

The Law of COOPERATIVES

Business, Structure, and Legal Issues



STOEL
RIVES
LLP
ATTORNEYS AT LAW

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WELCOME TO THE LAW OF COOPERATIVES

Dear Member of the Co-op Community,

Cooperatives are a continuing source of fascination. Our everyday experiences with them are caught between Karl Marx's hope of "[f]rom each according to their ability, to each according to their need," and Adam Smith's observation that "[i]t is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner but from their regard for their own self-interest." No other business organization operates within these polar extremes so comfortably, and without apology.

It is clear to us that cooperatives do create rather than destroy value. We wrestle with whether service should trump profit, and whether a cooperative should subsidize one business from the surplus of its other businesses. But at the end of the day, no other business organization so encourages us to bring out our best and rise above ourselves. Cooperatives embody the best of Marx and Smith, and become more a way of life than just another entity choice or business organization.

Whether designed to produce food, provide services for our daily lives, distribute products or generate alternative energy, where there is (1) a group of individuals with common business or living needs, who are willing to (2) join forces and mutually provide and fulfill those needs for themselves, and are willing to (3) distribute earnings on the basis of use and patronage rather than investment, you will find a cooperative. Cooperatives are the ultimate self-help business organization, and both Marx and Smith would find something to like about them.

Recognizing this vibrancy and the accompanying legal challenges, the Stoel Rives Agribusiness and Co-op Team developed this book. It contains some of the insights and lessons that we have developed and applied over the past few years in the co-op community, as well as during the more than 100 years that our predecessors have been leaders in the use of the cooperative as a business organization.

You have in your hands the first edition of THE LAW OF COOPERATIVES. This volume is one in a series that Stoel Rives has produced over the past four years; the others include THE LAW OF WIND—A Guide to Business and Legal Issues (in its third edition), LAVA LAW—Legal Issues in Geothermal Energy Development (in its second edition), THE LAW OF BIOFUELS—A Guide to Business and Legal Issues (in its first edition) and THE LAW OF BUILDING GREEN—A Guide to Business and Legal Issues of Sustainable Real Estate Development (in its first edition). THE LAW OF COOPERATIVES will be updated as theory continues to evolve, and no doubt will be supplemented with additional chapters covering issues such as governance, use of patron loans for financing, and management of equity capital. We hope that you find it useful, and please contact us with any comments.

A handwritten signature in black ink that reads "Mark J. Hanson".

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Chapter One*
LAW OF COOPERATIVES
—Legal Framework of Cooperative Development—
Mark J. Hanson

Cooperatives—Legal Structure Built on Principles

“Cooperation is not dead! The legal structure is tired, worn out, and needs to be buried,” announced a frustrated partner of mine. The law practice of working with producer-owned businesses, cooperative and otherwise, throughout the country seems to focus on the unreasonable restrictions of co-ops and the flexibility of limited liability companies (LLCs). The advance of business and economics has always outpaced the law. Producers and cooperators desiring social and economic change in the 1920s decried legal impediments to cooperation and the law changed.

In the past 20 years, producers have successfully formed hundreds of New Generation Cooperatives (NGCs), which are based on producer investment and proportional patronage returns; however, the financially successful co-ops are running into structural roadblocks resulting in conversion to LLC or taxable corporations, or the contribution of assets to joint venture entities that can operate profitably for the benefit of their owners. Now, many NGCs are starting the expensive conversion to LLCs because taxation issues have convinced their leaders that “all the co-ops are facing the same thing” and “everyone is making the change to an LLC” (Uecker and Talley 2002).

Successful NGCs do not fit well with many of the social and political principles developed and legislated 80 to 150 years ago that have remained part of American co-ops. These principles for member-financed cooperative stores simply do not work with the capital-intensive, value-added processing co-op of the twenty-first century. The economics of agriculture have changed from gaining efficiencies through direct marketing of raw agricultural products to users to further processing of unique or higher-quality agricultural products into higher-valued consumer products. The new business model is capital intensive and necessarily so to derive competitive market presence and economies of scale.

A new cooperative model has been developed called a “Wyoming Processing Cooperative,” which is essentially a co-op that operates in an LLC structure on the Rochdale cooperator’s business principle of returning profits to the patrons of the co-op (Hanson 2001b). Wyoming’s cooperative law allows outside investment and eliminates the restrictions imposed by federal corporate cooperative tax law while requiring profits returned to patrons based on patronage and allowing returns to investors based on capital investment. This structure has been praised by producers and cooperators as allowing the co-ops the flexibility to adapt their structures to changing business conditions, but it has also been criticized by traditional cooperators as not being a true cooperative law (Fredrick 2002; Torgerson 2002, 2).

* From *Cooperatives and Local Development: Theory and Applications for the 21st Century* (Christopher D. Merritt and Norman Walzer eds., 2004). Copyright 2004 by M.E. Sharpe, Inc. Used by permission.

This chapter reviews the formation of cooperative legal principles codified through the development of state statutes to organize co-ops. The provisions of typical state cooperative statutes and modern corporate cooperative statutes are analyzed, and the formation of a valued-added agribusiness is compared under corporate cooperative statutes versus LLC or Wyoming Processing Cooperative structures. The federal control of corporate cooperative legal structure through federal tax law and other statutes is then examined.

For those who believe that cooperation is not dead and needs to be given the opportunity to further develop, a number of state and federal objectives and legislative changes are identified that will foster cooperative development.

Formation of Cooperative Legal Principles

Farmers in the United States have organized companies to find markets for their products for 200 years (Goldberg 1928, 270). The development of legal principles to structure marketing companies as co-ops began with the Order of Patrons of Industry, commonly known as the Grange, which spread concepts for collective action to farmers in order for them to organize as Rochdale co-ops (Evans and Stokdyk 1937, 20; Goldberg 1928, 272).

Rochdale Cooperation

Workers in England formed a cooperative store in 1844 called the Rochdale Society of Equitable Pioneers. Their plan emphasized participation in profits according to business conducted with the co-op rather than participation in profits based on invested capital (Holyoake 1908, 277; Woeste 1998, 20). This principle defined and differentiated Rochdale cooperation. The society published twelve principles, four of which became the legal foundation for American co-ops and are referred to as the “Rochdale Principles”: (1) business at cost with net returns paid to members based on patronage, (2) democratic control—one person/one vote, (3) limited dividends on invested capital, and (4) ownership (or beneficial membership) limited to patrons (Woeste 1998, 20). The Rochdale store was not capital intensive and, in fact, limited the capital of its members (Holyoake 1908, 277).

The national Grange endorsed the “Rochdale Principles” to be adopted as rules by local organizations of farmers for any commercial organization (Nourse 1927, 35). The rules included organization as stock companies with the purchase of at least one share of stock required for membership, required purchases each year, interest on capital limited to 8 percent, and profits distributed in proportion to purchases (36). One vote per member was also a Grange principle (Goldberg 1928, 272).

The Grange Fails, But Cooperative Principles Succeed

The explosive growth of the Grange movement relied in part on cooperative strategy to overcome failed or unprofitable marketing conditions. The Rochdale Principles were appropriately developed for purchasing co-ops, and the Grange rules were developed for cooperative stores, with the legal structure fitting the business. These same rules were applied to Grange elevators and shipping associations with minor changes to the

purchasing or store requirements (Nourse 1927, 37). The Grange's attempt to use a collective purchasing or cooperative store model for marketing ventures failed. Rochdale Principles restrict business volume to a level supported by the members' pooled capital, generally from operations. Marketing activities, especially those of storing, grading, or processing products, requires significant outlays of capital, and the Rochdale cooperative business model had limited capital per member (Woeste 1998, 24).

The meaningful operations of the Grange were short, rising rapidly and generally collapsing in the 1870s (Hanna 1931, 6; Nourse 1927, 34). Even so, the impacts of organizing farmers and promoting the Rochdale Principles as cooperative legal requirements have carried forward to co-ops today (Fite 1978, 8; Woeste 1998, 22).

Development of State Organizational Statutes

Farmers Allowed to Form Cooperatives Under General Statutes

In many states, the formation of corporations in the mid-1800s was by special legislative act. As states developed general business incorporation acts by industry, union movements and the Grange farmer protest movements led farmers to appeal to their state legislatures for general statutes to form local co-ops (Hanna 1931, 5-7; Nourse 1927, 39-50).

Michigan authorized the formation of cooperative stores in 1865 (Michigan Laws 1865; Nourse 1927, 39). Massachusetts passed a cooperative law in 1866 (Massachusetts Laws 1866) governing cooperative procedures that were a pattern for the statutes of Pennsylvania (1868), Minnesota (1870), Connecticut (1875), and Ohio (1884) (Nourse 1927, 40). The Massachusetts statute generally allowed co-ops to be formed as a corporation to conduct lawful pursuits, including agricultural businesses, with capital stock limiting a member's interest in the co-op to \$1,000, voting power of not more than one vote per member, and limited liability of members. The statute also authorized a distribution of the profits to the purchasers and stockholders as described in the bylaws, provided that 10 percent of the net profits were deposited in a sinking fund until the amount of the sinking fund balance was a sum equal to 30 percent in excess of the capital stock (Massachusetts Laws 1866).

In 1877, Kansas, Wisconsin, and Pennsylvania enacted cooperative laws (Nourse 1927, 42-43). The Kansas law was brief, requiring "one-man-one-vote" (42). The Wisconsin law was similar to the Massachusetts law but limited debts to two-thirds of the paid-up capital and prescribed voting: "members and not shares of stock shall vote in electing officers and transacting any business of the association of whatsoever nature, but no proxies shall be allowed" (42).

The Pennsylvania law was longer and more detailed, covering limited voting, patronage dividends, trade for cash, and so forth; it also included a unique base capital provision characterized as "permanent" and "ordinary" stock. "Ordinary" stock could be bought and sold, but each member held permanent stock allowing one vote and patronage dividends that were applied to payment for the stock until the \$1,000 maximum was attained (Nourse 1927, 43).

The First Model Statutes. In 1911, Wisconsin and Nebraska enacted cooperative laws that prescribed by statute the distribution of profits by patronage dividends to members. Prior laws had allowed co-ops to distribute dividends as provided in the bylaws (Nourse 1927, 46). The Wisconsin law required earnings to be apportioned first to pay dividends on stock not to exceed 6 percent; then, of the remainder, not less than 10 percent for a reserve fund until it was equal to 30 percent of capital stock; 5 percent for education to teach cooperative development; then, of the remainder, one-half according to purchases of shareholders and upon wages of employees, and the other half according to the purchases of shareholders and nonshareholders, providing that for processing co-ops the dividend would be on raw products delivered instead of purchases (Wisconsin Laws 1911). The Wisconsin law was generally adopted in sixteen other states in the following eight years (Nourse 1927, 46). The cooperative laws based on the Wisconsin model generally required capital stock co-ops to operate on the Rochdale Principles of limited capital holdings, democratic voting, and distribution of profits based on patronage (48).

Non-Stock Cooperative Alternative

An alternative to capital stock co-ops was developed concurrently with the Wisconsin and Nebraska state statutes primarily to avoid the corporate attributes associated with capital stock. Critics alleged that capital stock co-ops were merely a modified form of for-profit corporations and that an alternative organization should (1) avoid capital stock by putting all invested capital on a “loan” basis, (2) eliminate the competitive-price relationship with the member (transfer price for product) and substitute a net returns settlement, and (3) restrict cooperative transactions to members only (Nourse 1927, 52-58).

