership interests as the board determines advisable to create or maintain a capital reserve.

501A.1005. ALLOCATIONS AND DISTRIBUTIONS TO PATRON MEMBERS. Subsec. 2. RESERVES. In addition to a capital reserve, the board may, for patron membership interests: a. Set aside an amount not to exceed five percent of the annual net income of the cooperative for promoting and encouraging cooperative organization. b. Establish and accumulate reserves for new buildings, machinery and equipment, depreciation, losses, and other proper purposes.

501A.1005. ALLOCATIONS AND DISTRIBUTIONS TO PATRON MEMBERS. Subsec. 3. PATRONAGE DISTRIBUTIONS. Net income allocated to patron members in excess of dividends on equity and additions to reserves shall be distributed to patron members on the basis of patronage. A cooperative may establish allocation units, whether the units are functional, divisional, departmental, geographic, or otherwise. The cooperative may provide for pooling arrangements. The cooperative may account for and distribute net income to patrons on the basis of allocation units and pooling arrangements. A cooperative may offset the net loss of an allocation unit or pooling arrangement against the net income of other allocation units or pooling arrangements.

501A.1005. ALLOCATIONS AND DISTRIBUTIONS TO PATRON MEMBERS. Subsec. 5. FORM OF DISTRIBUTIONS. A cooperative may
distribute net income to patron members in cash, capital credits, allocated patronage equities, revolving fund certificates, or its own or other securities.

**F. Wisconsin Activities**

The Wisconsin legislature has recently passed a bill similar to the above described laws though with some significant changes. It was vetoed on a technical issue and is expected to become law in the near future.
VIII. Proposed Uniform Statute

The National Conference of Commissioners on Uniform State Laws (NCCUSL) created a Study Committee on a Business Cooperative Act to address the possibility of developing a new cooperative law for State consideration. After initial meetings and discussions, the Reporter prepared a draft for the annual NCCUSL meeting July 30 - August 6, 2004. The effort early on focused only on agricultural and agricultural related cooperatives. By resolution of July 26, 2005, NCCUSL’s drafting committee stated:

RESOLVED, that the scope of the drafting committee on agricultural and agricultural related cooperatives act be changed to delete the existing limiting reference to “agricultural and agricultural related” and instead have a broader definitional scope, with specified appropriate exclusions, and that the drafting committee report to the Committee on Scope and Program at the midyear meeting. The committee also recommends the name of the committee be changed to the “Uniform Cooperative Association Act.”

Additional drafts are being considered and prepared for further discussion. The processes of uniform law drafting and recommendations to the states is not a rapid process.

Selected excerpts from the most recent draft follow as suggestions of current views on topics relevant to the subject of this Paper. Any final drafts and recommendations may, of course, differ substantially from those under current discussion.

* * * * *

The definition of “Cooperative” requires activity “pursuant to a cooperative plan.” “Cooperative plan” has intentionally been left undefined based on committee discussion. The term “cooperative plan” appears in other cooperative acts without definition but acting in conformity with a cooperative plan is required for definitional purposes in other law. Thus, a plan is a basic cooperative notion that is not defined or described in this draft.

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144 It was this resolution that prompted response by the six national cooperative organizations noted in the introduction.
A. Governance Provisions

SECTION 115. DUAL CAPACITY.

A person may be both a patron member and a nonpatron member. A person that is both a patron and a nonpatron member has the rights, powers, duties, and obligations provided by this [act] and the organic laws and rules in each of those capacities. When the person acts as a patron member, the person is subject to the obligations, duties and restrictions under this [act] and the organic laws and rules for patron members. When the person acts as a nonpatron member, the person is subject to the obligations, duties and restrictions under this [act] and the organic laws and rules for nonpatron members.

SECTION 312. VOTING BY PATRONAGE MEMBERS.

(a) Each patron member has one vote except the organic rules may provide additional voting power to members on the basis of patronage under Section 313 (a) and may provide for voting by district, group, or class under subsection (b) of this section.

(b) The organic rules may provide for voting by geographical district or other group or class and the voting district, group or class may elect delegates to vote on its behalf at any annual or special members meeting. Delegates shall have one vote subject to Section 313 (b).

(c) If a cooperative has both patron and nonpatron members:

(1) the aggregate voting power of all patron members shall be not less than [two-thirds] [three quarters] of the entire voting power entitled to vote [but the organic rules may reduce the collective voting power of patronage members to not less than a majority of the entire voting power entitled to vote]; and

(2) the entire aggregate voting power of patron members shall be voted as determined by the majority vote of patronage members voting at the members meeting.
Preliminary Comments

The quantum of voting reserved to patron members under Section 312(c) is controversial because it is a departure from the general law of cooperatives. It has been controversial in Committee discussion. It is also one of the primary changes that allows for greater flexibility for capital formation. Other “new generation” cooperative laws are far less restrictive than this draft. For example, Minnesota substitutes fifteen (15) percent for the two bracketed alternatives and the “majority” floor.

* * * * *

SECTION 314. DETERMINATION OF VOTING POWER OF PATRONAGE MEMBER OR DELEGATE.

(a) The organic rules may provide additional voting power be allocated for each patron member for:

(1) actual, estimated, or potential patronage or any combination thereof;

(2) equity allocated or held by a patron member in the cooperative;

[(3) if the patronage member is a cooperative, the number of patron members of the member cooperative]; or

(4) any combination of clauses (a)(1), (a)(2) and (a)(3) of this subsection.

(b) The organic rules may provide additional voting power be allocated to each district group or class or delegate for the aggregate of the number of patron members in each such district, group or class or as provided under subsection (a).

SECTION 315. VOTING BY NONPATRONAGE MEMBERS.

(a) If the organic rules provide for nonpatron members, each nonpatron member has one vote except as otherwise provided by the organic rules.

(b) The collective voting power of nonpatron members is subject to Section 312(c).
SECTION 403. TRANSFERABILITY OF MEMBERSHIP INTERESTS.

Unless otherwise provided in the organic rules and subject to Section 404 [Transfer of Financial Interests] membership interests shall be nontransferable. The terms of the restriction on transferability shall be set forth in the cooperative’s organic rules, the interest transfer records of the cooperative, and shall be conspicuously noted on any certificates evidencing a member’s interest if certificates are provided by the organic rules.

SECTION 404. TRANSFER OF FINANCIAL INTEREST.

(a) A member may transfer its financial interests in the cooperative unless the transfer is restricted by the organic rules. Any restriction on the members’ right to transfer its financial interest shall not be manifestly unreasonable.

(b) The transferee of a member’s financial interest has, to the extent transferred, the right to share in the allocation of surplus, profits or losses and to receive the distributions to the member transferring the interest.

(c) The transferee shall not become a member upon transfer of a member’s financial rights unless it is admitted as a member by the cooperative.

(d) Subject to Section 901, the member transferring the interest shall continue to have the power to exercise its governance rights in the cooperative unless otherwise provided in the organic rules.

(e) A cooperative need not give effect to a transfer under this Section until the cooperative has notice of the transfer.

(f) A transfer of a members financial interest in violation of a restriction on transfer contained in the organic rules is ineffective as to a person having notice of the restriction at the time of transfer.

(g) Unless otherwise provided by the organic rules, the granting of a security interest in the financial interest by a member shall not be considered a transfer for purposes of this Section.

* * * * *
SECTION 601. EXISTENCE AND POWERS OF BOARD OF DIRECTORS.

(a) Each cooperative shall have a board of directors consisting of not less than three directors as provided in the articles of organization.

(b) The affairs of the cooperative shall be managed by, or under the direction of, the board of directors.

(c) A director does not have agency authority on behalf of the cooperative solely by being a director.

SECTION 602. NO LIABILITY AS DIRECTOR FOR COOPERATIVE OBLIGATIONS.

An obligation of a cooperative, whether arising in contract, tort, or otherwise, is not the obligation of a director. A director is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the cooperative solely by reason of being a director or officer.

Preliminary Comments


SECTION 603. QUALIFICATIONS OF DIRECTORS AND COMPOSITION OF BOARD.

(a) The organic rules may provide for qualification of directors subject to this Section.

(b) A director must be an individual.

(c) A director need not be a resident of this state unless otherwise provided in the articles of bylaws.

(d) If provided by the articles of organization or organic rules, one-fifth or less of the board of directors may be directors who are neither members of the cooperative nor designated representatives of members who are not individuals.

(e) No less than two-thirds of the board of directors shall be elected exclusively by patron members.
Preliminary Comments

The allowance of nonmember directors and, conversely, the limitation in subsection (d) need to be discussed.

SECTION 604. ELECTION OF DIRECTORS.

(a) The articles of organization may provide the election of all or a specified number of directors by the holders of one or more groups or classes of membership interest.

(b) The articles of organization or bylaws may provide for the nomination or election of directors by geographic district either directly or by district delegates and if provided shall state:

(1) the number of directors to be elected or nominated by each district;

(2) the manner and method of reapportioning the directors; and

(3) the manner and method of redistricting the geographic territory covered by the cooperative.

(c) Except as provided in subsection (b) directors shall be elected at an annual members meeting.

* * * * *

SECTION 616. VOTING.

(a) Unless otherwise provided in the articles of organization each director shall be entitled to one vote on matters before the board of directors.

(b) The articles of organization may allocate director voting power in any manner provided two-thirds or more of the votes required for action on general matters of the cooperative shall be allocated to directors elected by patron members.

(c) Unless otherwise provided in the articles of organization the board may take action by affirmative majority vote or assent of the director voting power present at the meeting.
Preliminary Comments

Reporter was directed to move the following subsection to a Reporter’s Note as a matter of economy and for further discussion of its necessity.

(d) A director who is present at a meeting of the board of directors when action is taken shall be deemed to have assented to the action taken unless:

(1) the director objects at the beginning of the meeting or promptly upon the directors arrival at the meeting and does not thereafter vote for or assent to action taken at the meeting;

(2) the directors assent or abstention from the action is made in a record

(A) in the minutes of the meeting; or

(B) the director

(i) does not vote for or assent to the action taken at the meeting; and

(ii) delivers notice in a record to the presiding officer of the meeting before adjournment or to the cooperative immediately after adjournment of the meeting.

* * * *

B. Benefits Allocation Provisions

SECTION 804. APPORTIONMENT OF NET PROCEEDS, SAVINGS OR PROFITS.

(a) Subject to subsection (b), the organic rules shall provide the apportionment or allocation of net proceeds, savings, profits or losses between classes, groups or districts of members.
(b) Patron members shall be apportioned not less than 50 percent of the net proceeds, savings, or profits in any fiscal year but the articles of organization may reduce the percentage apportioned to patron members to not less than 30 percent.

SECTION 805. DISTRIBUTIONS AND RESERVES.

(a) Unless otherwise provided in the organic rules, the board of directors may retain or set aside a portion of net proceeds, savings or profits apportioned to patron members for purposes of the following:

(1) to create or accumulate a capital reserve;

(2) to create or accumulate reserves for specific purposes including but not limited to expansion and replacement of capital assets; and

(3) for promoting cooperative organization but the amount set aside for promoting cooperative organization shall not exceed five percent of the annual net proceeds, savings or profits for the last fiscal year.

(b) Subject to subsection (c), distribution of the amount apportioned to patron members in excess of the uses under subsection (a) shall be made at least annually in accordance with the ratio of each member’s patronage during the period to total patronage of all members during that period.

(c) For purposes of apportionment of net proceeds, savings or profits to patron members the organic rules may establish allocation units based on function, division, district, department, or other methods, and may account for and distribute to patrons based on allocation units or pooling arrangements.

(d) Unless otherwise provided by the organic rules, distributions to members may be made in the form of cash, capital credits, allocated patronage equities, revolving fund certificates, or its own or other securities.

Preliminary Comments

Two shadow issues raised by the draft language are: (1) whether the cooperative may allocate or distribute “dividends” based on the amount of apportioned but retained member capital; and (2) Whether the provisions in this Section should expressly apply to nonpatron distributions (is there an “untoward” negative implication in the language used?).
SECTION 806. REDEMPTION OF EQUITY.

Subject to Section 807 and unless the articles of organization otherwise provide, a cooperative may redeem member’s equity upon dissociation of the member. Consideration for such equity shall be the amount of the member’s contributions or fees as previously allocated or apportioned under Section 805 plus any accrued allocations to the member’s equity.

Preliminary Comments

This Section may be needless repetition of other authority for distributions under this draft but, on the other hand, it may make the draft more user-friendly for those cooperatives which contemplate “stock” or certificated interests. It is important to note that this Section is permissive at the discretion of the cooperative and does not give any member a put right.

SECTION 807. APPORTIONMENT OF LOSSES.

Unless otherwise provided in the organic rules, losses shall be apportioned and charged in the same manner as net proceeds, savings or profits.

SECTION 808. LIMITATIONS ON DISTRIBUTIONS.

(a) A cooperative may not make a distribution if after the distribution:

(1) the cooperative would not be able to pay its debts as they become due in the ordinary due course of the cooperative’s activities; or

(2) the cooperative’s assets would be less than the sum of its total liabilities.

(b) A cooperative may base a determination that a distribution is not prohibited under subsection (b) on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances.

(c) Except as otherwise provided in subsection (g), the effect of a distribution under subsection (b) is measured:
(1) in the case of distribution by purchase, redemption, or other acquisitions of a transferable interest in the cooperative, as of the date money or other property is transferred or debt incurred by the cooperative; and

(2) in all other cases, as of the date:

A) the distribution is authorized, if the payment occurs within 120 days after that date; or

(B) the payment is made, if payment occurs more than 120 days after the distribution is authorized.

(d) A cooperative’s indebtedness to a member incurred by reason of a distribution made in accordance with this section is at parity with the cooperative’s indebtedness to its general, unsecured creditors.

(e) A cooperative’s indebtedness, including indebtedness issued in connection with or as part of a distribution, is not considered a liability for purposes of subsection (a) if the terms of the indebtedness provide that payment of principal and interest are made only to the extent that a distribution could then be made to partners under this Section.

(f) If indebtedness is issued as a distribution, each payment of principal or interest on the indebtedness is treated as a distribution, the effect of which is measured on the date the payment is made.

Preliminary Comments

This limiting language is from ULPA (2001) and, generally, cooperative acts do not deal with this issue with this level of detail. Nonetheless, it seems the same policy and governance issues are raised in cooperatives, limited partnerships, and corporations.

This Section also raises another issue specific to this draft: Who is liable? Under typical unincorporated law it is possible to require members to return a proportionate amount of an unlawful distribution. It is one of the few bright-line areas for director liability under corporate law.

* * * * *
IX. Additional Legal Considerations

Much focus and discussion has concerned State cooperative incorporation, limited liability company, partnership, and related statutes. These are not, however, the only expressions of national public policy toward cooperatives. Several statutory structures are particularly important when discussing issues of cooperative governance, finance, and allocation of benefits. Federal laws identified here relate directly to the principles upon which cooperatives are founded.