In 1909, California enacted a nonstock cooperative law (Statutes of California 1909), providing for a membership association on a nonprofit basis that allowed equal or unequal voting and property interests as provided in the articles of incorporation. Capital contribution from members was authorized as “membership” fees. Six states adopted nonstock cooperative laws based on the California model from 1909 to 1921 (Nourse 1927, 65).

Nonstock cooperative laws were further modified by provisions of a U.S. Department of Agriculture (USDA) model nonstock cooperative act under the title “Suggestions for a State Co-operative Law Designed to Conform to Section 6 of the Clayton Act” (Nourse 1927, 73-92). The USDA model act required co-ops to only conduct business with members. Seven states enacted statutes based on the USDA model nonstock cooperative act (Hanna 1931, 42).

The Capper–Volstead Cooperative Definition

The initial period of cooperative statutes allowed the farmer businesses considerable flexibility to form and adapt co-ops to business conditions. As co-ops formed to exert market power, the principles were litigated in the context of antitrust violations (Guth 1982; Sapiro 1923).

The Clayton Act provided certain exemptions for co-ops organized without stock. In 1922, the Capper–Volstead Act was enacted by Congress to provide an exemption from antitrust enforcement for narrowly defined farmer co-ops organized as stock or nonstock co-ops whose membership was limited to agricultural producers,

restrict voting to one vote per member or limit dividends on equity to 8 percent per year, and handle products for members whose value exceeded that of products handled for nonmembers (Lauck 1999, 491-493).

The Capper–Volstead Act definition of co-ops continued to be the federal definition of co-ops for purposes of federal regulatory relief and financial assistance. The impact of federal financial assistance institutionalized the cooperative business structure. The federal government loaned \$330 million to co-ops from 1929 to 1932, an additional \$68 million by 1934, and more than \$400 million on an annual credit basis by the end of World War II (Lauck and Adams 2000, 67-68).

By 1970, one-third of the capital used by co-ops (subject to the Capper–Volstead definition with some modification) stemmed from debt, and the federally chartered banks for co-ops provided nearly all of the remaining debt financing (Lauck and Adams 2000, 68). The restriction of outside capital and limited capital returns did not impede cooperative development when favorable federal debt financing was available.

Commodity Marketing Acts

The most pervasive development in cooperative law occurred from 1921 through 1926, with more than forty states enacting a commodity marketing act to incorporate co-ops (Sapiro 1927, 8).

Sapiro's Plan. The movement was started by Aaron Sapiro based on his California commodity cooperative marketing experiences (Larsen 1967, 446-454). Sapiro's plan consisted of (1) organization of the association on a commodity basis; (2) limitation of membership to and democratic control by actual growers; (3) control of the deliveries by means of a long-term, legally binding contract signed by every member; (4) pooling of product according to grade, basing returns to each member on the average annual price received for the pool to which they contributed, and providing orderly marketing of the product throughout the productive period; and (5) control of a sufficient portion of the entire crop to be a dominant factor in the market and to make possible an economic distribution of overhead expenses (Knapp 1973, 9; Sapiro 1923, 200-201).

According to Sapiro (1927), the fruit growers in California experimented with cooperation to suit their needs and federated local associations of growers for marketing all of the growers' fruit:

[T]his was an organization by the commodity in contrast to organization by locality This adjustment could not be made by a single farmer; nor by a local association or even a small group of locals. But it could be made by farmers who could control and be certain of the control of a large percentage of the commodity and could help guide the flow of that commodity into the markets of the world The inevitable happened. Law began to conform slowly to the economic advance. The farmers had found a definite trend; and law put flesh on its dry bones and grew again in the same measure. (Sapiro 1927, 2-3)

A National Model: The Bingham Act. Sapiro, whose national stature with farm organizations allowed him to participate in preparing drafts of the Capper–Volstead Act, prepared a draft commodity marketing law based on the cooperative requirements of the Capper–Volstead Act and the California marketing principles. The first

commodity marketing act was adopted in Texas in 1921, but the best form and most widely adopted model was the Bingham Cooperative Marketing Act (Bingham Act) enacted by Kentucky in 1922 (Sapiro 1927, 7).

The Bingham Act was uniquely conformed to the Capper–Volstead Act. It thwarted unwarranted judicial intervention of competitors by legislatively announcing public policy issues requiring farmers to cooperate while providing a legal framework for cooperative organization and operations. The key features of the Bingham Act are as follows:

- public policy statements of the producers’ right to conduct cooperative marketing;
- provisions for a preliminary investigation of the marketing conditions to ensure success of the co-op;
- statutory authority to conduct the commodity marketing for the members of the co-op;
- restriction of members to agricultural producers, including share crop landlords and tenants;
- authorization of district voting for directors, directors and officers elected from the membership other than by appointment, or election of directors to represent the interests of the general public;
- statutory authorization of a marketing contract with members, including remedies of liquidated damages and injunction as a penalty for breach of the contract;
- criminal penalty for inducement of breach of the contract or spreading false reports about the finances or management of the co-op;
- penalties against warehousemen for soliciting or persuading members to breach marketing contracts;
- a declaration that commodity marketing or the marketing contracts shall not be deemed to be a conspiracy or combination in restraint of trade, an attempt to lessen competition, or an attempt to fix prices arbitrarily in violation of any law of the state (Acts of Kentucky 1922 1922).

A substantial amount of litigation ensued in many jurisdictions following the enactment of the commodity marketing acts, but the acts were held to be constitutional (Sapiro 1927, 10-11; Meyer 1927, 90-93; Tobriner 1928, 19-34). The general adoption of the Bingham Act started the uniform acceptance of legal principles for marketing co-ops and was referred to as the “Standard Act” (Evans and Stokdyk 1937, 298). Many legislatures modified the Standard Act with local concerns over operations; however, the main provisions of the Bingham Act were enacted.

A Ten-year Effort for National Uniformity Fails. The push for uniformity of the commodity marketing acts was undertaken by the National Conference of Commissioners on Uniform State Laws in 1925. After consideration of five consecutive drafts over ten years, the Conference and the American Bar Association approved the draft for submission to state legislatures. A national uniform cooperative law was referred to as an “epochal development in the field of marketing law” (Evans and Stokdyk 1937, 300), but the uniform law was not widely

included. Only two states had adopted the Uniform Act with modifications by 1945 (Jensen, 1950, 12). Even so, with the Uniform Act and substantial case law supporting the principles and language of the Bingham Act, the co-op as an organizational structure had reached legal maturity by 1950 (Ela 1950, 524).

Modern Corporate Cooperative Statutes

In the late 1980s and 1990s, Minnesota, Colorado, and Ohio redrafted their cooperative statutes. While commodity marketing acts were restricted to agricultural producers marketing their products, many states had modified these statutes to allow nonagricultural producers to form co-ops for other purposes. The modern corporate cooperative statutes are general cooperative statutes with certain provisions to accommodate agricultural producer co-ops. In Minnesota, five different stock and nonstock cooperative statutes were recodified and revised into one corporate cooperative statute (Hanson 1993; *Minnesota Laws* 1989).

Colorado repealed and reenacted one of its corporate cooperative statutes (Colorado Session Laws 1996, 1996; The New Colorado Cooperative Act 1996), and Ohio adopted a corporate cooperative statute in 1998 (Ohio Laws 1998). The impetus for revision was the increased interest and formation of a new generation of value-added co-ops (Hanson 2001a, 41-42). Most of the NGCs are processing co-ops with a different focus than commodity marketing co-ops.

A Comparison of Modern Corporate Cooperative Acts to a Commodity Marketing Act. The modern corporate cooperative acts generally differ from commodity marketing acts in facilitating modern corporate functions. The Rochdale Principles embodied in the commodity marketing acts are largely unchanged. Table 5.1 compares the major distinctions.

Cooperative Organization Under Noncooperative Statutes. State cooperative statutes provide a framework for organization and incorporation (Baarda 1982). Co-ops can also be organized under general business corporation statutes to meet federal cooperative tax criteria, and under LLC statutes to operate on a cooperative basis and to be taxed on a pass-through or partnership tax basis. Organization and incorporation under noncooperative statutes require substantial modification of articles, bylaws, and operating agreements to achieve operation on a cooperative basis.

A New Model Under Old Statutes: New Generation Cooperatives

Starting in the 1970s and 1980s and rapidly developing in the 1990s, a new form of co-op—the “value added” or “new generation” co-op—was being organized throughout the Midwest by agricultural producers to further process agricultural products (Hanson 2000b; Patrie 1998).

The New Generation Cooperatives (NGCs) were formed under existing cooperative statutes but were capitalized and operated differently from supply and marketing co-ops. The NGCs acquired or constructed processing facilities through 40 to 50 percent member equity and 50 to 60 percent debt financing. The member equity is obtained from each member subscribing to stock in proportion to the amount of crops or livestock committed to be delivered to the co-op.

Through stock subscriptions, the member producers essentially purchase the processing and marketing capacity of the co-op to process and market the agricultural products committed for delivery under marketing contracts. Products delivered are in proportion to stock purchased, and patronage is paid to the producers based on product delivered. The different variations of this model utilize common stock for the voting membership stock, and preferred stock is divided into delivery shares. In both cases, the amount of product committed to be delivered under uniform delivery and marketing agreements are proportional to delivery share ownership (Hanson 2000a).

Table 5-1. Comparison of Modern Corporate Cooperative Statute With Commodity Marketing Act.

<u>Modern cooperatives statutes</u>	<u>Commodity marketing act</u>
1. Organization	
<ul style="list-style-type: none"> • <i>Statutory policy declarations</i> • <i>Purpose</i> – any lawful purpose • <i>Incorporators</i> – one or more persons • <i>Stock and nonstock organization</i> – with same power and authority • No similar provisions • No similar provisions 	<ul style="list-style-type: none"> • Policy declaration – orderly marketing stabilizes marketing of agricultural products • Marketing, processing, handling agricultural products of members; or manufacturing, selling, or supplying members with machinery, equipment or supplies • Requires 10 to 20 persons; a majority must be residents of state • Grants powers to both stock and nonstock co-ops • Preliminary investigation of marketing conditions by university • Statement that cooperative marketing is in public interest
2. Articles of incorporation	
<ul style="list-style-type: none"> – Board Authority to designate classification of shares if not designated in articles – General statement of rights and obligations of shares – Statement of governance rights (voting) – description of voting allocations – Statement of restrictions on share transfer (approval of board) and whether bylaws and board may further restrict transfer – Limitations on dividends on stock (typically 8 percent) – Allocations and distributions of income in excess of dividend based on patronage • <i>Amendment</i> – by board majority and majority of members voting; board may amend articles until co-op has members or stockholders with voting rights; board authority to adopt specified amendments or without shareholder approval 	<ul style="list-style-type: none"> – No similar provision – Similar – One vote per member, no variance – Bylaws required to only allow transfer to producers – No similar provision – No similar provision • Approval by two-thirds of board and majority of all members; no authority for board amendments

Modern cooperatives statutes

Commodity marketing act

- *Bylaws* – cooperative may have but need not have bylaws. Initial adoption by board; subsequent adoption by members unless bylaw authorizing board.
 - Admission, withdrawal, and suspension of members
 - Voting rights; privileges of members
 - Reports and financial statements to members
3. **Powers**
- Generally, all acts necessary and proper to conduct co-op’s business or to accomplish purposes of co-op
 - Accept deposits from co-op members
 - Acquire and dispose of stock or ownership interests in other entities
 - Establish, pay and operate pension plans, share bonus and option plans and benefit plans for directors, employees, and agents
 - Indemnify directors, officers, and employees
 - Create subsidiary corporations, co-ops, limited liability companies, and other business entities
4. **Agricultural Marketing Contracts**
5. **Board of Directors**
- *Board governance of cooperative* – all authority of co-op exercised by board unless otherwise provided by articles or bylaws
 - *Limitation of directors’ liability*
 - *Encumber all assets without shareholder approval*
 - *Sale or disposition of all property without shareholder approval* – to subsidiary, in ordinary course of business
6. **Members**
- *Districts* – authorized in bylaws implemented by board
 - *Member violations of bylaws* – surrender or conversion of equity; cancellation of membership; redemption authorized not mandated
 - *Required reports to members*
 - *Access to records by members*
 - *Voting* – who may vote, mail and absentee voting, proportional patronage voting
 - *Limits of liability for corporate debts*
 - *Approval required for certain transfers of all or substantially all of the assets*
- Must have bylaws adopted by members
 - Note mandatory redemption upon withdrawal
 - One vote per member
 - No similar provision
 - Generally similar; may be more restrictive
 - No similar provision
 - Restricted to co-ops with similar producer membership
 - No similar provision
 - No similar provision
 - Similar but related to tax, no authority for LLCs
 - Generally same except no penalty for contract interference, and restrictions on warehousemen
 - Board governance; authority to exercise powers not explicit
 - No similar provision
 - No similar provision
 - No similar provision
 - Authorized in bylaws
 - Similar; however appraisal of interests and redemption within one year of withdrawal or expulsion required
 - No similar provision
 - No similar provision
 - One vote per member
 - Similar
 - No similar provision

Modern cooperatives statutes

Commodity marketing act

7. Stock

- | | |
|---|--|
| <ul style="list-style-type: none"> • <i>No similar provision</i> • <i>Authority and rights for preferred stock</i> • <i>Perfected lien of co-op for debts and obligations to co-op</i> | <ul style="list-style-type: none"> • No member may own more than 1/20 of stock of co-op, common stock may only be owned by producers • With or without right vote; purchase of property, value • No similar provision |
|---|--|

8. Allocations and Distributions

- | | |
|--|--|
| <ul style="list-style-type: none"> • <i>Reserves authorized, net income in excess of dividends distributed at least annually on basis of patronage, form of distribution prescribed</i> | <ul style="list-style-type: none"> • No similar provision; distributions of income referenced in marketing contract |
|--|--|

9. Mergers and Consolidations

- | | |
|--|--|
| <ul style="list-style-type: none"> • <i>Generally authorized with co-ops and in certain cases with corporations</i> | <ul style="list-style-type: none"> • No similar provision |
|--|--|

Nonuniform State Cooperative Laws Impede New Generation Cooperative Organization

The nonuniform development of agricultural co-ops and cooperative law has resulted in significant variations in state cooperative statutes—many of which were enacted from 1910 to 1925. In fact, few states have the same cooperative statute. This author and his partners have formed NGCs under stock and nonstock cooperative laws of many of the agrarian states, and although some state cooperative statutes have impediments, these can be generally overcome by shareholder agreements, article or bylaw provisions, or financing provisions.

Organization Under Commodity Marketing Acts: Indiana. Indiana enacted a commodity marketing act in 1925, which has had few amendments, to incorporate stock and nonstock, nonprofit co-ops whose members must be agricultural producers (West’s Annotated Indiana Code 1998). Forty other states have similar commodity marketing acts. The statute requires all members to be individuals or political subdivisions of Indiana engaged in the production of agricultural products, with the redemption of expelled or retired members’ interests to be as provided in the bylaws. The co-op may restrict voting to one vote per member regardless of number of shares owned or capital invested. Distributions after restoration of deficits, payments of stock dividends, and allocations to reserved are as provided in bylaws to members, nonmembers, and patrons, but only on the basis of patronage. The limitations of a commodity marketing act require skillful lawyering to organize NGCs.

Organization Alternatives Under Separate Stock and Nonstock Cooperative Statutes: Missouri. Missouri enacted stock and nonstock cooperative statutes in 1923 and 1925. In these statutes, twelve persons may incorporate a stock co-op to produce or furnish goods or services; to conduct an agricultural or mercantile business on a cooperative plan; or to sell to or buy from all stockholders, groceries, or other merchandise (*Missouri Statutes* 2001, § 357.010). Stock may only be owned by natural persons (as opposed to juridical persons such as corporations), and co-ops must be organized in Missouri on a cooperative plan. As enacted until 1945, the directors were elected on a basis of one vote for each share of stock owned, but now the legislation requires one vote per shareholder and states that the policies of the co-op, including declaration of dividends, setting aside reserve funds, and method of distributing profits are reserved and conferred upon the shareholders (§§ 357.090, 357.100). Profits are

distributed to shareholders or, if authorized, to nonstockholders on a patronage basis after first setting aside 10 percent for a reserve fund until the fund equals 50 percent of the paid-up capital stock (§357.130). Dividends on stock may be declared not to exceed 10 percent.

Missouri also enacted a commodity marketing act which requires eleven or more persons, a majority of whom are residents of Missouri, to incorporate a nonstock, nonprofit co-op (*Missouri Statutes* 2002, §§ 274.010-274.300). Membership is restricted to agricultural producers. The nonstock co-op is governed by the board of directors, who must be members; however, one-third of the directors may refer any question to the membership (§ 274.150). In the case of the death, withdrawal, or expulsion of a member, the directors, when authorized by the membership, must appraise the value of the former member's property rights and pay the amount to the former member or the member's heirs or representatives as if the member had continued membership (§ 274.090). This requirement can be burdensome or cause the dissolution of an NGC in that the statute shifts the burden of the member to the co-op to find replacement equity for a member who leaves.

The Missouri stock cooperative restrictions on stockholders to natural persons or Missouri co-ops and the high statutory reserve in excess of paid-up capital stock (50 percent) significantly impair the formation of NGCs or other contemporary cooperative businesses. As a result, most new co-ops are organized on a nonstock basis with stock-like equity participation units established in the organizational documents.

Organization Under Unique For-profit and Nonprofit Distinctions: Michigan. Michigan generally organizes its corporate law into for-profit and nonprofit corporations. Each division has provisions for incorporating a co-op, while for both the operation is on a cooperative basis similar to other statutes. Other than the differences in the operational provisions between a for-profit and nonprofit co-op, a primary consideration is that the shares or equity of a for-profit co-op offered to members is subject to the Michigan securities registration requirements, while the shares or equities offered to members of a nonprofit co-op are generally not required to be registered.

NGCs that organize in Michigan typically organize initially under the nonprofit corporation cooperative laws but are operationally better suited to the provisions of the for-profit cooperative corporation laws. The nonprofit and for-profit distinctions for corporations do not appropriately apply to co-ops.

A New Era: Unincorporated Cooperative Associations

As more NGCs were organized, farmers voiced their complaints about state law restrictions and impediments of federal law. Midwestern states with anticorporate farming laws (*Iowa Code* 2001, Ch. 9H; *Minnesota Statutes* 2001, § 500.24) did not allow co-ops to participate in confined hog feeding, dairy, and egg laying operations. In these cases, corn farmers desired to process corn into feed to be fed to the poultry or livestock owned by the co-op and to realize profits from marketing pork, milk, or eggs. Iowa and Minnesota both modified their anticorporate farming laws to allow restricted farmer entities, including co-ops, to engage in these ventures.

Iowa Chapter 501 Statute. Iowa enacted a cooperative statute in 1996 “to provide an opportunity for producers of agricultural commodities to contribute a portion of their production for a single enterprise for purposes of enhancing the value of that production and to restrict control of these enterprises to agricultural producers”

(*Iowa Laws* 1996, Ch. 1010, § 1). This corporate cooperative statute required “farming entities” (*Iowa Code* 2001, §§ 501.101, 9H.4) to have at least 60 percent of the voting control and financial rights, and required “authorized persons” to have 75 percent of the voting control and financial rights (§§ 501.101[2][6]), with the profits distributed on a patronage basis and interests in the co-op not exceed 8 percent of the total. In some cases, profits may be allocated to reserves or retained savings (§ 501.503).

The statute also requires redemption of a member’s interest over a period not to exceed seven years upon withdrawal or expulsion. Some ventures had incorporated and attempted to obtain a § 521 certification as a farmer’s co-op from the Internal Revenue Service. The process resulted in questions as to whether such a co-op operated on a cooperative basis (Brown 1998). In 1998, the Iowa legislature substantially amended the corporate cooperative statute to eliminate the terms of “incorporation,” “incorporators,” “stock,” “shareholders,” and similar corporate terms and replace them with “association,” “organizers,” “members,” “interests,” and similar LLC terms (*Iowa Laws* 1999).

With these changes, promoters claimed that a co-op organized under the statute would be considered an unincorporated association and qualify for partnership type pass-through taxation similar to an LLC (Brown 1998). A revenue ruling confirming this approach has not been obtained.

Wyoming Processing Cooperative Law. In 1999, lamb producers in Wyoming and its surrounding states desired to acquire lamb meat, wool, and pelt processing and marketing businesses to make lamb production more profitable. The lamb producers realized that more capital would be needed than could be supplied by producers on a per lamb basis. They wanted to organize their business on a cooperative basis but the existing models did not fit their business plan (Hanson 2001b, 8-9).

The Wyoming legislature adopted changes in the existing cooperative statute, and a new processing cooperative statute was enacted to be effective on July 1, 2001 (*Wyoming Laws* 2001). A ruling request submitted to the Internal Revenue Service confirmed that a co-op organized under the Wyoming processing cooperative statute would be considered an “unincorporated association” and subject to partnership taxation or corporate taxation by election similar to an LLC (PLR 2001).

A Wyoming processing co-op may be formed and organized on a cooperative plan as provided in the Wyoming Processing Cooperative Statute to market, process, or otherwise change the form or marketability of crops, livestock, and other agricultural products and purposes necessary or convenient to facilitate the production or marketing of agricultural products by patron members.

A Wyoming processing co-op has flexibility in two important areas that are not available to corporate co-ops. The nature of the patronage relationship with its members can be determined by the organizational documents, and the co-op can enter what would otherwise be considered nonpatronage source business without tax at the co-op thereby passing income, losses, and tax credits through to the members; the co-op can also attract capital through outside investments (Hanson 2001b, 6-8).

The co-op's owners are its members divided into two classes. Patron members have rights and obligations to deliver the product to the co-op, while nonpatron members do not have product delivery obligations and are primarily "investment" members. Patron members may also participate as investment members. The patron members have preference in both governance and financial rights.

The voting rights of the members are differentiated between patron and investment members. Patron members vote on a democratic basis of one vote per member subject to certain exceptions. The patron member vote, however, is counted collectively based on a majority of the patron members voting on an issue. Investment members have voting rights proportional to their investment or as otherwise provided in the bylaws. The collective nature of the patron member's vote ensures patron members maximum representation in cooperative voting.

The co-op is governed by a board of at least three directors. At least one director must be elected by the patron members. Directors elected by patron members have at least 50 percent of the voting power of the board or voting power on an equal governance basis.