If cooperatives are changed to a substantial degree two issues are raised. First, organizations operating according to State laws do not necessarily fit within or conform to Federal law requirements affording special recognition to cooperatives. Federal laws contain their own definitions of cooperative organizations and operating on a cooperative basis whether explicitly, implicitly, by reference. Thus it is possible that a “cooperative” for purposes of some laws are not “cooperatives” for purposes of other laws. The second concern is that Federal statutes relating to cooperatives may, for policy reasons, be based on perceptions of cooperatives no longer valid because the character of the organization is changed significantly. Policy-based laws relating to cooperative may be re-considered with the growth of organizations that do not match the spirit or letter of policies expressed in statutes.

Three statutory structures are considered in this Paper. The first is Federal income taxation with a focus on the unique characteristics of the distribution of cooperative benefits to its users on the basis of use, reflecting the user-benefits principle. This is followed by a brief note on antitrust laws and the specifications of the kinds of relationships to whom special antitrust treatment is extended. The securities laws and the fundamental question of the definition of a security are then noted.

A. Federal Income Taxation

Three sources define special treatment that cooperatives receive under the Federal tax laws although the major principles simply follow established definitions of income rather than afford advantageous tax status. Subchapter T of the Code applies to any corporation operating on a cooperative basis. Of course, unincorporated entities operating on a cooperative basis do not fit within this definition. The substance of Subchapter T provisions for purposes of this Paper focuses on the process of determining the tax status of cooperative income that is allocated and distributed to patrons on a patronage basis. The “cooperative process” determines taxability.

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145 Numerous Federal laws apply specifically to cooperatives for one reason or another. These provisions have been compiled by Donald A. Frederick of Cooperative Programs, Rural Development, U.S. Dept. of Agriculture.
A second special reference to cooperative taxation offers very limited advantages to farmer cooperatives meeting strict requirements, the “Section 521” cooperatives. Although denominated “exempt,” these organizations are actually taxable entities. Section 521 goes beyond the income generation and distribution process of Subchapter T and establishes requirements for the organization itself.

Finally, for cooperatives not covered by Subchapter T, long-standing treatment of patronage refunds and related events are recognized as activities whose principles and effects exclude certain gross revenues from taxable income. This historical development draws on the patronage relationship to describe the precise relationship between a cooperative and its patrons - unique to cooperatives and the subject of much of this Paper.

1. The Single Tax Principle

Corporate entities not operating on a cooperative basis are taxed as either “C Corporations” or as “S Corporations.” S Corporations are taxed much like a partnership, with the corporate entity itself paying no tax but with the stockholders recognizing their proportion of the corporation’s income as their own. The benefits of the S Corporation are limited to organizations that can meet the requirements and limitations. C Corporations pay income tax on their entity taxable income. When net income is distributed as a dividend on capital stock, the corporation takes no deduction and the stockholder recipient recognizes the amount received as income. Thus, “double taxation” occurs.

Cooperatives make distributions of their net margins based on cooperative principles described previously. Distributions based on use of the cooperative – patronage – are made as patronage refunds. Under circumstances described below, the cooperative may deduct the amounts so paid and the recipient patrons recognize the income. Unfortunately, the term “patronage dividend” was used in the tax code rather than patronage refund, leading to some initial confusion about dividends and refunds. Cooperatives may make distributions to their member stockholders on an other-than-patronage bases in which case they are treated generally like C corporations. Distributions made as refunds that fail to meet the statutory requirements for a patronage refund will generally be treated as dividends paid on capital stock.146

The result of this simple rule is that income flowing into the cooperative and through to patrons, according to fundamental cooperative principles summarized in the Code, is taxed but once. Only the final recipient of the income, the cooperative's patron, receives income on which tax is to be paid. This tax concept is usually called the "single tax" principle.

146 People’s Gin Co. v. Comm’r, 41 B.T.A. 343 (1940), aff’d, 118 F.2d 72 (5th Cir. 1941); Juneau Dairies, Inc. v. Comm’r, 44 B.T.A. 759 (1941).
2. A Simple Rationale for Cooperative Tax Treatment

Basic cooperative tax principles can best be understood by analyzing their logic rather than treating them as arbitrary rules unrelated to the scheme of Federal income taxation. Cooperatives are given different tax treatment because they operate differently, not because they are thought to deserve special privileges, with the exception of very limited additional deductions given farmer cooperatives qualifying under section 521. A simple analysis is given here to place the technicalities and considerable complexity of cooperative taxation in perspective.

Cooperatives' right to deduct patronage refunds from taxable income is, of course, now a matter of statutory law and requires no further justification or explanation of underlying rationale for that system. However, an inquiry into some of the reasons for the single tax treatment afforded cooperatives' patronage refunds demonstrates the close association between patronage refund taxation and general principles common to taxation generally. It also suggests the foundation for many requirements and definitions found in Subchapter T, and why they are important.

From 1913 to 1962 exclusion or deduction of patronage refunds from a cooperative's income was based on interpretation of generally applicable tax principles to patronage refunds. During this time all the major requirements and definitions of what eventually became subchapter T were developed without separate statutory authority. Rather, the patronage refunds payment system, including noncash refund distribution, was found to have characteristics such that they deserved single tax treatment by general application of tax principles.

Several reasons were proffered to explain and require exclusion or deduction of patronage refunds paid by cooperatives. Discussions of cooperative tax rationale, especially deduction of patronage refunds paid, are found in numerous legal sources, many predating any statutory recognition of patronage refund deductions.

Although several reasons were used to explain patronage refund deductions prior to specific Code provisions, two show how the logic of tax law led to a single tax treatment for cooperatives. The "price adjustment" concept viewed patronage refunds as adjustments to prices cooperatives paid patrons for product delivered to the cooperative for marketing or prices received for supplies provided patrons. For example, a cooperative may receive product and make an advance payment. Then, following its sale of the product, it pays an additional amount to the patron as a patronage refund. Under fundamental tax rules applying to all businesses, a business can deduct expenses incurred, a large part of which may be costs of goods purchased. The price adjustment concept simply said the price the cooperative had to pay for goods received, for which it could take a deduction as any other business, was the advance paid immediately and the refund paid later. The total cost of goods to the cooperative included all payments to patrons for the product delivered. Thus, a logical application of fundamental tax rules applied to all businesses required deduction for patronage refunds.
A second justification for patronage refund deduction (or, more accurately, exclusion) was based on rights patrons had in any income the cooperative might receive. In general, an agent who receives money for sale of someone else's property only on behalf of the property owner does not earn income. The income belongs to the seller, not the seller's agent. This idea was applied to cooperatives obligated to return any income to patrons, circumstances similar to an agent. As a result, if a cooperative was obligated to return all income to patrons the cooperative did not actually receive money as income on its own behalf, but only as an agent acting on behalf of patrons. The patron, not the cooperative, was obligated to recognize income for tax purposes. This concept was the main basis for the legal obligation requirement contained in present tax laws.

3. Comparison With Other Businesses

The assertion is sometimes made that cooperatives receive tax advantages as compared to noncooperative business corporations because they may keep part of a patronage refund without paying tax on it. Corporations, on the other hand, must pay corporate tax on profits generated by the corporation except in the case of the S corporation. Non-incorporated partnerships are not themselves treated as taxable entities. Rather, all of the income for the partnership is attributed directly to the partners who are themselves the taxpayers. Similarly, limited liability companies may be taxed as partnerships even though they possess the limited liability characteristics of a corporation.

Retained patronage refunds and per unit capital retains should not be equated with corporation profit by a cooperative. Rather, they are capital investments in the cooperative by patrons. This concept helps clarify the reason cooperative may deduct patronage refunds even when not all is paid in cash.

For any individual or corporation, taxes apply to "earned income." Contributions to capital occur when investors purchase stock from a corporation. This inflow of money into a corporation is not classified as earned income. When noncooperative corporations receive money for an equity interest in the corporation, it is not taken into account as taxable income.

This is the situation when a cooperative issues written notices of allocation to patrons telling them a certain portion of their patronage refund has been applied as equity in the cooperative. The patrons have effectively received the patronage refund, then invested part of it back in the cooperative's equity structure. No part of the refund, including that retained by the cooperative, is kept as cooperative profit. Rather, the refund is paid by the cooperative and is an investment made by the patron. Just as noncooperative corporations do not recognize money received in exchange for equity purchases as taxable income, so cooperatives do not recognize patronage based exchanges for equity as taxable income.
When the patronage refund process is viewed this way, it is clear that tax rules for cooperative patronage based financing are, in fundamental substance, no different from those for noncooperative corporations.

The substance of all cooperative taxation is contained in the following definition of a patronage refund. Payments to patrons that qualify for this definition are afforded cooperative tax treatment reflecting the single tax principle.

1388(a) Patronage Dividend. - For purposes of this subchapter, the term "patronage dividend" means an amount paid to a patron by an organization to which part I of this subchapter applies -

(1) on the basis of quantity or value of business done with or for such patron,

(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and

(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

4. Basic Tax Rules – Subchapter T

Rules that determine what is taxed can be divided into three general parts for cooperatives. First, the most basic rules apply to patronage refunds paid to patrons. This includes circumstances under which a cooperative may take a deduction when the patronage refund is paid and the taxable nature of the refund when received by a patron. These three processes are noted following.

The second set of circumstances occurs when the patronage refund is paid in a form other than cash or property. This is a very common situation for cooperatives because of the nature of cooperative financing methods. When certain conditions are met, the cooperative and patron are treated as if the entire refund was paid in cash or property. Under other circumstances, only the cash portion of the refund is treated as a refund for tax purposes, with a possibility that it will be treated as a cash refund at some time in the future. Under such circumstances, the final result regardless of timing is for most purposes the same.
The third and final transaction between cooperative and patron occurs when the cooperative redeems the patron’s equity. If the patronage refund generating the equity under the cooperative financing system was treated as a refund deductible by the cooperative and taxable to the patron, no tax consequences occur upon redemption. If, on the other hand, the refund was not qualified for cooperative treatment at the time of the payment, the cooperative takes the deduction and the patron recognizes the income at the time of the redemption.

The detailed mechanics of the three processes are not described here. They are, however, critical for anyone advising cooperatives, patrons, or tax enforcement agencies. Further discussion is contained in Frederick, Donald A. *Income Tax Treatment of Cooperatives: Distribution, Retains, Redemptions, and Patrons’ Taxation*. USDA, Rural Business-Cooperative Service, Cooperative Information Report 44, Part 3 (January 1995).

1382(a) **Gross Income.** - Except as provided in subsection (b), the gross income of any organization to which this part applies shall be determined without any adjustment (as a reduction in gross receipts, an increase in cost of goods sold, or otherwise) by reason of any allocation or distribution to a patron out of the net earnings of such organization or by reason of any amount paid to a patron as a per-unit retain allocation (as defined in section 1388(f)).

(b) **Patronage Dividends and Per-Unit Retain Allocation.** - In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year -

1. as patronage dividends (as defined in section 1388(a)), to the extent paid in money, qualified written notices of allocation (as defined in section 1388(c)), or other property (except nonqualified written notices of allocation (as defined in section 1388(d)) with respect to patronage occurring during such taxable year;

2. in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation which was paid as a patronage dividend during the payment period for the taxable year during which the patronage occurred;

3. as per-unit retain allocation (as defined in section 1388(f)), to the extent paid in money, qualified per-unit retain certificates (as defined in section 1388(h)), or other property (except nonqualified per-unit retain certificates, as defined in section 1388(i)) with respect to marketing occurring during such taxable year; or
(4) in money or other property (except per-unit retain certificates) in redemption of a nonqualified per-unit retain certificate which was paid as a per-unit retain allocation during the payment period for the taxable year during which the marketing occurred.

For purposes of this title, any amount not taken into account under the preceding sentence shall, in the case of an amount described in paragraph (1) or (2), be treated in the same manner as an item of gross income and as a deduction therefrom, and in the case of an amount described in paragraph (3) or (4), be treated as a deduction in arriving at gross income.

The general rule is, not surprisingly, that patrons who receive patronage refunds from their cooperative receive taxable income. Complications develop when the cooperative pays patronage refunds in a form other than money. As we will see, in most circumstances the patron will be required to take into account, for tax purposes, all patronage refunds or per unit retain allocations received in whatever form received. In general, patrons' tax liability will be coordinated with that of the cooperative. If it is deductible by the cooperative it is taxable to the patron, and vice versa.

5. Taxes and Cooperative Finances

Tax laws recognize financing methods cooperatives use that other kinds of businesses do not. This does not mean "special treatment" applied to those methods gives cooperatives "tax breaks." Instead, these rules establish treatment for capital additions to cooperatives similar to that for noncooperative businesses, though additions to a cooperative's capital are made in a different way than are purchases of equity in a noncooperative business.

To put these concepts in perspective, basic tax principles and terminology for cooperatives can be summarized. Then cooperative tax principles can be compared with those for other kinds of businesses to see how the principles are fundamentally similar, though applied in quite different situations. At the same time, it becomes clear that the simple single tax principle for patronage refunds is preserved when investment and refunds are combined in more complicated arrangements common to cooperatives.

Most cooperatives use one of two methods by which patrons invest in the cooperative based on the amount of business each patron does with it. Part of the patronage refund due each patron may be paid in the form of equity in the cooperative rather than in cash. This is generally called "retained patronage refund" financing. A cooperative may also retain from its proceeds a certain amount per unit of product as a patron investment. These are called "per unit capital retains." In either method, patrons finance their cooperative in proportion to use. Tax treatment of per unit capital retains closely tracks that of patronage refunds.
The single tax treatment for patronage refunds applies to refunds even when part is retained by the cooperative, but only if a number of tax law requirements are satisfied. When patronage refunds are not paid entirely in money, the cooperative issues "written notices of allocation" to patrons indicating the amount of refund being retained as patron equity in the cooperative. This is often referred to as the "noncash portion" of the patronage refund. In a typical cooperative financing system, this is added to the cooperative's equity each year and older equity is redeemed as new equity comes in.

6. Taxing Retained Patronage Refunds

Tax rules applied to these arrangements depend on whether a written notice of allocation is "qualified" or "nonqualified." To be "qualified," at least 20 percent of the total refund must be paid in money. Many cooperatives pay more than 20 percent in cash. The average for all cooperatives is about 42 percent.147

Tax law also requires, as a condition for qualification, that each patron consent to take the entire amount of the patronage refund into account as income for tax purposes although as much as 80 percent is not received in cash. Required consent can be given in three ways. A patron may give consent in writing, usually on a form the cooperative provides. An example is a marketing agreement signed by the patron. A second form of consent is through a cooperative's bylaws. Bylaws may contain a consent provision that says anyone who becomes a member agrees to take the entire patronage refund into income for tax purposes, although part is paid in cash and part in written notice of allocation. A copy of the bylaw consent provision must be given patrons when they become members. Bylaw consent is effective only for members.