The financial rights are distinguished between patron members and investment members. The patron members are allocated financial rights (i.e., profits, losses, and distributions) based on patronage or business done by the patron member for or with the co-op. Investment members are allocated financial rights based on capital contributions. Financial rights are allocated between patron members collectively and investment members based on capital contributions, provided, however, that the patron members collectively receive at least 15 percent of the profit allocations and distributions.

Restrictions on member control, contributions, governance rights, and financial rights must be stated in the bylaws or within separate member control agreements. Investment members have redemption rights if bylaw amendments alter governance or financial rights that affect their investment. To protect both patron and investment members upon their entrance to the co-op, the co-op must disclose to any person or entity acquiring membership interests in the co-op the capital structure, business prospects, and risks of the co-op, including the nature of governance and financial rights of the membership interests being acquired and of other classes of membership and membership interests (Hanson 2001b, 6-8).

Variations in Statutes Will Ultimately Lead to Organizational Forum Shopping

The modern corporate cooperative acts retain the cooperative principles of the 1920s but typically do not restrict the purposes for which a co-op may be formed. The Iowa Chapter 501 cooperative statute, while restrictive, made the first step in allowing co-ops to form without the restrictions of federal corporate cooperative taxation and allows up to 25 percent nonproducer ownership and control. The Wyoming cooperative processing law provides the most flexible format for organizing a business organization on the cooperative business principle of distribution of earnings to patrons on the basis of patronage with or without federal corporate cooperative taxation.

The large variation in cooperative laws among states invariably leads to shopping for the best state statute when a new co-op is to be organized. The business principles of operating successfully drive new co-ops, especially NGCs, to seek an organizational statute that accommodates their business plan and structure. Forum shopping has been in practice for many years, with many corporations throughout the country incorporating under Delaware corporate statutes.

Impact of Federal Law on Cooperative Structure

A co-op is organized or incorporated under state law and must abide by the requirements of the organizational statute to maintain its charter to operate as a separate legal entity. While some state statutes under which a co-op may be organized offer more flexibility than others, federal laws require a co-op to have a certain legal structure (required by its articles and bylaws) in order to receive the corresponding benefit of the federal law.

Corporate Cooperatives Structured to Meet Tax Law

Virtually all corporate co-ops must be structured and operate on a cooperative basis as determined by the cooperative taxation provisions (“Subchapter T”) of the federal Internal Revenue Code (the “Tax Code”) in order to not be taxed as a corporation. The combined state and federal marginal tax rate is about 35 to 40 percent of taxable income in many states. Co-ops that operate on a cooperative basis under Subchapter T of the Tax Code are allowed to deduct patronage-sourced income that is allocated on a patronage basis. Simply stated, a corporate co-op organized under state law may avoid a combined state and federal 35 to 40 percent tax at the co-op level by operating on a cooperative basis prescribed by Subchapter T of the Tax Code and properly allocating its patronage-sourced income to its members.

Two types of co-ops qualify to deduct income allocated to patrons: (1) an “exempt” or § 521 co-op, and (2) a nonexempt co-op that operates on a cooperative basis for the purposes of Subchapter T.

Operation on a Cooperative Basis. The U.S. Tax Court has determined three guiding principles for operating on a cooperative basis: (1) subordination of capital; (2) democratic control by members; and (3) proportional allocation of income on the basis of patronage (*Puget Sound Plywood* 1965). In the 1990s, the IRS added four additional factors in considering whether a corporate co-op is operating on a cooperative basis: (1) existence of a joint effort on behalf of members; (2) a minimum number of patrons; (3) member business should not exceed nonmembers’ business; and (4) upon liquidation, present and future patrons must share in the distribution of any remaining assets in proportion to the business each did with the co-op during some reasonable period of years (Frederick and Reilly 2001, 26-27).

An exempt § 521 co-op has two additional deductions from gross income that are not available to a nonexempt co-op: (1) amounts paid as dividends on capital stock and, (2) amounts allocated to patrons with respect to income that is not patronage-sourced. To qualify for these two additional exemptions, an exempt co-op generally must (1) have substantially all (85 percent) agricultural producer members; (2) return profits in excess of expenses and permitted reserves to all patrons (members and nonmembers) on the basis of patronage with the co-op; (3) restrict dividends on capital stock not to exceed the legal rate of interest in the state of incorporation

or 8 percent, whichever is greater; and (4) restrict nonmember marketing business not to exceed member business, and restrict nonmember nonproducer purchasers not to exceed 15 percent of all purchases (Frederick 1996; *Internal Revenue Code* 1992, § 521).

Deduction Only Applies to Patronage Sourced Business. Co-ops that qualify for the ability to deduct income allocated to patrons are further restricted in that the deduction applies to patronage-sourced business for nonexempt co-ops and for patronage- and nonpatronage-sourced business approved within the exempt co-op's scope of business certified by the IRS (*Internal Revenue Code* 1992, §§ 521, 1381-1388). The limitations of both of these restrictions are beyond the scope of this article but have been discussed extensively by Frederick and Reilly (2001). In general, a deduction qualifying for patronage-sourced business must be related to the patronage business, and not be derived from other products, ingredients, or further processing by others. In limited cases, the income from investments in joint ventures that further process and market a co-op's products may qualify as patronage-sourced business.

Many of the Tax Code regulations were promulgated in the 1950s through the 1970s prior to the advent of NGCs and LLCs. At that time, virtually all companies were organized as corporations and all income was taxed at the entity level. Deductions such as those for income generated from patronage-sourced businesses or for exempt co-ops, the scope of business for which the patronage-sourced business deductions were derived, have been narrowly construed and restrictively regulated by the IRS.

Antitrust: Capper-Volstead Protection

The Capper-Volstead Act (*U.S. Laws* 1922 1992) has been hailed as the "Magna Carta of Cooperative Law." The acknowledgment was appropriate because marketing co-ops and, especially, stock co-ops, were being successfully challenged under state and federal antitrust laws as illegal combinations that restrained trade in the early part of the 1900s (Guth 1982). The Capper-Volstead Act provided a limited antitrust exemption for co-ops that (1) limit membership as agricultural producers; (2) operate for the benefit of members as producers; (3) restrict voting to one vote per member or limit dividends on equity to 8 percent per year; and (4) handle products for members that have a value exceeding the value of products handled for nonmembers. Subsequently, the Cooperative Marketing Act of 1926 was enacted, allowing co-ops that meet these requirements to share marketing information (Cooperative Marketing Act of 1926, 1992).

The criteria for a co-op qualifying for protection under the Capper-Volstead Act were developed primarily from the U.S. Department of Agriculture (USDA), but it is important that these same criteria formed the basis of the commodity marketing acts adopted throughout the country (Guth 1982).

Agricultural Marketing Act of 1929

This act defines co-ops to include the requirements of the Capper-Volstead Act (Agricultural Marketing Act of 1929, 1992). The act was originally intended to define which co-ops were eligible for cooperative bank financing but has subsequently been used as the test for (1) the protection against handler coercion and discrimination in the Agricultural Fair Practices Act; (2) the cooperative exemption from the registration requirements of the

Securities Act of 1934; (3) the cooperative exemption from the trust provisions of the Perishable Agricultural Commodity Act; and (4) the cooperative trucking exemption from trucking regulations under the Interstate Transportation Act (Frederick 2002).

Entity Selection: Corporate Cooperative vs. LLC or the Wyoming Cooperative

Co-ops are organizations that have been developed on social and policy principles, primarily the Rochdale Principles and business principles of the patronage relationship. When producers are organizing an agricultural business that requires delivery and processing of products, an evaluation of the types of entity to organize focuses on corporate co-ops versus LLCs and now the Wyoming Processing Cooperatives (Wyoming Cooperatives).

Pass-Through Taxation and Limitations of LLCs

Limited liability companies (LLCs) offer pass-through taxation--that is, no tax at the entity level and a pass-through of gains, losses, and tax credits to members. An LLC can be organized to separate governance and financial rights (i.e., voting can be proportional or disproportional to the investment). Allocations and distributions can, but need not, be proportional to the investment. LLCs require operating agreements to be signed by all members and are cumbersome to amend. Unlike bylaws as organizational rules, operating agreements are viewed as member contractual rights.

The flexibility of an LLC requires a careful crafting of organizational documents to effect business provisions and a careful analysis of the tax ramifications. The federal partnership tax law was developed for partnerships and has not been revised to accommodate LLCs. If the business will require member delivery of the product to be processed by the LLC, the issue of transfer price and allocation of income based on the product delivered or on the investment must be addressed. An LLC structure can be adopted to allocate or distribute income based on product delivered but the documentation and agreements are cumbersome and complicated.

Corporate Cooperative Restrictions and LLC Alternatives

The Business Principle: Income Allocated Based on Patronage. The most important business principle of a co-op is allocation and distribution of income based on patronage (i.e., business done for or with the co-op) rather than investment. In other corporations, the investor need not do any business or purchase or use any of the corporation's products or services to receive stock dividends representing profits allocated through share ownership of profits of the corporation. A co-op is organized to benefit members who deliver or acquire product from the co-op. Noncooperative businesses can acquire and market products of their investors; however, the product procurement and marketing is done on a contractual basis typically based on the transfer price of the product.

A co-op is organized to allocate income to members based on business done for or with the co-op. In NGCs, members invest money to purchase stock or equity proportional to the amount of product to be delivered. In essence, the processing facility can be considered to be divided and allocated into processing and marketing units with each member purchasing a block of processing and marketing units through his/her equity ownership. This

collective action on behalf of the members' units results in the income attributable to those members' units being allocated and eventually distributed to each member. The cooperative organizational statutes of the various states facilitate and, in many cases, mandate this principle.

If producers, with or without others, intend to form an agricultural business that does not utilize their products or is intended to reward producers solely on investment, the business should not be organized as a co-op.

Subordination of Capital. Organization on this business principle as a co-op carries several nonbusiness principles, especially with corporate co-ops. State and federal statutes have legislated that subordination of capital means outside investment should receive no more than an 8 percent dividend on equity. During most of the last twenty-five years, 8 percent would not have paid for the use of capital and, in fact, would pay less than a commercial bank debt. LLCs and Wyoming Cooperatives can have outside investors and pay returns at market rates to attract that outside investment.

Dealing Primarily with the Products of Members. Exempt corporate co-ops are to deal only with the products of producers, and the value of member products must exceed nonmember products. While nonexempt corporate co-ops may deal with a greater amount of nonmember products, this principle is embodied primarily in federal corporate cooperative tax law. Most processing and marketing businesses need a variety of grades and pricing of products to be successful marketers. Certain nonmember producers may offer to sell products at harvest at a substantial discount. A corporate cooperative processing entity would be at a competitive disadvantage if it could not acquire products from nonmember producers at the same discount as its competitors. If a corporate co-op is authorized to conduct business with nonmembers on a noncooperative basis, the income is not deductible as patronage-sourced business and, therefore, will be subject to state and federal tax at the co-op level. LLCs and Wyoming Cooperatives can acquire products from members or nonmembers at the most competitive price.