The third consent form is a "qualified check." At least 20 percent of a patronage refund must be paid in money if a written notice of allocation is to be qualified. The cooperative may write a check for the money portion in "qualified check" form. A qualified check is simply a check upon which consent is printed. If the patron endorses and cashes the check, the patron agrees to include the refund's noncash portion, of which the qualified check is part, in the patron's income for tax purposes. If the patron does not endorse and cash the check, consent is not given and the patronage refund is nonqualified.

If a patronage refund, part of which is paid in cash or qualified check and part of which is paid through a written notice of allocation, is in "qualified" form, the single tax principle for patronage refunds applies. The cooperative may deduct from its taxable income the entire amount of the patronage refund, including both the cash and noncash portions. At the same time, the patron is taxed on the entire amount of the patronage refund, whether received in cash or

noncash form. As a result, only a single entity, the patron who receives the patronage refund, accounts for the income for tax purposes. When the cooperative eventually redeems the equity, it gets no further deduction and equity holders have no taxable income from the cash received at redemption.

A two-step system is used if a written notice of allocation is in "nonqualified" written notices of allocation. The cooperative does not deduct amounts paid in nonqualified form, and patrons do not take them into account in income for tax purposes. This means the cooperative pays income tax on that income at corporate tax rates in the year the income is received. When the retained refund is redeemed, the process is reversed. The cooperative does not deduct amounts paid in nonqualified form, and patrons do not take them into account in income for tax purposes. This means the cooperative pays income tax on that income at corporate tax rates in the year the income is received. When the retained refund is redeemed, the process is reversed. The cooperative then deducts redemption amounts from its income according to alternatives described in the tax law, and patrons pay tax on the amount received upon redemption. This two step system still results in a single tax applied to the refund, with the final burden falling on the recipient patron.

7. A Special Organization – Section 521 Cooperatives

Section 521 of the Internal Revenue Code was also enacted in 1962, as was Subchapter T, and reflects a particular view of farmer cooperatives. Its importance for this Paper is that it gives a very specific and restrictive description of cooperatives eligible for two special tax advantages.148

Section 521(b) Applicable Rules. -

(1) Exempt farmers' cooperatives. - The farmers' cooperatives exempt from taxation to the extent provided in subsection (a) are farmers', fruit growers', or like associations organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.

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148 Most farmer cooperatives do not choose to qualify for Section 521 because the disadvantages of qualification outweigh the limited advantages. However, Section 521 status grants exemptions from parts of the securities laws and some cooperatives are attempting to qualify for that reason. See the section on securities laws below.
(2) Organizations having capital stock. - Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association.

(3) Organizations maintaining reserve. - Exemption shall not be denied any such association because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose.

(4) Transactions with nonmembers. - Exemption shall not be denied any such association which markets the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, or which purchases supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases.

(5) Business for the United States. - Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this section.

Section 1 of § 521(b) defines basic characteristics of the cooperative to which section 521 will apply. As may be expected, it emphasizes the business relationship of the cooperative and its patrons, including the flow of funds through the cooperative to its patrons. Although the language may seem straightforward, its interpretation has led to a substantial list of requirements and prohibitions. Following are the principle requirements as developed from the statute through IRS rulings and judicial decisions. For purposes of this Paper all of the requirements need not be detailed. However, notes on a few emphasize that the term “cooperative” has definite meanings in many contexts and cannot be easily modified by simply changing the name.

i) Membership Limited to Farmers

Section 521 can only be claimed by cooperatives whose members are farmers or fruit growers and “like associations.” This requirement has led to discussions of the type of activity included in “farming” and whether “like associations” expanded the coverage beyond farming if
the business was organized and operated on a cooperative basis. Regulations give general guidelines but specific examples are left to other rulings.

Section 521 status may be claimed by those producing fish on privately owned fish farms but not for supplying commercial fishermen. It may be claimed by those engaged in grazing cattle but not those engaged in the tree growing and lumber business. “Like associations” do not include cooperatives whose members are engaged in non-farming activities.

ii) Organized and Operated on a Cooperative Basis

Section 521 describes the process – marketing producer products and turning back to them the proceeds of sales, less necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by the producer or purchasing supplies and equipment for producers at actual cost plus necessary expenses.

IRS has applied the marketing and supply descriptions somewhat restrictively. However, activities that are an integral part of marketing can be included. The definition of marketing discussed in Rev. Rul. 66-108 “is broad enough to include all activities which are an integral part of the marketing function. Therefore, a cooperative may be exempt under section 521 of the code without actually handling the sale of a product. Adding value to members’ products through a processing activity is a marketing function.

See Frederick, Donald A. Income Tax Treatment of Cooperatives. USDA, Rural Business-Cooperative Service, Cooperative Information Report 44, Part 4 (June 1966) for further discussion

Treas. Reg. § 1.521-1


Rev. Rul. 66-108, 1966-1 C.B. 154 (grove caretaking and harvesting for groveowners not marketing.)


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iii) Members or Other Producers

The “members or other producers” requirement has two implications. The first, addressed here, is that only producers (farmers, etc.) may be patrons. The second, discussed below, is that members and other producers must be treated alike.

Rev. Rul. 67-422, 1967-2 C.B. 217 describes the producer principle, requiring the producer to bear the “risks of production, cultivates, operates, or manages a farm for gain or profit – in short, if he is engaged in the trade or business of farming.” Similarly, one who merely purchases the product and sells it to the cooperative is not a producer because “he fails to take the risks and responsibilities of the owner of a growing crop. The requirement applies specifically to the product delivered and those who are primarily engaged in other activities will not be disqualified so long as the conditions apply to the product. Both landlords and tenants may be producers if they share in the risks of production.158

Products delivered to the cooperative for marketing must be produced the entity delivering that product. Delivery by a non-producer, even if that producer is a member of the cooperative, will jeopardize the status of the cooperative.

iv) Limited Exceptions

A few very limited exceptions to the totally producer requirement have been developed over time. They include.

1. A de minimis rule for very small amounts of non-producer purchase, although the rule cannot be relied upon for any significant purchases.159

2. Emergency purchases made to meet binding contractual obligations “made for the sole purpose of meeting pre-existing contractual commitments to facilitate dealings with member patrons and nor for any purpose of investment or profit.”160 The emergency purchase will be strictly applied and a cooperative may lose its Section 521 status where the IRS determines that a true emergency did not exist.

3. A cooperative qualifying for Section 521 that engages in processing may purchase ingredients for the process that are not purchased on a cooperative basis from producers.

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158 Rev. Rul. 67-422.


However, the “ingredients” may not be products of the same kind produced by those delivering to the cooperative on a cooperative basis. Thus, the ingredients rule cannot be used to purchase non-producer products otherwise prohibited by Section 521.161

4. “Incidental” purchases may be made by a Section 521 cooperative to fill out a product line or directly facilitate the marketing of member/producer products. While early decisions and rulings addressed the incidental purchases rule,162 the key guidance is given in Rev. Proc. 67-37, 1967-2 C.B. 668, discussed in Land O’Lakes, Inc. v. United States, 514 F.2d 134 (8th Cir. 1975), rev.g, 362 F. Supp. 1253 (D. Minn. 1973), cert. denied, 423 U.S. 926.

v) Equality of Treatment

The “members or other producers” terminology in Section 521 applies the cooperative relationship to members and non-members alike. As a result, a Section 521 cooperative must treat members and non-members alike with respect to all of its cooperative dealings, including returns of patronage refunds. The principle is summarized in the following treasury regulation:163

If the proceeds of the business are distributed in any other way than on such a proportional basis, the association does not meet the requirements of the Code and is not exempt. In other words, nonmember patrons must be treated the same as members insofar as the distribution of patronage dividends is concerned. Thus, if products are marketed for nonmember producers, the proceeds of the sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association.

The variety of circumstances in which this requirement becomes an important consideration for an association considering Section 521 status is discussed in Frederick, Donald A. Income Tax Treatment of Cooperatives. USDA, Rural Business-Cooperative Service, Cooperative Information Report 44, Part 4 (June 1966).

vi) Control and Membership

The stock ownership provisions of Section 521 have several implications. The limitation on returns to equity capital is an objective measure, though not necessarily simple in


Of greater implication for policy considerations is the requirement for certain relationships between member (stockholder) and cooperative as a reflection of the organization’s cooperative character. This is reflected in two requirements.

First, substantially all of the stock in a Section 521 cooperative must be owned by those who patronize the cooperative. An 85% rule has been developed by the courts over a period of time.

Second, such stock ownership can be counted only for active members – members who use the cooperative. Individuals who do not actively patronize the cooperative cannot be counted as members of the cooperative and their rights to vote must be removed according to rules developed over a period of time.

vii) Numerical Requirements and Restrictions

Section 521 specifies several quantitative limitations that are generally strictly interpreted. Among them are the 50 percent member business rule for both marketing and supply functions and the 15 percent rule allowing limited purchases for persons who are neither members nor producers.165

B. Antitrust

Over a period of time, judicial decisions established interpretations and “working rules” for application of the Sherman Act and subsequently the Clayton and Federal Trade Commission Acts. The progress of the interpretations showed no special protection for farmers’ cooperative marketing nor did it establish any rules that would apply in a special manner to cooperative marketing. In fact, some of the rules were directly applicable to the central methods of operation of farmer cooperatives.

The Sherman Act prohibits monopolization and restraint of trade, separating the two offenses by section. Monopolization and restraint of trade describe different actions or patterns of behavior. They are associated, however, because restraint of trade actions may lead to monopolization.


Several judicial decisions have parsed legislative history to determine the meaning and scope of the Capper-Volstead Act. A general Congressional purpose to give “individual farmers ... through agricultural cooperatives acting as entities, the same unified competitive advantages – and responsibility – available to businessmen acting through corporations as entities” was noted in *Maryland & Virginia Milk Producers v. United States*, 362 U.S. 458, 466 (1960), a decision containing an extensive discussion of the Act’s development. The 5th Circuit Court of Appeals in *National Broiler Marketing Ass’n v. United States*, 550 F.2d 1380 (5th Cir. 1977), aff’d, 436 U.S. 816 (1978), the Supreme Court in *Case-Swayne Co. v. Sunkist Growers, Inc.*, 389 U.S. 384 (1967) and in *National Broiler Marketing Ass’n v. United States*, 436 U.S. 816 (1978) considered the legislative history of the Capper-Volstead Act to determine the nature of producing entities that the Capper-Volstead Act was intended to protect.

1. Capper-Volstead Act


**CAPPER-VOLSTEAD ACT**

42 Stat. 388 (1922)

§ 1. Authorization of associations; powers (7 U.S.C. § 291)

Persons engaged in the production of agricultural products as farmers, planters, ranchmen, dairymen, nut or fruit growers may act together in associations, corporate or otherwise, with or without capital stock, in collectively processing, preparing for market, handling, and marketing in interstate and foreign commerce, such products of persons so engaged. Such associations may have marketing agencies in common; and such associations and their members may make the necessary contracts and agreements to effect such purposes: Provided, however, that such association are operated for the mutual benefit of the members thereof, as such producers, and conform to one or both of the following requirements:

First. That no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own therein, or,

Second. That the association does not pay dividends on stock or membership capital in excess of 8 per centum per annum.

And in any case to the following:
Third. That the association shall not deal in the products of nonmembers to an amount greater in value than such as are handled by it for members.

Protection of the Capper-Volstead Act has several prerequisites. Individuals to whom the Act is directed are identified and distinguished from others who cannot obtain Capper-Volstead Act protection. The Act lists actions that may be taken pursuant to the Act. Certain structure is required in the joint actions such as “mutual benefit of the members,” voting, and limits on non-member business.

2. Qualifications for Capper-Volstead Act Protection

By its terms, the Capper-Volstead Act applies only to “persons engaged in the production of agricultural products ... .” The Act does not use the term “cooperative.” The focus is on the marketing process and on those who may engage in the protected collective activity.

Agriculture is changing dramatically, and with the changes come new issues of when the 80-year-old Capper-Volstead Act is central to coordinated pricing or other practices that would be, but for the Capper-Volstead Act protection, illegal under antitrust laws. The growth of integrated production systems and contract agriculture are just examples of such changes. The character of a cooperative member and the nature of the membership relationship are relevant for inquiry.166

3. Relevant Antitrust Issues

It is not the intent of this Paper to make any judgments or suggestions about specific qualifications to meet statutory requirements for purposes of the antitrust laws. The following two sections simply note subjects that may be considered by cooperatives and their advisors as they determine the form of organization most appropriate for collective farmer action. An immediate issue is the implication for Capper-Volstead Act protection of various involvements of outside equity holders in a cooperative. More broadly, where statutory or other policies open a cooperative to outside ownership with varying degrees of control, whether explicit or implicit, do cooperative participants lose a natural form of protection imposed by the more traditional cooperative-oriented policies.

In keeping with the themes of this Paper, discussion will revolve around characteristics of ownership, control, and distribution of benefits. The Capper-Volstead Act, in particular qualification for the protection of the Act, contains explicit descriptions or requirements on some aspects of the three characteristics and may implicitly contain descriptions or requirements of others.

i) Problematic Activities

The Capper-Volstead’s prohibition on cooperatives engaging in any activity prohibited absent the protections of the Act with organizations that are not cooperatives is a reminder that the purposes of the Act are strictly enforced. Farmers afforded Capper-Volstead Act protection through the mechanism of a cooperative may not involve non-protected entities in the cooperative endeavors. Cooperative members may not, individually or through their cooperative, engage in any concerted activities with non-cooperative entities if that action would otherwise be prohibited by the antitrust laws.

One issue raised by outside equity holders is the possibility that such equity holder’s participation in the cooperative may, under some circumstances, establish means by which the prohibitions of Borden are compromised. If an owner that is not a farmer member of the cooperative is engaged in its own marketing activities and joint ownership interests in the cooperative make coordination of pricing or other marketing practices with the cooperative possible, the cooperative may not be able to guarantee that it represents only the interests of its farmer members and is not colluding with the outside investor as prohibited by Borden.

A related issue, though quite distinct in its approach, is the strict limitation of cooperative membership to producers of agricultural products. The specification that “[p]roducers engaged in the production of agricultural products as farmers, planters, ranchmen, dairymen, nut or fruit growers may act together in associations ...” has been applied to eliminate from cooperative membership any person or organization that is not a producer. The leading decision, also issued by the U.S. Supreme Court, is National Broiler Marketing Ass’n v. United States, 436 U.S. 816 (1978), stated that if even one cooperative member is not a producer of agricultural products, the Capper-Volstead Act protection is lost for all members. Other decisions have taken the same position (Case-Swayne v. Sunkist Growers, 389 U.S. 384) and have followed National Broiler (United States v. Hinote, 823 F. Supp. 1350 (S.D. Miss. 1993).