Limitation of Patronage-sourced Income. Although a corporate co-op is based on a single-level tax theory—income is either taxed at the entity or at the member level—the deduction at the co-op level is only available for patronage-sourced business, which, through years of IRS challenges is restrictively interpreted to mean that level closely associated with the members' products. For example, if a farmer's corporate co-op produced a pharmaceutical drug in a plant that was extracted in the co-op's processing facility, combining that drug with other drugs in a capsule to be labeled and marketed to consumers, the drug extracted from the farmer's plants would likely have a small value relative to the overall capsule; therefore, the income from the sale of the capsules would not be patronage-sourced and would be taxed at the state and federal marginal rate of approximately 35 to 40 percent at the cooperative level. LLCs and Wyoming Cooperatives are able to pass this income to their members.

Tax Credits and Losses. Corporate co-ops that are taxed under Subchapter T have a number of corporate tax attributes under Subchapter C of the Tax Code, including the inability to pass losses or tax credits through to members. For an ethanol production co-op startup operational losses are retained at the co-op level, and tax credits, which may exceed \$2 to \$3 million, generally remain unused at the corporate co-op. LLCs and Wyoming Cooperatives can pass these losses and credits through to their members.

Operation at Cost with all Profits Returned Based on Patronage. This is a principle embodied in federal corporate cooperative tax and case law and in some state statutes. Nonpatronage-sourced investment venture partners and other participation in profits are precluded, which limits outside capital and management who desire profit participation as part of their compensation, similar to corporate management. An LLC or Wyoming Cooperative can allow outside investment and management participation in profits as part of their compensation.

Governance: Board of Directors Elected by One Member/One Vote. Corporate co-ops are governed by a board elected from members and membership voting on the basis of one member/one vote. This principle has two facets: (1) how the members vote, and (2) who they can vote for to govern the co-op. The Rochdale Principle of one member/one vote was an alternative to voting based on investment and paralleled the Rochdale Principle of subordination of capital with no voice in management. Co-ops in some states have recognized that in the case of a federated co-op (i.e., a co-op with one or more co-ops as members), a fair method of member voting is on a basis proportional to patronage (Barton 1989, 26-33).

In addition, board governance frequently has directors selected from districts based on geographical areas, products, patronage, or other distinctions. The general principle of one member/one vote, while an alternative to voting based upon investment, does not vest voting authority with the patrons who have the most at risk with the success or failure of the co-op. Consequently, member governance tends to be less effective than it should be and board elections can be political and based on popularity.

Corporate co-ops usually require directors to be elected from the membership who are patrons and, in many cases, who are required to be producers. Representation of patron members on the board is important, but equally important is board representation to facilitate strategic planning; capitalization; and hiring, retention, and termination of management on appropriate terms. The producer board members of a capital intensive processing and marketing co-op may not possess the same skills and knowledge as a diverse board with outside directors who are familiar with the processing and marketing industry or of capital availability.

LLCs and Wyoming Cooperatives can allocate voting based on patronage and investment. The directors elected by members need not be members, which allows the hiring of outside directors for their expertise.

State and Federal Opportunities to Assist Cooperative Development

State and federal assistance should recognize five factors in making changes to assist cooperative development: (1) the cooperative business model must compete favorably with other business models or it will not be used; (2) many if not most cooperative opportunities require capital beyond the means of producer members; (3) the cooperative business model must grow with the success of the co-op; (4) co-ops need more flexibility today to succeed than at any previous time; and (5) cooperative development can represent sustainable rural development and have exponential benefits beyond the cooperative business.

Legislative Changes to Remove Legal Impediments

Legal principles originally developed to support cooperation have become statutory legal impediments. The statutory changes and cooperative requirements of the 1910s and 1920s do not fit today. Cooperative development is best served when the ingenuity of the cooperator is allowed to apply cooperation competitively to the business plan. Today's cooperators who try to develop value-added processing businesses are hamstrung by restrictions applicable to cooperative stores of the mid-1800s and business conditions of the early 1900s.

Business organizations have evolved since 1960 to Delaware-style corporations and LLCs. Until the Wyoming Processing Cooperative Law, the cooperative legal principles essentially had matured by 1925. Simply stated, the corporate cooperative form of business offers few advantages and a number of significant business disadvantages over other forms of business for today's processing businesses; however, only the cooperative form of business rewards the users of the business, which is why state and federal governments should support its continued development.

Tax Laws. Federal tax law has one of the most chilling effects on cooperative development. Much of the regulations and tax law theory were developed before the advent of LLCs and are only compared to the differences of a corporation. While corporate cooperative taxation provides some advantages over corporations, in most areas cooperative organization competes with LLCs:

- *Certification of cooperatives under § 521.* The certification criteria for producer co-ops under § 521 should be changed to certify co-ops in which 50 percent or more of the ownership or control is held by producers; dividends on capital do not exceed three times the prime rate on a preferred basis or the collective return on patron investment on an equity basis; and patron voting is not based on the amount of investment but on patronage or marketing rights. Certification should be allowed as a corporate co-op qualifying for Subchapter T taxation or a co-op on an Iowa or Wyoming plan qualifying for Subchapter K partnership taxation.
- *Patronage-sourced business.* The restrictions on the deduction for patronage-sourced business should be revised to allow producer co-ops to prepare and effectively market their product in the marketplace. A pasta co-op should not be taxed on the income attributable to a prepackaged spaghetti dinner just because the beef and tomato ingredients cost more than the spaghetti noodles.
- *Tax free or tax deferred reorganization of corporate cooperative to an Iowa or Wyoming cooperative.* The reorganization of a corporate co-op to an Iowa or Wyoming co-op is taxed as a liquidation of the corporate co-op. The tax law should allow a corporate co-op to complete a tax reorganization from a corporate co-op to an Iowa or Wyoming co-op or, as an alternative, allow the deemed liquidation to be deferred until actual liquidation of the Iowa or Wyoming co-op after conversion.

Securities Laws. When producer co-ops start businesses, capital is needed from producers and others. The federal and most state securities laws are not well-suited for producer entities raising capital. Co-ops should not be treated as public companies in raising funds under the registration and public company reporting requirements.

The securities laws should allow co-ops with proper disclosure to raise \$50 million or less from patrons, accredited investors, and nonaccredited investors within an influence radius (e.g., local rural investors) as certified by the securities division of any state without registration or reporting requirements. This would allow local and rural investors to participate in co-ops.

Cooperative Laws. States should facilitate Wyoming-type cooperative laws to allow co-ops to organize without federal corporate cooperative tax restrictions. Federal laws such as the Capper-Volstead Act and Marketing Acts of 1926 and 1929 should be held to a twenty-first century definition of a co-op to meet their original intent of being effective tools to help cooperating farmers (Lauck 1999, 491-493).

Financial Assistance

Producers have limited financial resources to start up and develop co-ops. Much of the financial assistance available is in the form of grants and loan guarantees.

Equity. Financial assistance programs should be expanded to include subordinated debt and an equity investment to match producer equity plus an exit strategy should be included.

Incentives Tied to Market Power. Government assistance programs should be targeted to enhancing producer market power. For example, more than eight farmer cooperative ethanol production facilities were built in Minnesota with state financing incentives. Some attempts were made to market the ethanol collectively on a cooperative basis, but it was never achieved. Today, these same plants market with four or more different marketers, and the corn farmers who organized cooperatively are competing against each other for ethanol markets.

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Chapter Two
LAW OF COOPERATIVES
—Do Cooperatives Create or Destroy Value—
Joel J. Dahlgren

In fall 1947, the co-op movement was under attack in the United States. Some cooperators said that the totalitarian forces of Fascism and communism were lined up against cooperatives. In that day, the biggest lobby in Washington was the anti-cooperative lobby. One co-op proponent described this lobby as the most sinister and vicious lobby that ever invaded the nation's capital.

The Ways and Means Committee of the U.S. House of Representatives held hearings that fall regarding the tax advantages of exempt and nonexempt cooperatives. Proponents and opponents of cooperatives lined up to testify. Some owners of private businesses threatened to fold up their tents and convert their corporations to cooperatives, and consequently to stop paying federal income taxes if something wasn't done about the advantages that cooperatives enjoyed.

There is nothing like political adversity to hone and polish the articulation of arguments for and against ideas, and the hearings of the House Ways and Means Committee were no exception. More recently, one of the questions posed for discussion at the 2007 Farmers' Cooperative Conference in St. Paul, Minnesota was whether cooperatives create or destroy value. We think the testimony of select co-op proponents from those 1947 hearings explains as well as anything how cooperatives create value. What follows is a selection of that testimony regarding the value co-ops provide to their members and the economy as a whole:

Showing Private Industry What's Possible. Statement of Jerry Voorhis, Executive Secretary of the Cooperative League of the United States of America, Chicago, Illinois:

“Let me just briefly point out in the field of world electrification, the situation where the power company said we cannot carry electricity into the rural areas, and then when the cooperatives came along and did bring electricity into those areas, they did so to the extent that about 1,200,000 farms have been electrified, and only half of that was done by the cooperatives. The other half of it was done by the electric companies who said it cannot be done, who found that if you brought electricity into the farms at a fair price on a mass production basis, that they would take it. That has been brought about as a result of the efforts and activities of the cooperatives.”

Co-ops Are Nongovernmental Yardsticks Against Which to Measure Private Industry. Mr. Voorhis' statement continued:

“Yardsticks of service, quality and price have been established, not by the government, but by the people. Believe me, gentlemen, this is the real reason for the opposition to cooperatives. The big fellows who have been able through the years to keep their margins, their formulas, their methods of restricting production secret don't like yardsticks in the hands of the people. . . . [B]ut, these yardsticks can restore economic health just the same. Cooperatives give the little people of the country a chance to compete with the big ones. In so doing, they afford a means of solving the monopoly problems which does not involve any of the disadvantages and even dangers which are involved in increasing government controls. . . . [B]ut, cooperatives cannot perform this great task unless the general point of

view toward them is one of at least live-and-let-live, and I believe they are entitled also to the moral support of all people in positions of public trust.”

Economic Prosperity. Statement of the Honorable Wright Patman, U.S. Representative in Congress from the state of Texas:

“But, I am just as sincere from my viewpoint, that cooperatives are part of the free enterprise system and part of the profit system. Ask these farmers who have profited by it; they will tell you. The farmers are paying income taxes today who never paid income taxes before, because of cooperatives. So it is a part of the free enterprise system and the profit system.”

The Co-op as “Honest Broker.” Statement of M.J. Briggs, general manager of the Indiana Farm Bureau Cooperative Association, Inc.:

In supply activities: “[I]he average margin on a ton of fertilizer was \$12 a ton. I took it from the records of a fertilizer corporation which I saw myself in 1920. The average margin on a gallon of gasoline used in a tractor was 6.9 cents a gallon. . . . [I]he margin on a ton of chick mash feed was \$22. I saw that invoice. The influence of the cooperatives in this State have reduced these average margins to \$5 a ton on fertilizer . . . [a]nd the margin of gasoline to 3½ cents per gallon. That is on the nose. And it is about \$5 per ton on feed. That saving is reflected in the farmer’s individual income-tax report when he pays his Federal income tax.”

In marketing activities: “Indiana Farm Bureau Cooperative Association, Inc., in June 1947, instituted the first egg marketing on a Federal grade basis ever established in Indiana. . . . [I]he first day after the cooperative price was announced, the quotations of competitors jumped 12 cents per dozen on current receipts, and that is a statement of absolute fact.”

The Co-op as Community Builder. Statement of the Honorable Wright Patman, Representative in Congress From the State of Texas:

“[I] want to tell you an interesting story, very briefly. It will not take over a minute. One of the best cooperatives in the West was organized by a public-spirited man, who told me that he believed that at the first meeting he had, 95% of them were extremely radical and people who would be considered as Socialists or Communists now, but after we organized them [in a cooperative], they began to profit from their marketing and buying operations and they became prosperous, and now they have many hundreds of members in the association, and there are only two in that group who are the least bit radical, which demonstrates the fact that cooperatives help to get them out of that radical status, and I have not seen any Communist leaders among the cooperatives around in this country with whom I have come in contact. I do not know of any at all.”

Concluding Thoughts. Congressman Patman’s statement continued:

“In conclusion, I would like to summarize some thoughts for the consideration of this committee:

“1. Cooperatives are borne out of economic necessity. They protect people from exploitation who would be helplessly unorganized – in other words, these individuals whose standing alone would be exposed to the greed of vested interests.

“2. Cooperatives have done more to protect poor and helpless people from the chisellers, cheaters and racketeers than any other one effort that I have known of during my lifetime.

“3. The cooperatives build community life. They protect, preserve and encourage the three great institutions on earth – the home, the church and the school.

“4. Cooperatives are the greatest protection to the little man of the farm, ranch and orchard. The cooperative makes a businessman out of every member, regardless of how small an operator he is, which results in a better citizen. His one voice would never be heard, but organized in the cooperative way, the collective voice of thousands of little fellows is heard throughout the length and breadth of the nation, in the state legislatures and also in the National Congress. Incidentally, this is what the big lobbyists object to – being so successfully opposed by representatives of farm organizations who are permitted to be here with the aid of cooperatives.

“5. Cooperatives keep their profits at home in the hands of its members, and they are deposited in a local bank, thereby making additional credit available for people in that area to further help in building the community.

“6. Cooperatives prevent the concentration of wealth in the hands of the few, which is the life blood of a democracy.

“7. Cooperatives are the greatest bulwark against monopoly, Communism and Fascism. No real cooperative association exists in Russia or any other totalitarian government.

“8. Small business generally is in a more favorable position in areas of the United States where farmer cooperatives are the strongest. This is also true in other countries.

“9. Cooperatives represent an important part of the free enterprise system. They are not confined to farmer buying and farmer marketing cooperatives. Mutual fire, health, casualty, automobile and life insurance associations, mutual banks, mutual building and loans, credit unions and world electrification associations are also involved. Credit unions protect the people from loan sharks where they would be charged from 50-1,000% interest on loans. The REA cooperatives have provided the farmers with one of the greatest blessings of mankind, electricity.

“10. Farmers who are members of these cooperatives, handicapped by less manpower and more war machinery than ever before, produced more food during our great war emergency in the second World War than ever before, despite these handicaps. Food was just as important in winning the war as bullets. Should we so quickly forget this great

contribution the farmers made in the war effort by slapping them in the face with a death tax against their cooperative organizations?

“11. Cooperatives usually prosper and survive either by their members having an interest in common, which enables them to unselfishly work in the interests of the entire group, or by reason of necessity to protect themselves from exploitation. There was no objection to farm cooperatives until they commenced to step on the exploiters’ toes.

“12. The charge is made that cooperatives should be stopped as a way of doing business because some of them are large. I’m glad they are large. This is the only way they can bargain collectively with large concerns. Until a cooperative becomes as large as the largest private corporation in that field, there should not be any complaint against the cooperative.”

Our economy has evolved a long way since 1947. Some of the co-op proponents’ arguments might seem a bit overdone or zealous now. Look at how our state and federal laws have developed and how much more the law protects consumers and businesses from illegal competition and untoward business practices. In 1947 though, many of today’s protections did not exist, and co-ops really were under attack.

We cannot overstate how well the co-op community and the general public have supported cooperatives in the intervening 60 years. Co-ops are still deeply respected today for their integrity, and they are trusted by consumers all over the world.

At the end of the day, the raw emotion, the will to succeed, the hope of fairness, and the desire for a level economic playing field that were reflected in the testimony of participants in those 1947 hearings are still familiar to each of us, even today. And all of the values that existed and were articulated by participants in 1947 are the same values held close today.

Chapter Three
LAW OF COOPERATIVES
—Renewable Energy: Trends in Finance and Business Structures—
Debra H. Frimerman, Joe R. Thompson

This chapter provides an overview of alternative cooperative business models and trends in financing renewable energy projects. The three business models examined below and often used in renewable energy projects are (1) a cooperative with producer members qualified for certain preferred tax treatment pursuant to section 521 of the Internal Revenue Code (“section 521 cooperative”), (2) a cooperative with both producer and nonproducer members organized under Minnesota Statutes chapter 308B or equivalent state statute (“308B cooperative”), and (3) a joint venture or other combination of a section 521 cooperative and a limited liability company. Three key factors to consider in choosing a business structure for a renewable energy project are the desired relationship between the members and the entity, financing, and taxation.

I. Section 521 Cooperative

A. Membership

Cooperatives exempt under section 521 of the Internal Revenue Code (the “Code”) are formed by farmers, fruit growers, or similar producers organized and operated on a cooperative basis for the purpose of either (1) “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 (2) “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.” For renewable energy projects, the section 521 cooperative is composed of members that are producers of the feedstock to be converted to energy at the facility. Although nonproducers may invest in a section 521 cooperative, their investment must be through a separate, nonvoting class of stock with annual dividends limited to state-specific maximums usually ranging from 8 to 10 percent.

As a condition to a producer becoming a member of a section 521 cooperative, the producer must, in most instances, enter into a marketing agreement with the cooperative regarding the amount of the feedstock the producer is obligated to deliver to the cooperative on an annual basis. The return paid to each member is based on either the quantity or dollar value of the feedstock the member delivers to the cooperative each year, which is referred to as “patronage.” An advantage to the delivery requirement is that, for example, a cooperative organized to produce cellulosic ethanol may require members to deliver corn stover, guaranteeing the cooperative the feedstock needed to produce the ethanol at a predetermined price or under a predetermined pricing mechanism.

B. Tax Considerations

All associations that operate on a cooperative basis can deduct earnings that are returned to members as dividends on the basis of business done by the cooperative with or for its member (“patronage dividends”). In addition, a section 521 cooperative is allowed to deduct a limited amount of the dividends it pays on capital stock and the earnings from nonpatronage sources that it distributes to its members on the basis of patronage (together, “nonpatronage dividends”). To qualify for a deduction of nonpatronage dividends, a cooperative must receive a favorable determination letter from the Internal Revenue Service that it is an exempt cooperative under

section 521 of the Code. Whether a dividend is a patronage or nonpatronage dividend depends on “the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative.” Patronage and nonpatronage dividends are subject to state self-employment taxes, with limited exemptions for certain retired producers receiving nonpatronage dividends in certain states.

C. Financing

Under section 3(a)(5) of the Securities Act of 1933, as amended (the “Securities Act”), securities issued by a section 521 cooperative are exempt from federal registration. Securities issued by a section 521 cooperative are considered federal covered securities, which means the states are preempted from regulating the registration of the securities. The benefits of this exemption include the ability to solicit a large number of prospective investors through public means, including radio and newspaper advertisements, which are not typically available to other entities issuing securities that are not registered with the Securities Exchange Commission (the “SEC”). However, to qualify as a section 521 cooperative, the securities can only be sold to producers who are able to and agree to enter into a patronage relationship for the delivery of commodities to the cooperative and nonproducers. Further, the states can regulate who can offer and sell the securities and under what circumstances.

II. 308B Cooperative

A. Membership

Iowa, Minnesota, Tennessee, and Wyoming have specific cooperative laws that apply to cooperatives with both producer and nonproducer members. For example, cooperatives organized under Minnesota Statutes chapter 308B permit producers and nonproducers to be members so long as certain protections are in place for the benefit of the producer members. The producer members must retain at least 50 percent of the voting power to elect members to the board of directors and at least 60 percent of the cooperative’s profit allocations and distributions unless the producer members vote to reduce their financial rights, but in no event can the financial rights of the producer members be reduced to lower than 15 percent, regardless of the ownership interest of the producer members.

The benefit of a 308B cooperative is that there can be nonproducer members and those nonproducer members can provide needed capital for the entity and enjoy voting rights and allocations and distributions based on ownership. Further, the combination of the equity from the nonproducer members and the feedstock from the producer members allows a renewable energy cooperative to obtain outside capital for the construction and operation of the renewable energy production facility while still having a guaranteed source of inputs needed to produce the renewable energy. For example, a 308B cooperative could require its producer members to deliver corn stover for a cellulosic ethanol facility, as a condition of investment, while the nonproducer members would provide additional capital necessary to purchase the land, equipment, and construction services for the facility.

Cooperatives in states other than Iowa, Minnesota, Tennessee, and Wyoming can take advantage of being a 308B cooperative by organizing in any of these states pursuant to the applicable statutes and qualifying to do business in the appropriate local jurisdiction. However, some states do not recognize 308B cooperatives as cooperatives for purposes of state law. In those states, the entity must qualify as a foreign corporation instead of a foreign

cooperative. This can have adverse state tax and state securities law implications, which are discussed below. Because of the varying degrees of recognition of 308B cooperatives in states other than Iowa, Minnesota, Tennessee, and Wyoming, the applicable state laws must be considered before organizing as a 308B cooperative.

B. Tax Considerations

308B cooperatives can be taxed as either a cooperative under Subchapter T or a partnership under Subchapter K. Under Subchapter T, the 308B cooperative is treated as a cooperative and all taxation occurs at the entity level, with the cooperative receiving a deduction from taxable income for any patronage dividends it pays to its producer members. However, a 308B cooperative taxed under Subchapter T does not receive a deduction for nonpatronage dividends.

Under Subchapter K, the 308B cooperative is treated as a pass-through entity and all taxation occurs at the member level. Allocation of income, gain, deduction, loss, or credit as set forth in the cooperative's bylaws are subject to partnership tax accounting rules, and deductions of loss are limited to the extent of a member's investment and share of the cooperative's debt. One important item to note is that generally for all producer members and for any nonproducer members that are involved in the management or otherwise employed by the cooperative, all of the pass-through income is subject to self-employment tax, regardless of the amount of distributions received by the members from the 308B cooperative. The benefit of being taxed under Subchapter K for a 308B cooperative is that any income from nonpatronage business is passed through to the members instead of being subject to double taxation at both the entity and member levels.

C. Financing

To raise equity, a 308B cooperative must offer and sell securities either after registering under the Securities Act or pursuant to an exemption from such registration. Registration requires the cooperative to prepare and file a detailed registration statement with the SEC for its review and approval. Once the registration statement is effective, the cooperative can offer its securities without any limitations on general advertising or the number or type of investors that can invest in the cooperative. Unless the securities are going to be traded on a national securities exchange, such as Nasdaq®, the securities must also be registered under the applicable state securities laws. However, some states have exemptions for cooperatives, regardless as to whether they are 308B cooperatives. Whether such an exemption is available to a 308B cooperative depends on if the 308B cooperative qualifies as a foreign cooperative or corporation and the text and interpretation of the applicable states' securities laws.