The as yet unanswered question for purposes of this Paper is whether the character of the non-patronizing investor/member makes a difference. The producer cases all involved non-producers who are engaged in the agricultural product supply chain by marketing a product at some level. Their participation in the cooperative was used in some way to engage in practices such as market coordination and joint product pricing that would have been prohibited save for the protections of the Capper-Volstead Act. Equity investors in a cooperative may not be the type of entities engaged in practices that need Capper-Volstead Act protection. The significance of how such equity investors participate in the cooperative leads to the next issue.

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167 The leading decision on this subject was issued by the U.S. Supreme Court in United States v. Borden, 308 U.S. 188 (1939)
As previously stated, the Capper-Volstead Act allows only producers of agricultural products to act together in associations to collectively process, prepare for market, handle, and market their products. No other entities are included in the specific identification of those who can act together. If an outside investor is deemed to be participating in the processing, etc., of producer products by reason of his or her share of ownership through investment and share of control through rights to vote, the exclusiveness of the Capper-Volstead Act is drawn into question.

The final concern noted in this Paper relates to the mutual benefit requirement in the Capper-Volstead Act. The Act provides that “such associations are operated for the mutual benefit of the members thereof, as such producers....” Given the narrow interpretations given of other restrictive terms, the requirement that a cooperative be operated for the mutual benefit of its members as producers of agricultural products may be expected to receive similar gloss. The question then becomes, at what point will an organization whose returns on equity go not to producers but to outside investors fail to meet the mutuality requirement? If, for example, three fourths of the benefits generated by a cooperative from business with producer members go not to those producers but to outside investors, is the organization “operated for the mutual benefit of its members ... as producers of such products....”?

ii) Legislative Understanding and Intent

The extensive legislative history of the Capper-Volstead Act\textsuperscript{168} shows that the antitrust protections extended to farmers allowing joint actions not permitted to other entities, is based on a careful consideration of the type of association farmers can use to coordinate their marketing activities. Principles of ownership, control, finance, allocation of benefits, and preservation of the cooperative for farmer marketing purposes are inherent in the public policy demonstrated in the Capper-Volstead Act. The issue for consideration in current debates simply poses the problem: If public policy is based on specific concepts of what cooperative associations are, and if principles explicit or implicit to those concepts are not met by organizations termed “cooperatives” by laws outside the purview of the Federal legislative system, will public policy changes be called on to further restrict antitrust protection for cooperatives?

C. Securities

As with income tax and antitrust laws, laws that regulate various aspects of the issuance and trading of security interests in a business shed light on policy considerations of ownership and control – the primary subject of this Paper. This section summarizes how the basis for securities law relates to cooperative principles and exemptions in unique and informative ways.  

Securities laws regulate various aspects of securities transactions. Regulation is based fundamentally on the premise that individuals are responsible for their own decisions after consideration and analysis, whether or not decisions are wise. It assumes also that the quality of information upon which individuals base their decisions is critical and can be the specific subject of regulation to support individuals’ decision-making authority. In addition, the assumption is made that markets for securities are prerequisite to efficiency in securities transactions, in valuing enterprises, and in enabling investor-oriented capitalistic economies. Cooperatives use different  

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financing instruments to obtain the capital necessary to carry on their business activities. Methods of financing are becoming more imaginative and perhaps further removed from the types of arrangements addressed by cases listed herein as discussed in this Paper. Therefore it is necessary to consider the application of rules relating to securities to cooperatives' financing instruments in a changing context.

Securities regulation is complex, and only a few general principles can be noted. As with taxation and antitrust issues, this Paper makes no attempt to suggest conclusions about the applicability of laws discussed nor of implications for various financing and governance structure. The purpose is simply to explore connections between selected financing methods and the ownership and control principles found in cooperatives as distinct cooperative principles.

This section is divided as follows: General information summarizing securities law purpose is noted; principles of ownership and the securities laws are described, followed by similar treatment related to organizational control. Finally, public policy toward cooperatives is noted in the special exemptions for cooperatives.

Securities laws focus on individual responsibility, the requirement for adequate and accurate information upon which individuals base investment information, transparency in markets, and efficient markets for security interests as enforced by registration and reporting requirements. If an ownership interest represented by a security does not require regulatory protection by its character, the usual rules do not apply.

Several broad questions define relevant issues.

1. Is a particular instrument a security for purposes of securities regulation?
2. Are there exemptions for cooperative instruments that would otherwise be regulated as securities?
3. To what instruments do exemptions apply, if not to all?
4. What is the extent of the exemptions?
5. What is the difference between issuing instruments that are not securities and issuing securities that are exempt?

The critical importance of determining the status of an instrument issued by a cooperative is highlighted by four factors:

1. The severity of implications of a securities problem for the cooperative and its members, as well as personal liability of the directors, officers, and advisors;
2. The increasing scrutiny of all types of financial arrangements as a general phenomenon in business, whether based on statutes, common law doctrines, corporate principles, or general tendency to seek a source of compensation for losses;

3. The increased complexity of cooperative finance, particularly for those venturing into new forms of cooperatives; and

4. The severe losses, in some cases resulting in bankruptcy, faced by some highly visible cooperatives that result in not only a loss of equity investment by farmers in the cooperative but loss of community presence, employment, and services.

1. Is It a “Security”?

Two key judicial decisions distinguish cooperative corporate business from other businesses. The conclusion is that the instrument issued by the cooperative with defined characteristics under carefully defined conditions is not the kind of instrument contemplated in securities laws. It is not, therefore, a security subject to the laws’ regulatory system. The governing decision is United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 95 S.Ct. 2051, 44 L.Ed.2d 621 (1975).[^170]

Exemption concerns and the distinctions between statutory exemptions and non-exempt activities are eliminated if the instrument is not a security at all. The 1975 United States Supreme Court decision defined the essence of a security and relate the principle features of an instrument with those characteristics deemed in need of attention for the protection of investors. The cooperative was a housing cooperative whose residents purchased stock as a prerequisite to living in the cooperative. The argument was made that the stock was necessarily a security subject to regulation because “stock” is statutorily defined as a security. After considering the character of the cooperative, underlying economics of the transactions, and the motivations and

This test, in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. By profits, the Court has meant either capital appreciation resulting from the development of the initial investment, as in Joiner, supra (sale of oil leases conditioned or promoters' agreement to drill exploratory well), or a participation in earnings resulting from the use of investors' funds, as in Tcherepnin v. Knight, supra (dividends on the investment based on savings and loan association's profits). In such cases the investor is "attracted solely by the prospects of a return" on his investment. Howey, supra, at 300, 66 S.Ct., at 1103. By contrast, when a purchaser is motivated by a desire to use or consume the item purchased -- "to
occupy the land or to develop it themselves," as the Howey Court put it, ibid. -- the securities laws do not apply. See also Joiner, supra.

– United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 95 S.Ct. 2051, 44 L.Ed.2d 621 (1975) [footnotes in original, renumbered]

The principles established by the Supreme Court in United Housing were soon applied to a farmer cooperative with similar results. A Federal District Court in Louisiana found investments in a farmer cooperative were not securities.

In searching for the scope of the word "security", name or form should be disregarded, and the emphasis placed on economic reality. The stock certificate here denotes nothing more than membership in the cooperative. It has none of the characteristics associated with the concept of a security. It is non-negotiable, bears no dividends, can only be owned by a member and can only be transferred with approval of the board of directors.

Nor do I find a share of stock in St. James an "investment contract" as contemplated by the Acts. The proper test in this regard is whether the stock reflects an investment of money in a common enterprise with profits to come

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171 In some transactions the investor is offered both a commodity or real estate for use and an expectation of profits. See SEC Release No. 33-5347, 38 Fed. Reg. 1735 (Jan. 18, 1973). See generally Rohan, The Securities Law Implications of Condominium Marketing Programs Which Feature a Rental Agency or Rental Pool, 2 CONN. L.REV. 1 (1969). The application of the federal securities laws to these transactions may raise difficult questions that are not present in this case.

172 In Joiner, 320 U.S., at 348, 64 S.Ct., at 122, the Court stated: "Undisputed facts seem to us however to establish the conclusion that defendants were not as a practical matter offering naked leasehold rights. Had the offer mailed by defendants omitted the economic inducements of the proposed and promised exploration well it would have been a quite different proposition." This distinction was critical because the exploratory drillings gave the investments "most of their value and all of their lure." Id., at 349, 64 S.Ct., at 123. The land itself was purely an incidental consideration in the transaction.


solely from the efforts of others.\textsuperscript{175} The term "profits" means a participation in earnings resulting from the use of the investors' funds.\textsuperscript{176} The distinguishing feature of a security transaction is that the investor is motivated solely by the prospects of a return on his investment from the efforts of third persons.\textsuperscript{177} However, when a purchaser is motivated by a desire to use what he has purchased, the securities laws do not apply.\textsuperscript{178}

Equity credits or patronage dividends are not profits similar to income from ordinary stock investments but are rebates or refunds to members based solely on patronage and not on the amount of money invested in the stock.\textsuperscript{179} A member accrues no equity credits if he produces no cane or if the association sustains a loss.\textsuperscript{180}

The fundamental characteristics [sic] of an agricultural cooperative is that it is operated for the mutual benefit of its members as producers – not as stockholders. Advantages which accrue to a member of a cooperative accrue primarily because of his patronage with the association and not because of any financial investment he may have made therein.\textsuperscript{181}

It is readily apparent that local sugar cane farmers purchasing shares of stock in the defendant cooperative did not believe that they were purchasing investment securities. The inducement to purchase was membership in an association that would provide the sugar cane farmer with services he might not otherwise obtain

\textsuperscript{175} \textit{S.E.C. v. Howey}, supra.

\textsuperscript{176} Id.

\textsuperscript{177} Id.

\textsuperscript{178} \textit{Tcherepnin v. Knight}, supra; \textit{United Housing v. Forman}, supra.


\textsuperscript{181} \textit{Co-operative Grain and Supply Co. v. C.I.R.}, Cir. 1969, 407 F.2d 1158, 1163.
These principles are described and relied upon in United Housing, B. Rosenberg, as well as other decisions and no-action letters from the Securities and Exchange Commission.


2. Objectives and Expectations

The key distinction between member/patron investment in their cooperative and the investment of others is one of objectives. In particular, it is the combination of ownership and benefit principles. In a cooperative, members invest in the cooperative to obtain the benefits of services rendered to themselves cooperatives.\(^{182}\) This contrasts with investors who invest to obtain benefits of returns as dividends paid to stock-holders or the enhancement in the value of the investment as measured in equity markets. Securities law views the cooperative member as unique. Relationship established by cooperative principles are the very reason for the investment instrument’s identity as something other than a security despite similarities in name and form.

Outside investors in a cooperative fall outside the scope of the member/patron described in United Housing and B. Rosenberg. They do not invest for the purpose of benefitting from services provided because they do not stand in the relation of a patron. The cooperative character, as carefully defined by the Supreme Court in United Housing, fails. All duties imposed by securities laws on organizations that issue securities apply to the cooperative absent specific exemptions noted below. With abandonment of the principles that define a cooperative in terms of use, ownership, control, and finance, the organization abandons the characteristics that distinguish it from any other business organization relying on outside investment.

3. Control and Ownership

Judicial discussions of the character of cooperative investments also include certain characteristic of cooperative control in addition to a focus on mere investment. If simple voting power were the only criteria to determine if a security qualified as a security, any investments carrying the right to vote would not be a security. Some additional control features associated with investment in a cooperative are determinative of the status of member/patron investment in the cooperative. These features focus on the combination of control and user benefit found in cooperatives as defined in basic cooperative principles.

United Housing and B. Rosenberg draw from the “efforts” test of Howey concluding that investments in a cooperative do not reflect investment of money in a common enterprise with

\(^{182}\) These principles are described and relied upon in United Housing, B. Rosenberg, as well as other decisions and no-action letters from the Securities and Exchange Commission.
profits to come solely from the efforts of others. It is the efforts of the membership itself that sets the course of the cooperative. The court in *B. Rosenberg* determined specifically that only a patron could be a member, membership lapsed for non-patronage, and membership was not tradeable. The court also noted that the complaining former member had himself actively engaged in the cooperative’s affairs by participating in meetings and voting on a major purchase in question. This entire control structure is distinguished from the control of a non-cooperative entity.

4. Statutory Exemptions

Cooperatives are exempted from identified securities laws requirements when securities are issues as provided in the following sections.

**SECURITIES ACT OF 1933**  

§ 77c. Classes of securities under this subchapter  
(15 U.S.C. § 77c)

(a) **Exempted securities.** Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:

(5) Any security issued

(A) by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution, or

(B) by (i) a farmer's cooperative organization exempt from tax under section 521 of Title 26, ...

**SECURITIES EXCHANGE ACT OF 1934**  

§ 78l. Registration requirements for securities  
(15 U.S.C. § 78l)

(g) Registration of securities by issuer; exemptions

(1) Every issuer which is engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce shall --

... register such security by filing with the Commission a registration statement ... .
(2) The provisions of this subsection shall not apply in respect of --

(E) any security of an issuer which is a "cooperative association" as defined in the Agricultural Marketing Act, approved June 15, 1929, as amended [12 U.S.C. 1411 et seq.], or a federation of such cooperative associations, if such federation possesses no greater powers or purposes than cooperative associations so defined.

(F) any security issued by a mutual or cooperative organization which supplies a commodity or service primarily for the benefit of its members and operates not for pecuniary profit, but only if the security is part of a class issuable only to persons who purchase commodities or services from the issuer, the security is transferable only to a successor in interest or occupancy of premises serviced or to be served by the issuer, and no dividends are payable to the holder of the security.

Exemptions noted are from specific statutory requirements. However, a security exempt from defined requirements for registration is not necessarily exempt from other requirements of the statute such as those pertaining to fraud or other prohibited practices.

For purposes of this Paper, the important fact about the exemptions is that exemptions only apply to organizations meeting the definition of a cooperative, albeit the two provisions use two different definitions. It is interesting to speculate whether the exemptions were devised under the assumption that instruments found by the Supreme Court not to be securities were thought to be securities at the time the laws were formulated. The alternative would suggest that exemptions were established because instruments issued by cooperatives may not have the characteristics identified in United Housing.