To avoid the time and expense of registration, securities can be sold pursuant to various exemptions from federal and state securities laws. One of the most common exemptions is pursuant to the federal safe harbor provided by Rule 506 of Regulation D of the Securities Act for transactions not involving a public offering. Similar to securities of a section 521 cooperative, securities sold in accordance with Rule 506 are considered federal covered securities and are exempt from state registration requirements. In general, sales can be made to an unlimited number of accredited investors (as defined in Regulation D) and up to 35 nonaccredited investors, there can be no general solicitation or general advertising, the securities cannot be resold unless registered or otherwise exempt, and the cooperative must satisfy certain disclosures requirements. The states can require notice filings be made for any offers or sales made in accordance with Rule 506.

Another potential exemption for transactions in securities is in compliance with section 3(a)(11) of the Securities Act and the Rule 147 safe harbor (the “intrastate exemption”). The intrastate exemption exempts from federal securities regulation offers and sales of securities that are offered and sold only to persons in one state. In general, to qualify for the Rule 147 safe harbor, the cooperative must be organized, doing business, and making offers and sales of its securities in the same state; the offers and sales can only be made in that state and cannot be made to any resident of another state within six months of the offering; and any transfers of the securities within nine months of the offering must be made only to residents of that state. The securities must be registered or exempt under the applicable state securities laws. As discussed above, some states have cooperative exemptions that apply to 308B cooperatives whereas other states require full registration.

III. Joint Venture Between Section 521 Cooperative and Limited Liability Company

A. Membership

Another common model is a joint venture between a cooperative and a limited liability company to take advantage of the benefits of both types of entities in renewable energy projects. One particularly successful type of joint venture is when a cooperative is formed, obtains a favorable determination letter from the Internal Revenue Service for section 521 status, and enters into marketing agreements with its members for delivery obligations of feedstock for the renewable energy production facility (*i.e.*, corn stover for a cellulosic ethanol plant). Next, a separate limited liability company is formed to own and operate the renewable energy production facility (the “LLC”). The LLC is composed of investors that contribute the necessary capital to construct the facility. One of the members of the LLC is the section 521 cooperative. As part of its membership in the LLC, the cooperative agrees to deliver the feedstock it receives from its members in exchange for membership interests in the LLC and/or cash. Although it is unclear whether a favorable section 521 determination letter could be obtained for such a project, it is possible that members of the cooperative could provide some minimal level of equity investment and land rights, wind rights, development rights or other non-traditional cooperative rights and the other members of the LLC that are able to take advantage of the production tax credit (the “PTC”) could provide the significant additional equity capital needed for the project.

B. Tax Considerations

The section 521 cooperative can deduct patronage and nonpatronage dividends as described above in Section I.B. The LLC is a pass-through entity taxed pursuant to Subchapter K. The LLC can enter into an operating agreement with its members for the allocation of profits and losses. The members of the LLC, including the section 521 cooperative, would be required to pay taxes on the net income allocated to the members by the LLC. However, to the extent the LLC’s income is distributed to the members of the section 521 cooperative as exempt patronage or nonpatronage dividends, the section 521 cooperative receives a deduction from its income of such dividends and effectively does not have to pay any tax on that income. The other members of the LLC pay taxes on their income similar to all nonproducer members of a 308B cooperative that elects to be taxed as a pass-through entity pursuant to Subchapter K as described above in Section II.B.

C. Financing

Any sales of securities by the section 521 cooperative are exempt from registration at both the federal and state levels as described above in Section I.C. Any sales of securities by the LLC must either be registered or made

pursuant to an applicable exemption, similar to the exemptions described above in Section II.C. However, the offers and sales of securities by the cooperative and the LLC must be two distinct offerings so they are not integrated into one offering for securities law purposes. A safe harbor exists if the LLC offers and sells its securities in reliance on Rule 506 and the offerings are more than six months apart. If the LLC and section 521 cooperative offerings occur within six months of each other, whether the LLC and section 521 cooperative are first integrated into a single offeree and then whether the two offerings are integrated into a single offering is determined based on the facts and circumstances. In general, two issuers are integrated if an investor able to invest in both companies would deem an investment in one enterprise as not being materially different from an investment in the other enterprise and/or the people in control of the entities are the same.

IV. Conclusion

There are distinct advantages and disadvantages to organizing a renewable energy production entity as a section 521 cooperative, a 308B cooperative, or some type of joint venture model between a cooperative and an LLC. One of the main benefits of forming any type of cooperative as part of a renewable energy project is the guaranteed delivery obligations of the members providing the feedstock for the facility.

Some of the benefits of forming a section 521 cooperative are that both patronage and nonpatronage dividends paid to members can be deducted from the section 521 cooperative's taxable income, thus preventing the section 521 cooperative and its members from double taxation at the entity and member levels, and sales of securities of a section 521 cooperative are exempt from federal and state securities laws. The main disadvantage to section 521 cooperatives is the limitation on raising capital because of producer membership requirements.

The benefits of a 308B cooperative are the pass-through treatment of all income, regardless of whether it is patronage or nonpatronage, and nonproducers can be members. The disadvantages of 308B cooperatives are that the securities are not exempt from registration under federal and some state securities laws just by virtue of the securities being issued by the 308B cooperative, and that some state regulators are unfamiliar with and dislike 308B cooperatives, which can make foreign qualification, state taxation, and compliance with state securities laws cumbersome.

Some of the benefits of a joint venture between a section 521 cooperative and an LLC are the section 521 cooperative can deduct the patronage and nonpatronage dividends it distributes to its members, including any of the income distributed to the section 521 cooperative by the LLC that is distributed to the section 521 cooperative members; pass-through treatment of all income to the members of the LLC; local landowners as well as large institutional investors may be able to benefit from the PTC and could develop a renewable energy production facility together; and sales of securities by the section 521 cooperative are exempt from federal and state registration so long as there is no integration between the offering of securities by the section 521 cooperative and the LLC. Disadvantages of the joint venture structure are that the section 521 cooperative members potentially have less control of the renewable energy production facility depending on the structure of the LLC and its operating agreement and that the complicated structure may not be as easily understood or trusted by producers.



Regardless of the type of cooperative or joint venture between a cooperative and another type of business entity, it is likely the advantages to having a consistent and reliable source of feedstock will make the cooperative structure important in the future of successful renewable energy projects.

Chapter Four
LAW OF COOPERATIVES
—Conversions and Restructurings of Cooperatives—
Joel J. Dablgren, Ronald D. McFall

Introduction

In the past few years, a number of cooperatives, including some rural electric cooperatives and credit unions, have restructured to adopt other business structures. In addition to rural electric coops and credit unions, some “value-added” or “closed” cooperatives have engaged in such restructurings, as have a small number of open membership cooperatives. Some of the cooperatives who have pursued such restructurings (often referred to as “conversions”) have converted into a corporate form of organization. Others have elected to become limited liability companies. This article is intended to briefly discuss the reasons for such conversions, to consider some of the conceptual obstacles inherent in the cooperative structure that may lead a cooperative to consider a conversion, and to provide an overview of the legal and procedural requirements involved in a cooperative conversion.

I. Why Convert a Co-op into an LLC or a Corporation?

Members of the co-op community have been upset by conversions of rural electric cooperatives and credit unions into LLCs in transactions in which the only beneficiaries appear to be management. If it appears that a cooperative’s senior management or the board of directors did not properly discharge the fiduciary obligations that are owed to the cooperative and its members, objecting cooperative members and other parties have considered and in some cases pursued responses through efforts to persuade cooperative members to vote against the proposed conversion, through litigation or through moral suasion. (An example of the latter occurred in the Washington, D.C. area when the National Cooperative Business Association exerted itself to stop the conversion of a federal credit union.[□]) While some members of the cooperative community will object on philosophic grounds to any conversion of a cooperative, circumstances may arise in which the conversion of a cooperative into some other form of business organization is necessary and beneficial to the cooperative’s members and the business operated by that cooperative.

The most commonly cited reason for a cooperative to consider conversion into an LLC or a corporation is the need for additional equity investment. This situation occurs when the cooperative is starved for equity capital and cannot raise sufficient equity from its patron members or the sale of preferred shares or similar equity interests to non-members. Preferred interests typically pay a dividend of no more than 8 percent or 10 percent per annum[□] and do not provide governance or

[□] See [□] HYPERLINK "<http://www.ncba.coop>" [□] www.ncba.coop[□] for news reports about this credit union.

[□] Dividends are usually limited by state law and are limited by Subchapter T, under which many co-ops are taxed.

voting rights. Non-patron equity investors typically want to invest in an instrument that pays dividends in excess of the 8 percent or 10 percent limitation, that appreciates in value and that permits participation in governance through voting rights that are proportionate to the equity investment. (Even if demand existed to purchase preferred equity in the co-op, co-ops, like any business organization, can tolerate only so much dividend-bearing preferred equity and will be forced to consider other approaches.) Non-member private equity investors are often not familiar with the cooperative structure and, consequently, may be uncomfortable investing in a business that is not organized as a corporation or LLC. As a result, if a cooperative's business requires equity investment beyond that which can be provided by the patron-members of the cooperative or through the sale of preferred stock, the cooperative's board may be compelled to consider conversion to another form of business organization to pursue the necessary equity investment.³

Another reason cited for converting a cooperative into an LLC or a corporation is to align the goodwill and going concern value of the cooperative (residual rights and claims) that might be obtained upon a future sale of the business with the investment provided by the member patrons. (This consideration seems to be most prevalent in the case of "value-added" or "closed" cooperatives in which the members are both patrons of the cooperative and have made a significant initial investment to participate in the cooperative.) If a producer owns \$1,000 of allocated equity in a cooperative that is expected to be worth \$10,000 in the event of the hypothetical sale of the cooperative, a conversion to an LLC or corporation is likely to be strongly supported by co-op members seeking that capital for their own operations.

A final reason often cited for considering the conversion of a cooperative arises from an understandable desire for liquidity. With the exception of certain classes of preferred stock, equity interests in cooperatives may typically be held only by producers who are patron members of the cooperative. That restriction limits the pool of prospective purchasers for any cooperative equity interest that a cooperative member seeks to sell. Corporations and LLCs typically do not have similar restrictions. As a result, following a conversion, the equity holder will be able to pursue sale of his or her equity interest to a larger group of possible purchasers, including non-producers.

Notwithstanding the reasons listed above, conversions of open membership cooperatives within federated systems have not occurred with any frequency. Federated systems are particularly immune to conversions because federated cooperatives (1) employ field staff that maintains confidence in the co-op form of business organization and (2) hold regular annual meetings in which senior management and directors are inculcated with the strengths of the co-op form of business organization. Perhaps most importantly, many federated cooperatives have taken the position that they will not distribute patronage refunds to non-co-ops. As a result, a local cooperative that

³ Several cooperatives that have converted to other structures have subsequently obtained additional equity investment from outside equity investors, providing support for the validity of this rationale for the conversion of a cooperative in some circumstances.

converts into some other form of business organization cannot expect to continue to receive patronage refunds from its interaction with a federated cooperative.

In addition to the reasons described above, analysis has also suggested that vaguely defined property rights within co-ops create disadvantages for co-ops that are central to understanding why co-ops occasionally convert their business structures to corporations or LLCs. The following section considers that impact.

II. Vaguely Defined Cooperative Property Rights

The property rights contained in LLC membership interests (or in shares in a corporation) are well defined and specifically benefit those members who hold equity in the enterprise. A member of the hypothetical LLC described in the table below knows that a membership interest is worth approximately \$22,000 per share or unit, assuming valuation of assets and liabilities is accurate. LLC members further know that increases in business valuation will accrue to their benefit and cause their interest to appreciate in value above \$22,000. Similarly, a decline in business valuation will cause the value of their interest to fall below \$22,000.