D. Summary

Income tax, antitrust, and securities laws each have their own focus on one or more particular characteristics of an organization that make it a cooperative. The totality of the three seems to clearly reflect the exact characteristics summarized in cooperative principles. The following table suggests the multi-dimensional relationships between cooperative principles and selected statutory systems that address cooperatives.
Table 1. Recognition of Cooperative Principles in Selected Statutes

<table>
<thead>
<tr>
<th>Principle</th>
<th>Taxation</th>
<th>Antitrust</th>
<th>Securities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. The User-Owner Principle:</strong> Those who own and finance the cooperative are those who use the cooperative.</td>
<td>Subchapter T refunds taxation requirements Section 521 requirements</td>
<td>Requirement that it be a producers’ organization</td>
<td>Security definition – Ownership limited to users of services; limited tradeability</td>
</tr>
<tr>
<td><strong>2. The User-Control Principle:</strong> Those who control the cooperative are those who use the cooperative.</td>
<td>Section 521 voting rights limitations, 50 percent rule</td>
<td>Limited to producer members Voting requirements and limitations</td>
<td>Security definition – No profits solely from efforts of others; direct participation</td>
</tr>
<tr>
<td><strong>3. The User-Benefits Principle:</strong> The cooperative's sole purpose is to provide and distribute benefits to its users on the basis of their use.</td>
<td>Subchapter T definitions and requirements Section 521 refund and equality of treatment provisions</td>
<td>Mutual benefit of members as producers; collective action on producers’ products</td>
<td>Security definition – Purpose of investment only to obtain benefits as patron</td>
</tr>
</tbody>
</table>
X. Concerns, Issues, and Controversy

As a general observation, responses to the major changes outlined in this Paper may fall in a range between two types. On the one hand, observers may accept the changes unreservedly and focus primarily on how farmers, cooperatives, advisors, and policy-makers can adopt and implement the new ideas in policy and practice. In this group are those who act as driving forces or those who directly facilitate such changes. On the other hand, observers may take a more critical approach and investigate the impacts on farmers and cooperatives, negative as well as positive, if fundamental changes were adopted as advocated by some. In either case, those in leadership positions can only be of effective service to farmers and cooperatives by seeking to understand thoroughly the implications of changes and ways that

(1) selected changes can be adopted with the least detriment and most effective benefit, and that

(2) farmers and cooperatives can respond under circumstances presented in the new environments.

Concerns with some of the dramatic changes that have been suggested in finance and control have been raised by many as shown in the quotation at the beginning of this Paper. The first step in addressing such innovations is to understand what their impacts might be and how possible detrimental impacts can be alleviated. This process is necessarily based on an objective assessment and analyses of all the issues.

This section outlines concerns that focus on the new uses of equity owned by those outside the cooperative. It is this “outside” equity that changes the fundamental character of cooperatives as expressed in cooperative principles. Issues of cooperative control follow directly from the financing modifications. The nature of those changes and the degree to which they replace cooperative characteristics require further analysis.

A. Matters of Principle

Investment and governance issues identified in this Paper can be analyzed from many perspectives. Examples may include: Impact on farmer organizations with more permanent sources of capital; effects on the balance sheet; decreases in financial burdens of member-only

183 Most of this analysis is based on Baarda, James R., “Outside’ Cooperative Equity: Obligations, Tradeoffs, and Fundamental Cooperative Character,” Paper presented at the NCR-194 conference, Kansas City, Missouri, November 2, 2004. Further references to the presentation will be minimized. However, material in this section of the Paper is not identical to the NCR-194 presentation. It includes deletions, additions, and modifications throughout.
financing; earnings and growth potentials from new sources of equity financing; expanded pools of potential investment; influx of financing in agricultural related business from inside the farm sector; influx of financing in agricultural related business from outside the farm sector; implications of non-patron voting power; effects of non-farmer board members; addition of differing types of expertise on the board makeup; planning horizon changes; and many others.

In keeping with the purposes of this *Paper*, the following discussion will focus on the unique character of cooperative organizations as summarized in statements of cooperative principles. For purposes of discussion, the principles discussed earlier will be accepted as guidelines that emphasize in clear and simple fashion the differences between a cooperative and all other business organizations, regardless of the formalities of creation. Of course, part of the disagreements and concerns with outside equity and changes in governance structures and processes may be based on disagreements as to what the cooperative principles are or what they should be. One approach by advocates of major change has been to simply state that “traditional” cooperative principles are outdated and must be changed. Another approach is to give formal acceptance to stated principles but argue that the innovative ideas being challenged by some observers are merely different ways to apply cooperative principles effectively in a dramatically changed economy.

A third occasionally stated position is that cooperatives have deficiencies that are so serious in today’s economy that they have become outdated, cumbersome dinosaurs among agile mammals in the changing competitive business jungle. A straightforward implication of this position would actually have little to do with the subject of this *Paper*. Other business forms would be adopted where desirable rather than using a cooperative. It is only when the name “cooperative” or certain organizational characteristics are used to appropriate the cooperative appellation that cooperative principles and many of the following analytical points become important.  

### B. “Outside” Equity

Outside equity yields three views of cooperative finance that are at odds with traditional cooperative principles. The principle that cooperatives are financed by those who use them is challenged when equity capital can be invested by those who do not patronize the cooperative. The principle that the benefits of a cooperative are devoted to and distributed to those who use the cooperative in proportion to use is challenged by the assertion that investors in a cooperative demand compensation solely for their investment. The latter view also suggests that the value of the equity can be realized by equity transfers in market-driven transactions rather than by the benefits of services received through use. The principle that cooperatives are controlled by those

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184 At the same time, however, those who go to extensive lengths to identify an organization as a cooperative must believe that such a designation has certain benefits.
who use them is challenged by the explicit or implicit participation in cooperative control by those whose only relationship to the cooperative is that of investors.

From a broad perspective, these challenges draw into serious question the character of an organization as a cooperative or, even more fundamentally, the very definition of a cooperative. From the member-patrons’ perspective, such challenges may create conflicting obligations, motivations, and governance issues that undermine essential rationales for a cooperative’s existence and farmers’ membership therein. For purposes of this Paper, cooperative “fundamentals” will be defined as the set of relationships established by generally accepted cooperative principles. The analysis is intended as a useful end in itself but also as a contribution to the factual and analytical foundation required in debates about the identity, character, and importance of cooperative principles. It also demonstrates that more thought, information, and analysis is needed to supply better answers to key questions.

For purposes of this Paper, “outside equity” is defined as having two essential characteristics. It is equity capital that is not contributed and owned by farmers who either currently patronize the cooperative or that have patronized the cooperative in the past. This eliminates capital that was contributed to the cooperative on a patronage basis at one time but that has not been redeemed to those who are no longer active cooperative patrons. Outside equity is invested by non-member, non-patrons with or without formal rights to participate in the control of the cooperative by vote or board membership. Such interests may be transferable by one holder to another at a privately negotiated price.

The second characteristic is that outside equity is not invested as part of a patronage relationship but rather has the characteristics of an investment instrument. Thus stock issued to the general public but that is also purchased by a member-patron of the cooperative is considered “outside equity” because the relationship between the investor and the cooperative is that of investor-corporation, not primarily patron-cooperative.

Two types of equity demonstrate issues to be addressed. One example is preferred stock, treated as equity capital rather than debt capital. The example preferred stock carries no voting power other than that commonly assigned in corporate change situations (merger, dissolution), has a set rate of dividend established by terms of the stock ownership, dividends are payable prior to patronage refund allocation, the stock is callable by the cooperative under

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185 These are formalized examples only and by no means cover the great variety of financial arrangements possible in which “outside” equity becomes an important part of the financial resources available to a cooperative.

186 While preferred stock is generally treated as equity, it has characteristics of a hybrid between debt and equity.
specified terms, but stockholders cannot force redemption, and the stock is tradeable without restriction. A variant that carries voting rights based on stock ownership may also be considered.

The second type of equity is common stock that carries full rights to vote and participate in the cooperative\(^\text{187}\) but without preference on dissolution. Voting is on a share basis, no patronage is required, stockholders do not receive patronage refunds, dividends on the stock are declared at the option of the cooperative, stock is tradeable, and stockholders cannot force redemption. A variation of this example places limits on comparative voting power of holders of common stock who do not patronize the cooperative.

### C. Stakeholders

Any person or entity who is in some way affected by the actions of a business entity is typically called a “stakeholder.” Precisely what the “stake” in the business entity is depends on the relationships developed. The focus here will be on interests rather than individual stakeholders, although the two may coincide. The difference between stakeholder and interest is paramount in cooperatives where one stakeholder – a member – for example, possesses multiple interests with respect to the cooperative entity. A cooperative member has the interests of a user (customer), the interests of an investor owner, the interests of one who has the rights and responsibilities of control, and the interests of one who will receive the benefits of the organization. Specific interests may be in direct conflict with each other. Where interests are in conflict but possessed by the same stakeholder, the individual stakeholder performs the task of balancing interests, yielding decisions about his or her relationship with the cooperative given the stakeholder’s personal aggregated set of objectives.

Where, on the other hand, a singular interest held by one stakeholder conflicts with an interest of another stakeholder, each with his or her own objective with respect to that particular interest, the process of resolving the conflict is quite different. It is at this point where the role of specific individual rights and obligations plays a central role. The struggle is no longer an internal issue for a stakeholder that is trying to determine what course of action is best given all of the alternative paths and the economic or other consequences of each for that stakeholder. It becomes an economic process that relies on external relationships, on inter-entity conflicts, on negotiated resolutions, and on market forces. Each stakeholder will make decisions based on his or her own peculiar interests. The set of actions that can be taken to advance each such interest is defined by the rights and obligations imposed on the inter-party relationship through which the interests are recognized and the stakeholders’ actions express themselves.

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\(^{187}\) The organization will be called a “cooperative” for purposes of discussion, although arguments may be made that this cannot properly be called a cooperative. This nomenclature eliminates the need for excessive, distracting quotation marks around the word cooperative or introduction of some new, likely confusing, terminology.
The fact that an interest exists, that is, that a stakeholder has one or more interests in the business entity through some association with that organization, does not define exactly what that interest is. More precisely, the fact that an interest exists and is recognized does not define either why the stakeholder has placed himself or herself in the position of having the interest nor the objectives of the stakeholder with respect to that interest. Interests and objectives apply, of course, to the business entity as well. The relative positioning of interest, stakeholders, and the firm itself play out in multiple markets, transactions, and strategies, all given the rights and obligations to which each player is subject. The business entity itself may be viewed as an independent set or as an aggregation of stakeholder interests and objectives.\textsuperscript{188}

D. Objectives

Objectives are inseparably associated with sets of rights and obligations that define business-oriented relationships. In most cases a set of relationships defined by rights and obligations would not be created in the first place unless different stakeholders possessed objectives that the parties believe would be advanced by entering into relationships. Once the relationships are established, the rights and obligations define the parameters by which actions by all parties lead to collective and individual objectives.

1. General Objectives of the Firm

Obligations to various interests by a business entity are derived from the organization’s objectives. Where firm objectives define what the business organization must do to satisfy the objectives of the stakeholders’ possessing interests in the organization, the firm takes on obligations to those stakeholder interests. The corporate entity obtains its objectives in turn from the character of the organization and from the objectives of the interests represented by the collection of stakeholders. In a modern non-cooperative corporate entity, obligations are oriented nearly exclusively toward the stakeholders who stand in the position of stockholders.

2. Objectives of the Public Corporation

The objectives of an incorporated business entity, owned by stockholders but an entity separate from them, are relatively easy to state. In the last two decades, stockholder value has

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190 This is the basis for contracts, legal theory of contracts, and economic theory of contracts. For business entities, rights and obligations are either established by multiple contractual relationships (the nexus of contracts theory of the corporation is adopted) or by the institutionalized entity that defines rights and obligations, (non-contractarian, corporate entity theories of the firm). For a description of comparative contractual characteristics of cooperatives and other organizations, see Baarda, James R., “Contractual Characteristics of Farmer Cooperatives,” Paper presented at the American Agricultural Economics Association Annual Conference, Providence, Rhode Island, July 26, 2005.

become the central legally-mandated objective of corporate firms although the general law and economics view of corporations has long held that position.\textsuperscript{192}

Simply defined from a financial point of view, “[t]he objective in corporate finance is stated, most broadly, as the maximization of firm value and, more narrowly, as the maximization of the stock price.”\textsuperscript{193} Several factors are intermediate between the value of the firm broadly stated and the stock price. The value of the firm differs from the value of the firm to its equity holders because a portion of the firm’s value is represented by liabilities. In addition, distinctions exist between the value of the firm, however defined, and stock prices. Stock price in an efficient equity market is assumed to be a reasonably accurate reflection of the value of the firm to its owners. Regardless of views or measures of firm value, firm value is focused solely on those who ultimately benefit from that value, the owners of shares of stock.

From a basic microeconomic viewpoint, the standard firm objective is profit maximization. This does not necessarily convert to an objective oriented toward maximizing the value of the firm to its owners, though a rather direct extension of the profit-maximizing objective would presumably yield that result. Nevertheless, where a firm is owned by a collection of stakeholders, profit maximization is a crucial element in the process of converting profit to firm value to owner value.

When we begin to consider the rights and obligations implicit in a business entity’s objectives, mere generalizations about what is economically or financial desirable fall short. Actual rights and obligations growing directly from objectives must be identified. The process begins with statutory and judicial mandates for objectives. The process continues by identifying specific situations in which business objectives focus on equity owner value in such a way that some aspect of the business entity can be forced to meet its obligations to stockholders. The interests of that group of stakeholders are recognized as a set of rights. The other side of the rights and obligations mirror imposes obligations on the business entity to engage in behavior that responds to the objectives of stockholder interests.

A general expression of the stockholder value mandate is found in direct statements of corporate objectives. This line of defining objectives relates directly to pricing and profitability decisions by the corporation. The larger question is whether a corporation is permitted to make deliberate pricing and operating decisions that do not maximize the value of the corporation to the stockholders. A classic statement on mandated corporate objectives and pricing practices


was given by the Michigan Supreme Court in 1919. Henry Ford had decided that the Ford Motor Company would forgo special dividends to its stockholders for the purpose of reducing the price of automobiles for the public benefit. The decision was challenged by the Dodge brothers who owned stock in Ford Motor Company and whose returns on the stock and therefore its value would decrease because of Ford’s decision. The Michigan Supreme Court held that the company could not implement that policy. The Court said:

it is not within the lawful powers of the board to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefitting others, and no one will contend that, if the avowed purpose of the [Ford] directors was to sacrifice the interest of shareholders, it would not be the duty of the courts to interfere.  

Mandated objectives to maximize the value of a corporation for the benefit of stockholders is also found in connection with incorporation statutes. Concerns with the stockholder benefit only view of corporations led to discussions of the issue in the context of corporate governance. What actions can be taken by those charged with governing the affairs of the corporation that may deviate from the stockholder-benefit objective? The issue was addressed by the American Law Institute’s (ALI) corporate governance project of the early 1990s. ALI stated the overall objective principle and described three exceptions to the stockholder-interests-only rule in §201.

The Objective and Conduct of the Corporation

(a) Subject to the provisions of Subsection (b) ..., a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain. [emphasis added]

(b) Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:

194 The same Dodge brothers who subsequently designed automobiles and created the Dodge motor company.


196 The American Law Institute’s Corporate Governance Project, while focusing on governance issues, addressed corporate objectives after more than a decade of sometimes heated discussions. The ALI published the *Principles of Corporate Governance: Analysis and Recommendations* in 1992.
(1) Is obliged, to the same extent as a natural person, to act within the boundaries set by law;

(2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and

(3) May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

3. Cooperative Objectives

Cooperative objectives have been the subject of inquiry for many years and continue to be of interest for cooperatives given changes in perspectives and fundamental perceptions of cooperatives. Cooperative objectives are inherent in much cooperative theory, though not always explicitly addressed.\(^{197}\)

Review of corporate principles reveals no organic statement of corporate objectives. As shown in the previous discussion, corporate objectives have been developed derivatively. Corporate obligations derived in turn from the objectives are the focus of this development, given that the objectives discussion is intended to draw rights and obligations into relief. Unlike general corporate principles, cooperative principles directly and explicitly address objectives. In large part cooperative principles are the objectives. Cooperative principles can be used as statements of the cooperative corporation’s entity objectives.

The objectives of a cooperative corporation are oriented differently, but in totality are only somewhat more complicated than those of a non-cooperative corporation. Cooperative objectives can be distinguished from non-cooperative corporate objectives in two regards, though in broad perspective the objective of a cooperative is to maximize its value to a single group of “outside” interests as well. It is (1) the identity of this “outside” group and (2) the nature of the cooperative’s value that define the distinguishing features of a cooperative. The implementation of such peculiarly cooperative objectives is reflected in cooperative principles just as corporate objectives are reflected in corporate principles.

While a comparison of cooperative and non-cooperative corporate objectives is necessary for purposes of this discussion, a thorough analysis is not. When a cooperative possesses outside equity the relationship between the cooperative and investor becomes just that, an investment relationship. This relationship then defines the obligations of the cooperative to the outside

\(^{197}\) Extensive literature on cooperative theory as it may relate to objectives is not reviewed here. Research, some being conducted by Cooperative Programs staff and some being conducted under a cooperative agreement funded by Cooperative Programs, is underway to revisit the issue of cooperative objectives.
It should be explicitly recognized that the interests of corporate investors are not homogeneous by any means. Changes in control, takeovers, mergers, consolidations, deadlocks, and dissolutions are only a few examples of inter-investment, intra-stakeholder interest conflicts leading to major changes in the corporate entity.

The fundamental cooperative, non-cooperative distinction is that the cooperative’s objective is oriented entirely toward user interests rather than entirely toward investor interests. This summary, of course, does not reflect the complications of such arrangements which are, indeed, different than the rubric used to define corporate objectives. The three cooperative principles are descriptions of objective implementation. However the cooperative’s corporate objectives may differ and however they are defined by cooperative principles, the fundamental statement of cooperatives’ objective is as simple and as powerful as is the statement of corporate objectives. Non-cooperative corporations generate value to their investors as investors – cooperatives generate value to their users as users.

The second distinction between cooperative and non-cooperative corporations resides in the identity of the interests to which the two types of entities are responsible. The interests to whom the corporate entity owes its objectives are singular – the investor. In a cooperative, the user interest to which the cooperative owes its sole allegiance (and existence) is necessarily and inseparably combined in member entities with the investment interests. The combination of user interests and investment interests exist in the same entity – the member – whereas in a non-cooperative corporation the interests of users are separable and not part of the central corporate objective. A similar distinction separates or combines non-investor control in a cooperative corporation. Objectives of user interests and investment interests most likely diverge. In a non-cooperative corporation, only entities holding investment interests are relevant to corporate objectives. In a cooperative corporation, to the contrary, the entities with user interests also have investment interests. Any divergence of these two interests is resolved by the entity and the resultant is conveyed to the cooperative corporate entity by a single stakeholder representing all interests. Needless to say, different entities may conduct the internal balance quite differently and resolutions presented to the cooperative will not be the same for every entity. This leads to a decision-making process within the cooperative to balance member/patron interests.

4. Competing Objectives

Internal stockholder conflicts may exist in a corporation having both common stock and preferred stock. Stockholder conflicts may also exist in corporations that have only holders of

198 It should be explicitly recognized that the interests of corporate investors are not homogeneous by any means. Changes in control, takeovers, mergers, consolidations, deadlocks, and dissolutions are only a few examples of inter-investment, intra-stakeholder interest conflicts leading to major changes in the corporate entity.
common stock. The outside equity hypothesized for purposes of this paper include both. A brief discussion of the nature of the obligation to outside equity holders represented by preferred stock and common stock notes the characteristics of such a conflict.

Certain transactions may pit the interests of the voting common stockholders against holders of preferred stock. This may occur whether or not holders of preferred stock have the right to vote on a particular action such as merger that affects them.

The “hybrid” character of preferred stock between debt and equity has been noted. An additional distinction between preferred and common stock exists in the relationship between the corporation and stockholder. The corporation-preferred stockholder relationship is often referred

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199 This seemingly innocuous statement actually encompasses several fundamental non-cooperative – cooperative comparisons. Under reasonable assumptions that equity capital markets reflect stock values, investors make decisions on the margin, that investors have different preference sets for equity investments, and that credit markets make lending and borrowing convenient in stock purchases and sales situations, the “Fisher separation theorem” states that a firm’s production decisions are “governed solely by an objective market criterion (represented by maximizing attained wealth) without regard to individuals’ subjective [investment] preferences which enter into their consumption decisions.” Copeland, Thomas E., and J. Fred Weston. Financial Theory and Corporate Policy (2d ed.). Reading, Mass.: Addison-Wesley (1983), p. 11. The implication follows that managers need not take into account the differing individual investment preferences of stockholders. The “unanimity principle” indicates that managers merely need to act so as to maximize the firm’s total shareholder value.

to as “contractual” rather than purely ownership in nature. A purely ownership characteristic carries with it a fiduciary obligation on the part of the corporation to preferred stockholders. A purely contractual character does not carry such a fiduciary level of obligation.

A fiduciary relationship may be found between a corporation and holder of preferred stock although some courts are reluctant to raise the level above that of contractual obligation. To resolve the problem, some courts have resorted to a split duty assignment. To the extent that the issue involves the preference, it is treated as a contractual relationship only. Where the issue is one of ownership similar to that of the common stockholders, the fiduciary duty of the corporation to stockholders applies. In either case, the corporate entity owes holders of preferred stock obligations that are measured at a high level of duty, whether completely fiduciary or not. Numerous obligations cannot be ignored simply because holders of preferred stock may not have a specific right to vote on an issue at hand.

Where a cooperative has members who own common stock but do not have a concurrent patronage relationship with the cooperative, two distinct interests are created among holders of common stock. For the publically traded corporation, remedies for dissatisfaction with corporate practices or with the value of the corporation to the stockholder are easy – sale of the stock. If a portion of common stock representing membership in a cooperative is held by patrons whose interest is in the benefits the cooperative provides through the use of the cooperative according to cooperative principles, sale of stock is not simply that of an investor seeking more lucrative returns on invested capital. The entire relationship deemed beneficial by the patron comes to an end. Conversely, holders of common stock whose only interest is as an investment may be harmed if actions are taken by patrons, also holders of common stock, undermining the value of stock.

The situation described is somewhat analogous to the position of minority stockholders in a close corporation. A close corporation is commonly characterized by a combination of control,

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204 Assuming no fraud or other impermissible actions that undermine the market process through which stockholders seek relief.
ownership, and management in a relatively few owners. In most cases, the relationship is formalized by contractual arrangements on management and control going beyond simple ownership of common stock. These relationships along with contractual constraints may result in a minority stockholder group that has no meaningful way to avoid oppression by the majority because no ready market for the stock exists.

The relative position of owners in close corporations has been addressed by imposition of fiduciary duties on those who have the power to make decisions that can harm minority stockholders. As stated by Cox:

[M]ost modern courts have accepted the principle that the controlling shareholders as well as the directors and officers owe a fiduciary duty to other shareholders – to public shareholders in a publicly held corporation to minority shareholders in a close corporation. Some courts have gone further and have held that persons in control of close corporations owe an especially strict fiduciary duty to minority shareholders – a duty said to be similar to the duty that partners owe each other and more stringent than the duty shareholders in a publicly held corporation owe to each other.

Where outside equity is held in the form of preferred stock, the cooperative’s obligation is defined by the terms of the documents with an overly of some degree of fiduciary duty, although circumstances may vary the degree somewhat. Where outside equity is held in the form of common stock not meaningfully distinguishable from common stock representing membership by patrons who look to patronage-based benefits from the cooperative, two circumstances create a special level of obligation. The most common would be where the outside equity holders are the minority stockholders in which case the majority (member/patrons) must take care not to oppress the minority. The other case would be where the outside equity holders of common stock are in the majority in which case the member/patrons would be a minority.

Expectations play an important role in determining what actions qualify as oppressive. Where actions of a majority lead to a defeat of the “reasonable expectations” of minority stockholder interest, courts may measure the expectations by objective standards and determine

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that such actions are oppressive. Expectation principles are not uniform and different courts will apply the rule on a case by case basis.

**E. Governance and Control**

The argument is sometimes made that so long as farmer members maintain at least a majority of the votes in a cooperative, the cooperative control principle is met and other principles become less important. This proposition may be questionable for several reasons. Obligations to outside equity holders may modify the normal control expected in a cooperative setting, perhaps significantly. The term “governance” encompasses a broad spectrum of decision-making processes in a cooperative from long-range and strategic planning to specific implementation and operation practices. Governance is far more than just voting for a board of directors.

Governance issues are of three general types.

The first and overall issue is who controls the cooperative. One rather obvious example of this issue is a cooperative’s obligation to the entities that provide capital and the decisions that those entities may impose on the cooperative. The legal rights of equity-holders of various kinds to take a direct part in cooperative governance, either on specific issues or on more general issues, is a key consideration in assessing the impact of financing methods on cooperative principles related to ownership and control.

The second issue is what controls the cooperative. The “traditional” cooperative has only one central objective – to provide the greatest returns to its patrons. This is often achieved by focusing primarily on favorable pricing or generating patronage refunds while the member-patrons’ investment in the cooperative is regarded only as a means to an end without an independent return-to-equity objective. Other forces may begin to control the cooperative with new types of capital, obligations, and objectives, forces related to returns to capital, capital value and marketability, and the interests of outside investors with no connection to the returns generated from use of the cooperative. These forces, too, may be considered contrary to the fundamental principle of returns of margins to users in proportion to use.

The third cooperative governance issue is that of the internal balance of authority and control. Examples include: Does management have more independent power and an independent objective vis a vis boards of directors representing farmer patrons if capital is “permanent” or if capital is obtained from non-member, non-patrons? Are members’ interests set in opposition to the interest of the cooperative and how are those interests represented in the cooperative’s governance system? What is the position of members or former members who have equity in the cooperative but no effective way to counter forces that focus on current returns? Are some groups of members advantaged or disadvantaged, or do groups of members have divergent interests in the cooperative as a result of changing financial systems? In general,
an already complicated internal dynamic may be further destabilized by the addition of new objectives and new participants in the cooperative enterprise.

1. Voting Power and Cooperative Control

The governance issue and outside equity can be divided into parts. The first question is whether holders of outside equity have formal rights to vote in the affairs of the cooperative. This is further divided into the specific situations in which outside equity holders may vote whether in the ordinary affairs of the cooperative or only on some event such as merger, consolidation, dissolution, or perhaps sale of all assets. Voting on special events may be a statutory requirement even where the investment agreement gives no rights to vote.

The second and more difficult aspect of outside equity holders and cooperative control occurs when the outside equity holders have no right to vote in the affairs of the organization but the cooperative’s obligation to such equity holders limits the range of decisions the cooperative can make. This constraint on the full set of decisions is an effective control feature imposed on the cooperative and thus becomes part and parcel of the cooperative’s governance process.

A further distinction is found in the source of voting power and the ability of equity holders to adjust their relative voting power. Voting power for cooperative member/patrons is typically limited to either one vote per member or some voting power based on patronage. Equity ownership is not a factor in voting power and member/patrons have limited ability to adjust equity ownership proportions that have any impact on voting power. For voting based on outside equity ownership, however, the non-cooperative corporate rule is that voting is based on equity ownership. To the extent this is true for holders of outside equity in a cooperative, the equity owners may gain voting power in the cooperative simply by purchasing more equity. Of course, such voting power is unrelated to the use of the cooperative.

The result of applicable voting rules along with limitations on some aspects of the cooperative’s decision-making process, including the range of decisions that can be made, shows that numerical voting power is not the same as the concept of control inherent in the user-control cooperative principle. Governance issues extend beyond measured voting power and relative control by those with a right to vote. The touchstone of voting is selection of boards of directors. Boards of directors will confront the issue directly in the range of decision they can make in the affairs of the cooperative. To the extent that obligations to outside equity holders affect what a cooperative can or must do in a myriad of situations, board of directors will be required to consider such factors and make decisions on behalf of the cooperative accordingly.

2. Levels of Obligation

The presence of outside equity holders whose interests diverge from the interests of member/patrons will place a duty on the board of directors to take such interests into account. This has been couched in terms of obligations running from the cooperative to holders of outside equity.
equity. In practice, the board of directors is required to consider cooperative obligations in the decisions it makes about the cooperative’s performance and strategies for future actions. Thus the board of directors is faced with an added constituency carrying rights that the cooperative must recognize. The fiduciary relationships within a cooperative have been modified, and the cooperative as an entity and board of directors specifically will need to reconsider fiduciary relationships to include another set of participants.

3. Constraints on Cooperative Decisions

A number of constraints and requirements have been outlined with the addition of outside equity ownership. The full range of constraints and obligations will limit and form cooperative decisions. This may range from short-term pricing practices to decisions about business strategies to long-term goals, some of which are noted above. The consequence is that effective control is limited by constraints regardless of formal voting rights. When obligations to conduct business in certain ways limit the usual full range of options, cooperative control is limited. This is not to say that the cooperative operates at the whim of others. The obligations were accepted in the first place by the cooperative so any resulting constraints are also within the cooperative’s control. The cautionary tale is that the many implications of incurring such obligations to obtain outside equity must be fully understood and appreciated as part of the initial decision-making process.

4. Measuring Performance

Cooperative performance is often somewhat problematic in the best of circumstances given cooperative objectives that focus on users. The meaning of the bottom line at the end of a fiscal year, tradeoffs between profit and pricing benefits to patrons, the satisfaction levels of member/patrons, adjustment of services whether added or deleted, growth or contraction, financial ratios, and many other factors enter into measuring a cooperative’s performance. Obligations to outside equity holders will to some degree change measures of performance. The cooperative will need to incorporate into the performance measures such items as its payment to outside equity holders, generation of funds to make such payments, capital structure satisfying the interests of equity holders in the investment value of the cooperative, and the impact of its performance for the year on the stock prices of outside equity holders. Failure to meet obligations to outside equity holders is detrimental to the cooperative regardless of the seeming excellent performance as performance is measured solely by member/patrons.

5. From Member/Patrons to Capital Markets

Governance and decision-making processes in a cooperative whose users, owners, and beneficiaries are the same stakeholders representing the same sets of interests are essentially internal. Both the character of cooperation and the corporate nature of the cooperative corporation keep decisions, objectives, and tradeoffs “within the firm.” Divergent interests and objectives and the resultant cooperative policies and strategies are part of a process whose
decisions are kept within the cooperative. The forces are all based on member/patron interests and obligations.

Outside equity interests are not member/patron interests when the equity is a traded commodity. The value of the equity is determined not by member/patrons who use the cooperative but by capital market forces. To the extent that the cooperative has an obligation to holders of outside equity to maximize the value of the cooperative and enhance the market value of the equity, the cooperative is judged not by its member/patrons but by those outside the cooperative. The value of the cooperative is judged in a different arena for different purposes.

For governance purposes, this phenomenon requires that the cooperative, particularly its management and board of directors, look outside of the cooperative and its member/patrons to determine how well it is meeting its obligations to outside equity holders and, even more challenging, how the cooperative must act to satisfy the participants in a entirely different market place. Both of these functions may strain the abilities of a board of directors whose fundamental purpose is the operate the cooperative for the benefit of member/patrons as users of the cooperative.

F. Selected Operating Strategies

The user-benefits cooperative principle provides the first, most comprehensive framework for discussing applications and implications of outside equity. The user-benefits principle entails two processes, though not always clearly separable. The first is the method used to generate benefits. The second is the allocation and distribution of that benefit in whatever form it takes. In these processes, particularly in the allocation and distribution process, the cooperative, non-cooperative corporate distinctions are stark. The first is discussed by addressing a selected few operating strategies. The second is described in the following section on the distribution of benefits.

The effect that obligations to outside equity holders have on a cooperative’s operating strategies depend, of course, on the extent of such obligations. In this section, we consider a few selected operating strategies that may be affected by obligations to outside equity holders. The discussion is necessarily broad each topic is deserving of more detailed economic and business analysis. In keeping with the theme of the paper, the general approach is to inquire if obligations to outside equity holders might modify operating strategies that would otherwise be possible for cooperatives to meet cooperative objectives.

Note previous discussion of the Fisher separation principle and the unanimity principle as the relate to the significance of equity trading in a market outside the boundaries of a firm.
1. Pricing and Profitability

Generation of benefits to patrons by a cooperative may include pricing practices that give a better price to patrons at the expense of overall cooperative firm profitability. In the extreme, a cooperative may price so as to cover all costs and expenses but to yield no net margin. Benefits are created directly by the pricing practice rather than through generation of net margin with subsequent allocation to patrons. To the extent that equity holders are compensated solely from the disposable income generated by the differential between total revenue and total costs, the described cooperative pricing practice eliminates the source of funding for compensation to equity holders. This same effect is felt by member/patrons, of course, but the benefits of the pricing practice are obtained directly by the patrons through advantageous prices.

The cooperative’s ability to use this pricing method to generate benefits for patrons may be restricted by the cooperative’s obligation to outside equity holders. The cooperative may not be able to strategically price where the pricing strategies reduce funding sources for outside equity holders. This does not mean that the cooperative cannot generate benefits for patrons. If the cooperative prices in such a manner as to generate a margin, a portion of that margin can be allocated and distributed to patrons as a refund after the fact. The exact portion will depend on the level of claims that the outside equity holders have on the cooperative’s funds. However, to the extent that obligations to outside equity holders require margins for payments to such equity holders, the cooperative’s pricing strategies are limited.

2. Profit Maximization and Firm Theory

More generally, the pricing issue is a part of a larger view. Cooperative theory has addressed pricing and other practices in various ways. An optimization strategy is determined

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based on the firm’s objectives as a cooperative organization, taking into account its economic obligations to member/patrons. The optimization position for a non-cooperative may be quite different. To the extent that the cooperative firm is obligated to maintain some modicum of a non-cooperative corporate optimization on behalf of and because of outside equity holders’ rights, the cooperative’s optimizing behavior must be modified with second best behavior.

A more generalized concept relates to the overall objectives of a cooperative that may go beyond services that are measurable in strictly economic or accounting terms. Cooperatives may have objectives that go well beyond simple profit maximization or even solely economic activities. The question then arises whether obligations to outside equity holders restrict those perhaps unmeasurable objectives because the obligations are based on the economic/accounting performance of the corporate firm.

3. Valuation and Value Maintenance

Based on corporate objectives, whether mandated or expected, maximizing the value of a non-cooperative corporation will differ from maximizing the value of a cooperative corporation. The obligation to maintain corporate entity value depends on precisely what gives value. The more direct provision of value to equity holders is the receipt of income as a return on their investment, income generated from the corporation’s operations. A second and critically important source of value for corporate stockholders is the market value of the stock. This value depends on a number of factors but most importantly for purposes of this analysis on the value of the corporate entity as an investment. Net earnings generation levels and stability, retention of
net earnings to increase the entity’s book value, and strategic factors such as growth combine to
determine the value of the corporation as measured by stock value.

Cooperative practices that maximize its value to member/patrons as users of the
cooperative may be limited by obligations that the cooperative has to maintain stock value for
outside equity holders. To the extent that net margins (generated from business done with or for
the patrons on a patronage basis) are distributed to holders of outside equity rather than to
patrons on a patronage basis, the value of the cooperative to its member/patrons is diminished. A
somewhat more difficult problem is presented where the cooperative organization must not just
share its annual net margins among outside equity holders but must maintain the overall stock
price for the benefit of the outside equity holders.

4. Scope and Choice of Market Participation

If we assume that the objective of a corporate entity is to engage in activities that
maximize its value, including returns to investors, then the scope of its activities and the choices
of market participation becomes objects of an obligation. The corporation makes investments
and engages in the kind of business that maximizes stockholder value, business that may change
significantly over time. In addition, if this basis for obligations to equity holders extends to
cooperatives who have obligations to outside equity holders, cooperative strategies regarding the
scope of their activities and their participation in markets that are contrary to this objective may
be limited. If that limitation reduces the cooperatives’ objectives to benefit solely its
member/patrons as users, the cooperative is restricted by such obligations.

5. Free Cash Flows

One of the broader measures of businesses is based on free cash flows. These are
generally cash flows remaining after specified obligations are satisfied. Free cash flows to the
firm are cash flows before required payments to compensate for debt capital. Free cash flows to
equity are cash flows available after compensation to providers of debt capital. For cooperatives
with outside equity holders, the free cash flow to the outside equity holders requires reduction of
total cash flow by amounts that would otherwise be dedicated to users on the basis of their use.
The question then is whether the cooperative with outside equity must modify its commitment to
users to provide free cash flow the benefits of which are captured by outside equity holders.

6. Non-Patronage Source Income

Cooperatives engage in business done with or for patrons as they conduct business on a
cooperative basis. While this terminology is drawn from Subchapter T of the Internal Revenue
Code, the principle is fundamentally cooperative. It captures the essence of the cooperative user-
benefit principle – the sole purpose of the cooperative is to generate benefit to its users in
proportion to use.
Cooperatives may also generate income from business that is not conducted with or for patrons. When this occurs, the cooperative has several choices about what to do with the net income generated from that business. Generally speaking, after taxes are paid on the non-patronage source income, it is available for the cooperative to use as it sees fit or return it to patrons on the basis of patronage (but not as a patronage refund). Importantly, it can be made available to outside equity holders as dividends on capital stock. The main issue presented here is whether the existence of outside equity places any obligations on a cooperative to generate more non-patronage source income.\textsuperscript{210}

Two possibilities for this pressure exist. First, the non-patronage income may be a source of funds for returns on equity. If no non-patronage source income were generated, any payment to outside equity holders would need to come from income that could otherwise be returned to patrons on a patronage basis. Only by engaging in activities that produce non-patronage source income can the cooperative compensate outside equity holders for their investment without raiding the funds that would otherwise be available for distribution to patrons on a patronage basis.

\textsuperscript{210} Two current event discussions are reminders that the balance of income from patronage and non-patronage sources is integral to the way the cooperative operates. Delivery obligations in new generation cooperatives as well as other cooperative arrangements have led some members to deliver product to the cooperative that is not their own. Such deliveries have long been held not to be patronage based transactions for Federal income tax purposes. See, \textit{e.g.}, \textit{Iberia Sugar Coop. v. Commissioner}, 360 F.Supp. 967 (W.D.La. 1972), \textit{aff'd per curiam}, 480 F.2d 548 (5th Cir. 1973). Recent legislation has overturned an Internal Revenue Service practice that required dividends paid on capital stock to reduce patronage and non-patronage source income proportionately. The law is the American Jobs Creation Act of 2004, P.L. 108-357 stating:

\textbf{SEC. 312. PAYMENT OF DIVIDENDS ON STOCK OF COOPERATIVES WITHOUT REDUCING PATRONAGE DIVIDENDS.}

(a) \textit{IN GENERAL-} Subsection (a) of section 1388 (relating to patronage dividend defined) is amended by adding at the end the following: 'For purposes of paragraph (3), net earnings shall not be reduced by amounts paid during the year as dividends on capital stock or other proprietary capital interests of the organization to the extent that the articles of incorporation or bylaws of such organization or other contract with patrons provide that such dividends are in addition to amounts otherwise payable to patrons which are derived from business done with or for patrons during the taxable year.'.

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The second pressure to increase non-patronage income business is based on the obligation of the cooperative to maximize its value to outside equity holders. Non-patronage income may be retained by the cooperative as retained net earnings, thus adding to the cooperative’s equity base. This practice may be viewed positively by outside equity holders as a hedge against losses in case of dissolution or bankruptcy. More generally, as the equity base increases, the cooperative’s capital structure may be viewed as positive in the capital markets, thus increasing the market value of stockholders.

**G. Allocation and Distribution of Cooperative Benefits**

The user-benefit principle describes distribution of benefits on a patronage bases. Margins distributable to those who purchase from or through the cooperative or who sell to or through the cooperative are allocated to users in proportion to their use of the cooperative. Equity ownership in the cooperative is not a factor in determining distributions. To the contrary, any income allocated to outside equity holders must necessarily be allocated on a basis other than that of use. Allocations to holders of outside equity are typically based on the relative amount of equity held.

Discussion of allocation and distribution cannot be clearly separated from the fact of benefits generation noted in the previous section. Four considerations are relevant to the purposes of this paper. The complete distinction in allocation methods is quite obvious. Distinctions are also seen in the relational structures of cooperative, patron, and outside investor. Timing differs in allocation and distribution. Finally, the variability of benefit generation and distribution is an important consideration.

1. **Benefits Allocation**

Two processes falling within the general concept of allocation relate to obligations to outside equity holders. The larger issue is the proportion of benefits that would otherwise be allocated and distributed entirely to patrons on the basis of their business with the cooperative. This is the substance of cooperative operation as expressed in the user-benefits principle. The distinctions between cooperative and non-cooperative operation is clear. To the extent that the cooperative must make distributions to outside equity holders, the funds so allocated cannot be allocated to member/patrons and thus are lost to the cooperative’s users.

An associated difference is found in the proportions by which benefits distributions are made. For non-cooperative corporations, benefits derived from ownership, whether through the generation of income in excess of expenses or the increase in market value of stock, are allocated to owners on the basis of the share of equity owned. The investor’s decision process essentially determines how much to invest given the returns obtained based on investment. For a cooperative, on the other hand, where benefits are distributed on the basis of business done with the cooperative, the decision process is quite different.
Objectives differ between the recipients of benefits allocated on the basis of use and the basis of equity ownership. Recipients of the benefits based on use – patrons – match their benefits allocation only with their use of the cooperative. The only way to receive added benefits is to increase patronage, a process dependent on many factors not related to investment but on farming operations, pricing, etc. Recipients of benefits based on equity ownership on the other hand can adjust the amount of benefits allocated to them by simply changing their level of investment in the cooperative, a process wholly dependent on return on investment criteria.

2. Relational Transactions

The transaction between an outside equity investor and the cooperative is rather limited in scope and time. One transaction is, of course, the purchase of the equity interest. This is a neutral transaction in the sense that it occurs only once and has a specific, limited affect on both the cooperative and the investor. At the end of a fiscal year, the cooperative will provide whatever compensation is required by the terms of the investment. The transactions between a cooperative and its member/patrons is relational not only because the transactions incorporate and recognize the multiple relationships between cooperative and member/patron but because the transactions are ongoing over a period of time. Purchase or sale transactions between cooperative and member/patrons may occur at multiple times within a fiscal year or over many years. In addition, such transactions involve the immediate transaction, later calculation of the impact the transaction had on the cooperative’s income, allocation of amounts as refunds, allocation of refunds or per unit retains to equity accounts, and a continuing relationship because of the equity retained until it is redeemed, also years later. The neutral and at arms length outside investor may modify a cooperative’s behavior that was based on traditional relational association.

3. Timing and Distribution

A cooperative calculates its net margins at the end of the fiscal year and makes distributes patronage refunds within eight and one-half months after the end of the fiscal year. The refunds may be paid in cash or in the form of retained patronage refunds but in either case the distribute occurs at that time. With few exceptions, the amount distributed as patronage refunds reflects the income for the relevant fiscal year and only for that fiscal year. The recipient patron will receive benefits related only to that patron’s patronage during the relevant fiscal year.

In contrast, distributions to outside equity holders will be in the form of dividends on capital stock and may generally be made at any time. Flexibility in payment will depend on the terms of the equity interest. Variation in corporate profits is not necessarily directly reflected in correlated payments to equity holders. Indeed, dividends may be paid even in years in which the corporate entity suffers a loss. If the cooperative takes on an obligation to holders of outside equity that permits this timing difference, the cooperative’s equity may be depleted regardless of when the equity will be replenished with retained net earnings.
4. Fixed or Variable Funds Flows

The fixed or variable funds flows problem is related to the timing and distribution problem but identifies an additional issue with outside equity investment. Funds flowing into and out of the cooperative will vary from year to year. To the extent that outflows are in the form of patronage returns, those outflows will depend on the amount of margins available each fiscal year. If no net margins are generated, the cooperative will have no outflows because no patronage refunds will be made. Obligations to patrons whose relationship with the cooperative is based on cooperative principles will be limited to cooperative net margins and will not force the cooperative to deplete its funds or capital in years in which net margins are nil or diminished.

Obligations to outside equity holders may not be so limited. To the extent that the obligation requires the cooperative to compensate outside equity holders regardless of current or past profits, the outflow of funds is fixed. In almost all cases, the outflow to equity holders is “more fixed” than outflows based solely on patronage refunds paid out of net margins. The result of this difference is an increase in net margin fluctuation brought about by the change in leverage, where leverage is defined in terms of obligatory payments versus payments required only from margins are generated.

H. Financing Practices and Strategies

Outside equity has its primary effect on a cooperative’s financial structure. It adds a new element to the owners’ equity portion of the balance sheet and a new requirement for compensation for capital. Several distinctions from member/patron equity and from capital generally contributed to the cooperative through membership and patronage relationships are noted briefly here.

1. Decoupling

Cooperative equity is based primarily, usually exclusively, on the patronage relationship. Additions to capital from membership fees, retained patronage refunds, and per unit retains make up the bulk of cooperative equity capital, and unallocated reserves are also generated by cooperative business though not usually business done with or for patrons. In every case, the addition of equity capital depends on the cooperative’s operation. Obligations to holders of cooperative equity likewise is integrally associated with the patronage relationship, from return based on use rather than level of equity ownership to the cycle of investment and disinvestment similarly based on the patronage relationship.

Outside equity is decoupled from the member/patron relationship. It is not added by any relationship with the patronage process nor are the obligations to equity holders for compensation or redemption based on the patronage process. Nor is it added because of what the cooperative
does with the funds on behalf of the equity holder. Obligations to the outside equity holders are not associated with a patronage relationship unlike cooperative obligations to member/patrons.

The cooperative must venture into new arenas to obtain outside equity because of this decoupling. Relationships and transactions necessarily a part of obtaining outside equity will require of the cooperative that it take on a set of obligations entirely different from those associated with member/patron equity. These obligations are based not on internal factors but on the capital market practices and forces. In return for obtaining the investment, the cooperative creates obligations to the investors.

2. Costs of Capital

Cooperatives costs of capital have been a difficult subject for cooperatives because of the multiple relationships of the investor as member/user and because benefits are not distributed directly on equity ownership but through the patronage relationship. Returns made to equity holders required by them as a condition for their investment are not in a one-to-one relationship with ownership but with use. Outside equity changes this in several ways.

Costs of capital may be direct or indirect. Indirect costs of obtaining outside equity may include the diminution of the strength of cooperative principles, limitations on strategies and practices in which the cooperative may otherwise engage noted above, or impositions of new governance burdens and requirements as noted below. Direct cost of the outside equity capital is generally the monetary outlay required to compensate investors. Intermediary costs are those that diminish the value of the cooperative for its member/patrons because it may not maximize its value to them as member/patrons given restraints associated with its obligations to outside investors. All these factors influence the total cost of outside equity in the cooperative. Their measure is unfamiliar to cooperatives with no outside equity. Outside equity creates a requirement that the various facets of obligation with direct and indirect implications for costs be measured. Such is not an easy task but incorrect conclusions can be seriously harmful to the financial condition of the cooperative.

3. Leverage

One form of leverage with outside equity may place member/patrons in a disadvantageous position. As one example, where half of a cooperative’s equity is provided by preferred stock, the risks to members of being junior to the preferred stock is increased. The cooperative’s obligation to outside equity holders to give them priority upon the occurrence of certain events comes at the expense of member/patron equity holders. Similarly, where the

211 The relevant capital market is not necessarily an organized market, nor is it necessarily an active one. It is any forum through which the equity is sold by the cooperative and traded by the equity holder.
cooperative is obligated to make either sum certain payments or payments is require before
distribution to member/patrons, fluctuations in the income generated by the cooperative will be
multiplied.

4. Objectives

Turning to the objectives of interests in the cooperative, differences between
member/patrons holders of equity and the holders of outside equity are clear. The objective of an
outside investor is to obtain returns on the equity that justify investment given opportunities for
alternative investments. The objective of member/patrons who invest in a cooperative is to
obtain the benefits of the cooperative in the multiplicity of methods cooperatives have to
generate and distribute benefits. Outside investment is made for the purpose of obtaining income
from the investment, while member/patrons invest to generate income in their farming operation.
Outside investment is associated with the savings sector whereas member/patron investment is
part of the production sector.

The character of the obligations to outside equity holders and to member/patrons reflect
the different objectives. One of the issues raised by the presence of outside equity is whether
member/patron investors are encouraged to adopt the objectives associated with outside
investment. If this occurs, the nature of obligations to member/patrons may change to look more
like obligations to outside investors. At this point the cooperative will face a significant
reevaluation of the character of a cooperative, principles that define a cooperative, and the
totality of the rights and obligations that make the cooperative a business enterprise. From
another perspective, if member/patrons are already viewing their equity investment in a
cooperative from an investor’s perspective with required returns on equity and liquidity, the
rights and obligations set within the cooperative will differ little from that directed to outside
investment.

5. Valuation – From Member/Patrons to Markets

Valuing a firm is a central problem in finance. The ultimate value of a corporation is
measured primarily by the value of the equity ownership in a market, whether that market is a
public market or a private transaction. The focus of a cooperative on the other hand is the value
it provides member/patrons through the patronage relationship. Starting with the proposition
that the objective of the corporation is to maximize value, obligations based on those objectives
are transferred from obligations to maximize the patronage benefits for member/patrons on the
part of cooperatives to maximizing the market price of the equity held by outside equity holders.
Perceptions of value are moved from an entirely internal forum based on complex
interrelationships to a market forum based on the market value of the equity. Not only is the
valuation different, those who determine value are different. It may also be expected that those
who determine value from the perspective of the market place may not fully understand the
internal dynamics of the cooperative being judged, or even its fundamental character.
6. Benefits Bias

Equity (and other capital) is obtained by business firms and is invested in assets that yield returns greater than the cost of capital. Cooperatives are no exception, though as noted the cost of capital is not as determinable as non-cooperative corporate equity. Returns to member/patrons justifying their equity investment in the cooperative are not based directly on equity but on several other factors. Nevertheless, if total benefits are not sufficient to justify equity investments, entities will not be cooperative member/patrons.

Outside equity would likewise be expected to generate income to the cooperative in excess of its costs, the excess providing the advantage to the cooperative of the outside investment. Total benefits to the cooperative will be divided between compensation to holders of outside equity and to member/patrons as users. The question then arises about the relative distribution of benefits that are generated by the addition of outside equity to the cooperative’s capital structure. A bias will exist if the benefits generated by the outside equity are captured by the outside equity holders disproportionately to total benefits generated by all equity capital. Theoretical and empirical investigations are necessary to provide an answer to the question but the cooperative’s obligations to outside equity holders will determine the rules to be applied and consequently on any biases in the process.

I. Broader Impacts

The above issues lead to several observations about the broader impact of outside equity in a cooperative. These go beyond the rights and obligations focus of the paper and are offered as ideas to consider for future inquiry.

1. Local Benefits

Cooperatives are frequently said to have a peculiar benefit to the community or region in which they exist because the income or other benefits stay in the community or region. In some cases it is possible that no business would exist in the community were it not for the intent of the cooperative to locate locality. Even if an business existed in the community, if the same business were carried out by a cooperative the argument is made that business profits will stay in the community in the case of a cooperative and not the non-cooperative. For a non-cooperative the profit will be benefit investors wherever they are located. Benefits generated by the business in the form of profits will leave the community. The same argument may be made in the case of a cooperative with outside equity holders. Benefits captured by the equity holders are not

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necessarily connected with the community in which the cooperative exists. The extent to which this occurs depends on many factors, of course. Outside investors may indeed be part of the community, and the profits may not be distributed but may be retained in the business to further enhance its profitability and growth. Although the general argument is true and appealing, specific facts determine the consequences of outside equity on the local community.

2. Distributive Consequences

Returns will be distributed to different groups of individuals as well as geographic regions when all returns, whether patronage refunds or returns on member equity, are allocated to members rather than investors. Investors may be located far from the local community in which a business operates. Funds under such circumstances will flow out of the community. Thus, the benefits of a local business will be lost at least so far as returns on investment go.

3. Consumption Functions

Multiplier effects of a business depend in part on the use made of business profits. The benefits of a cooperative whose members are producers become part of the producers income and thus the production process. The added income facilitates continued production or growth and adds to the production economy. Income to investors, on the other hand, is added to the savings sector as a return on investment. It may well be that the funds in the savings sector will find their way back into equity in another business, thus facilitating its continued operation and growth. That step, however, does not have as direct an impact on production, particularly at the local level, as does cooperative returns to users based on use. Theoretical and empirical investigation may shed light on this possibility.

4. Cooperative Roles

Cooperatives have traditionally been perceived to play important roles in the economy beyond merely marketing and purchasing on behalf of their own producer members. Cooperatives correct market failures, increase the efficiency of markets by adding effective competition, and according to Nourse establish a competitive yardstick by which other businesses can be measured. Such benefits presume certain types of behavior and performance on the part of cooperatives.

The presence of outside equity in a cooperative would not be expected to make a considerable difference in the roles cooperatives play. However, an inquiry may identify several concerns. In broad terms, one example may be demonstrated where a cooperative is expected to provide a competitive yardstick function in a poorly functioning market by lowering prices for a farm input. According to the competitive yardstick rule, the lower prices would force competitors to lower their prices as well. The price change would squeeze excess profit from competitors. If, however, a cooperative’s obligations to outside equity holders prevented the described pricing practice, the cooperative would not play its competitive yardstick role in the
economy. While this is an extreme example, nevertheless unexpected implications of outside equity in a cooperative may be found.

5. A “Trickle Down” View

A cooperative’s sole focus is on providing the maximum benefit to its member/patrons. To the extent that obligations to outside investors cause the cooperative to deviate from that single purpose, member/patrons are disadvantaged. The extent to which the user-benefit principle is compromised is a matter of degree. The concern with significant amounts of outside investment, especially when accompanied by significant control shifts, is that the farmer members will get what is left after the primary outside investors are duly compensated under whatever terms between cooperative and investors have been agreed upon. They will again be mere price takers in the market.

The concern is raised by some of the more forceful arguments for the need for outside equity investment. The argument is that unless outside investment is obtained, farmers will have no way to participate in value-added business and will have no means by which to capture profits of the value-added business. Only if farmers accept significant outside capital can they participate in a profitable enterprise. At some point the value-added business is essentially investor-driven. The argument may still be made that the farmers are receiving at least something that they would otherwise not otherwise receive. However, they are left essentially with only what remains after profits have been largely distributed elsewhere contrary to the
XI. Conclusion

It is clear that the issues outlined in this Paper are important for cooperatives and those who use and support them. It is a cliché that “cooperatives are at a crossroads.” However, by

The original objective of this Paper was to consider what deliverable services Cooperative Programs might provide regarding the key related issues of finance and governance given the significant changes in cooperatives and their members. Cooperative Programs’ statutory mandate in the Cooperative Marketing Act of 1926 (7 U.S.C. §453) is broad in scope and specifies a multi-dimensional approach. Technical assistance, development, research, statistics, publications, and education are parts of the mission.

For purpose of a more general discussion, however, discussion of specific roles for Cooperative Programs have been reduced. Rather, general observations focusing on unanswered questions are noted. Of course, Cooperative Programs’ goal is to take an active role in identifying important issues, conducting and supporting appropriate research, and developing ways to offer services that facilitate farmers’ and cooperatives’ abilities to make the most effective use of appropriate business forms through effective governance and creative financing methods in a cooperative business framework. It is clear that just as cooperatives are facing challenges that require innovative response, so USDA’s Cooperative Programs is required to change, respond, and lead. Positive response and effective leadership require a pro-active approach to the major changes facing cooperatives and their members – the subjects of Cooperative Programs’ mandate.

The Cooperative Marketing Act of 1926 states:

a) The division shall render service to associations of producers of agricultural products, and federations and subsidiaries thereof, engaged in the cooperative marketing of agricultural products, including processing, warehousing, manufacturing, storage, the cooperative purchasing of farm supplies, credit, financing, insurance, and other cooperative activities.

(b) The division is authorized -

(1) To acquire, analyze, and disseminate economic, statistical, and historical information regarding the progress, organization, and business methods of cooperative associations in the United States and foreign countries.

(2) To conduct studies of the economic, legal, financial, social, and other phases of cooperation, and publish the results thereof. Such studies shall include the analyses of the organization, operation, financial and merchandising problems of cooperative associations.

(3) To make surveys and analyses if deemed advisable of the accounts and business practices of representative cooperative associations upon their request; to report
all objective observations, such is truly the case. In the past the expression was usually used when assessing cooperatives’ economic strength and their ability to survive as businesses. Now, however, the very character of the cooperative form of business enterprise is called into question. Cooperatives and in particular those whose views of cooperatives are very different than those driving cooperatives in the past are embarking on new and unknown ventures.

Public policy, the organization of cooperatives, and dedication to the cooperative as a unique method of conducting business in a market economy will depend on how well the issues and principles suggested in this Paper are understood. Essential policy and philosophical decisions are being made by new players who do not necessarily share the history and culture of cooperatives. Entirely new questions are being posed, not merely as abstract inquiries but in circumstances that will have a direct impact on cooperatives and their future as unique businesses. It is also clear that critical answers to questions posed will have direct and practical impacts on how cooperatives are used and what they become. Implications reach beyond cooperatives to all sectors of the economy in which cooperatives play effective roles.

Answers to some important questions will need to be addressed by research, although some issues are not at present amenable to complete solution. Investigators will need to identify the issues most important in the short run as well as those that are important for the future. General issues suggested in this Paper need to be articulated as researchable topics to the extent
possible. Multiple disciplines will no doubt be required to find the best, most useful answers. Methodology can range from highly theoretical to the very practical. In summary, rich potential exists to draw the interest of many researchers to important issues.

Experience will play an important role as events unfold. Lessons will come from attempts, successes, and failures involving those who take creative approaches to challenges that face those who wish to participate effectively in the supply chain. However, lessons will not be learned if experiences in isolation are not studied and compared. This learning process requires awareness of events and the ability to analyze cases and communicate findings to others. It will require the combined efforts of stakeholders in a wide variety of professions who have significantly different interest in cooperatives and cooperative principles.

The types of issues discussed in this Paper suggest that a real need exists for focus on outreach and assistance. New options exist for prospective members, patrons, and investors; objectives for all parties in any kind of arrangement are mixed and perhaps in conflict; and the design of business arrangements are ever more diverse. Complexity makes objective, careful analysis of options especially important. Decisions are made early in business formation that will have significant consequences for the future of the organization and its stakeholders. Predicting consequences will depend on how well information from research is combined with experience to offer effective guidance and advice.

In all of this, the very idea of the cooperative form of business enterprise takes center stage. Limitations on cooperative businesses are recognized, but only when the full range of cooperative structures, operations, and financing are accounted for. Where cooperatives are not appropriate, decisions must be made about the extent to which extending the moniker “cooperative” achieves any purpose other than confusing the issues. Options for coordination with other business forms may be devised to maintain the cooperative but gain the benefits of non-cooperative businesses. Above all, an “integrity of ideas” is needed to guide researchers and advisors.

The ultimate interests to be considered are those of the use-owners, whether they be farmers in the case of farmer cooperatives or individuals from every other walk of life served by cooperatives. These interests are summarized simply and powerfully in cooperative principles. They can act as guides for research, direct assistance, education, communication, and public policy formulation. This central principle can not only guide research, it establishes the ultimate criteria for cooperative success in a dramatically changing world.