On the other hand, in the theoretical dissolution of the cooperative in the table below, holders of equity (past and present members / patrons of the co-op) know they have a claim only on \$5,025,000 of equity. Those holders also know that their claims will not appreciate in value because the value of those interests is limited to the face value of the allocated equity and par value common stock. The value of the claims of equity holders will never be more than \$5,025,000 in this case. In fact, inflation will cause those interests to depreciate in value until the equity is redeemed. Unlike the LLC where the membership interest includes a claim on all residual rights and claims in the total value of \$22,000 per share or unit, here in the case of the co-op the allocated, non-appreciable interest is set at only \$5,025 per share or unit.

	Cooperative	LLC
Common Stock or Units 1,000 @ \$25 /share or unit	\$25,000	\$25,000
Allocated Equity	\$5,000,000	\$5,000,000
Retained Savings	\$7,000,000	\$17,000,000
Difference between market and book value.	\$10,000,000	
Total Equity	\$22,025,000	\$22,025,000
Price per Share or Unit	\$5,025	\$22,025

Distribute
on
basis of
historical
patronage

Distribute
on
basis of
ownership

The co-op's patrons hold the residual rights and claims on all the remaining \$17.0 million proceeds based on the historical patronage of all members and patrons as defined by the articles of incorporation and bylaws. Importantly, those claims are only known or finally determinable if and when the cooperative dissolves. Obviously, few members or patrons want to dissolve the co-op just for that determination and understandably so. Until the actual sale and dissolution of the cooperative, however any analysis of residual rights and claims is an abstraction because the ultimate amount of historical patronage and the make-up of the holders of those historical patronage rights cannot be determined. The longer the co-op operates, the longer the list of potential claimants on the cooperative's good will and going concern value. The articles of incorporation and bylaws may set parameters around the identity of historical patrons by limiting the universe of all potential claimants to, for example, those patrons who have patronized the cooperative over the past ten years.

Professor Cook from the University of Missouri in Columbia attributes the challenges that cooperative have raising new equity or conserving what equity already exists to the fact that property rights in good will and going concern value are vaguely defined. Residual rights and claims in a cooperative are unassigned, unmarketable, and untradeable.⁴ As the discussion in the previous paragraph illustrates, the owner of those residual rights and claims may not be known until dissolution of the co-op clarifies those rights and claims based on historical patronage. Professor Cook describes these vaguely defined property rights by reference to the free-rider, horizon and portfolio problems.

The free-rider problem deters older patrons from providing new equity because newer patrons acquire a claim on goodwill and going concern value without the patron investing any equity in the cooperative. For example, a patron whose historical business with the cooperative constituted 0.01 percent of the cooperative's patronage business will have a claim on \$1,700 of the co-op's goodwill and going concern value of \$17 million. And that claim will exist regardless of how little or much equity the patron contributed to the co-op, *even if the patron never earned or contributed even \$1 of equity to the co-op*. The patron's claim arises at the expense of older patrons and members whose previous contributions of equity are the reason the co-op exists now at all.

The "horizon problem" deters investments of equity in the cooperative because financial returns (present and future) from those investments are not assigned to, and will not be capitalized into or appreciate the value of, that equity, leaving the equity unmarketable and untradeable. Holders of equity have no incentive to invest new equity into the cooperative. And the sooner their existing equity is redeemed, the better off members will be because the act of redemption will stop the equity from depreciating in value .

⁴ Michael L. Cook & Constantine Iliopoulos, *Ill-Defined Property Rights in Collective Action: The Case of U.S. Agricultural Cooperatives*, in INSTITUTIONS, CONTRACTS AND ORGANIZATIONS: PERSPECTIVES FROM NEW INSTITUTIONAL ECONOMICS 335 (Claude Ménard ed., 2000).

The “portfolio problem” deters investments of equity in traditional cooperatives because the risk preferences of holders of equity will always lean toward receipt of cash now rather than appreciation in the future that will be unassigned, unmarketable, and untradeable. Once again, holders of equity have no incentive to invest new equity into the cooperative, and they have no incentive to wait patiently for the redemption of their old equity because until it is redeemed, the equity will only depreciate in value.

The decisions of co-op members to vote in favor of a conversion are entirely rationale when viewed from the perspective of the free-rider, horizon and portfolio problems. The conversion of the co-op into a corporation or LLC sharpens the ownership of property rights that were previously vague and undefined. In doing so, the conversion will encourage investment of new equity capital from members. The conversion will also create an incentive for existing members and patrons not only to patiently wait for redemption of equity, but to benefit from appreciation in the going concern and good will value of the corporation or LLC

III. Overview of Conversion Procedures and Legal Issues

A. Typical Conversion Procedure. A cooperative whose leaders have determined that a conversion is an appropriate step will logically seek to minimize the procedural steps required to effect the conversion. In its most basic form, a cooperative conversion typically is completed by merging the cooperative into an LLC or corporation formed to continue the cooperative’s business.

Working with its legal and financial advisors, the cooperative will begin the process by forming a wholly-owned subsidiary organization that will be the surviving entity following the conversion. One of the key decisions that must be made by a cooperative pursuing a conversion is whether it should convert to an LLC or a corporation. Although there are numerous factors that should be considered in making this decision, cooperatives for whom tax efficiency following the conversion is the most important factor are likely to pursue conversion to an LLC. This choice is driven by the fact that LLCs are usually taxed as partnerships under Subchapter K of the Internal Revenue Code. This treatment allows the LLC to benefit from “pass-through” tax treatment in which the entity does not pay tax, but the entity’s income and loss are “passed-through” to the LLC’s members. A cooperative that is motivated to pursue a conversion in the hope of obtaining greater liquidity for the equity interests held by its members is more likely to consider conversion into a corporation. In that structure, the corporation pays tax at the entity level on its income and the stockholders are taxed again when the corporation distributes any dividends to its stockholders. However, a corporation is eligible for listing on a stock exchange, such as the New York Stock Exchange, or through NASDAQ, while LLCs taxed as partnerships typically are not.

Once the cooperative has selected whether it will convert into an LLC or a corporation, the subsidiary is formed and the necessary conversion documents are prepared. The most important document is the merger agreement between the cooperative and its wholly-owned subsidiary. The

merger agreement contains the terms upon which ownership interests in the cooperative will be converted into LLC units or corporate shares. In addition, the merger agreement typically provides that upon filing of notice of the merger with the appropriate state office, the cooperative will be merged into the LLC or corporation and that organization will be the surviving entity following the merger.

Given the magnitude of the change, state law will require that the cooperative's members vote to approve the merger with and into the wholly-owned subsidiary. Such a vote usually occurs at a special meeting of the cooperative's members. Before coop members vote on the proposed conversion, they typically receive a disclosure document fully describing the proposed conversion, the reasons for the conversion and a comparison of their rights as members of the cooperative before the proposed conversion and their rights as members of an LLC or stockholders in a corporation if the proposed conversion is completed.

If the coop's members vote in favor of the proposed conversion, the merger documents necessary to make the conversion effective are filed. Once that occurs, the cooperative ceases to exist and its assets and liabilities become the assets and liabilities of the surviving LLC or corporation. The equity interests held by coop members prior to the conversion become interests in the surviving LLC or corporation upon the terms and conditions stated in the merger agreement.

A conversion completed as described above is clearly subject to the state law governing cooperatives and mergers between cooperatives and LLCs and corporations. However, a proposed conversion also has legal implications under securities and tax laws. Those implications are discussed in the following sections and must be carefully considered by the cooperative and its advisors in analyzing and planning for any proposed conversion.

B. Securities Law Implications. In considering and voting for or against a proposed conversion, a cooperative member must make an investment decision. That is, the coop member must decide whether or not they are willing to exchange the equity interest they hold in the coop for either an LLC unit or a share of stock in a corporation. The fact that a proposed conversion involves such an investment decision has implications under applicable law for both securities registration and disclosure requirements.

A proposed conversion involves the issuance of new LLC units or new shares of stock by the surviving entity. Those new issuances are viewed by federal and state securities laws as the offer and sale of securities by the surviving entity. As such, the offer and sale must either be registered with the Securities and Exchange Commission or be able to rely upon an appropriate exemption from securities registration. Cooperatives considering a proposed conversion will initially consider the availability of an exemption from securities registration, as proposed conversions completed under a securities exemption will not be subject to the time and expense arising from detailed review of the proposed conversion by the SEC's staff. Although the federal securities laws contain a wide variety

of exemptions, only two different exemptions appear to have been used in connection with cooperative conversions. If the cooperative seeking conversion has a very small number of members, it may be possible to rely upon the private placement exemption for transactions not involving any “public offering”. This exemption, however, will not be available if LLC units or corporate shares are to be issued to a large number of former coop members in the proposed conversion.

Another exemption that has been used by cooperatives seeking to convert is the “intrastate” exemption; the intrastate exemption is available when LLC units or corporate shares are to be issued to residents of only the state where the surviving entity is organized. Other requirements of reliance upon the intrastate exemption from federal securities registration are that the surviving entity have a significant majority of its assets within the state where it is organized and that it generate a significant majority of its revenue within that state.

If an exemption from securities registration is not available for the proposed conversion, it will be necessary to register the offer and sale of LLC units or corporate shares by the surviving entity with the Securities and Exchange Commission. This is an extended and expensive process in which the surviving entity files a registration statement with the SEC. That registration statement contains the disclosure document that will be provided to members in connection with the vote on the proposed conversion. Only after the SEC staff has declared the registration statement “effective” following extensive review, comments from the SEC staff and any necessary amendments may the disclosure document be distributed to the cooperative’s members to solicit their vote for or against the proposed conversion.

The second key implication arising from the fact that coop members voting on a proposed conversion are making an investment decision is the need for appropriate disclosure to the members in connection with the vote. As indicated above, it is essential to provide that disclosure so that members can be fully-informed as they make their decision to vote for or against the proposed conversion. If the proposed conversion is registered with the SEC, the form of the disclosure is heavily regulated, with extensive regulations specifying the type of information that must be included and the manner in which that information is to be presented. If the proposed conversion can be completed in reliance upon an exemption from securities registration, there is more flexibility in the manner in which information may be presented to the cooperative’s members. In addition, the disclosure materials for use in an exempt offering are not required to be filed with or review by the SEC staff.

C. Tax Law Implications. When a coop considers the possibility of a conversion to some other form of business enterprise, it must carefully consider the tax implications of future operation of the business in the new organizational structure. As noted above, operation as an LLC can provide “pass-through” taxation in which no entity level tax is paid on income generated by the

business. Operation as a corporation generally subjects the income generated by the business to tax at the entity level and again when dividends are distributed to the corporation's stockholders.

In addition to the tax implications of operation of the business following the conversion, it is essential to consider the tax implications of the conversion itself. If the cooperative is seeking to convert into a corporation, it is likely that the conversion can be completed as a tax-free reorganization in which the conversion itself does not trigger tax recognition.

The situation is significantly different if the cooperative plans to convert into an LLC. Although cooperatives have special tax attributes not available to other corporate entities, cooperatives formed under virtually all cooperative statutes are corporations. Under the Internal Revenue Code, it is generally not possible to merge a corporate entity into a "pass-through" entity such as a partnership or LLC on a tax free basis. Instead, the applicable rules and IRS rulings characterize such a merger as a "deemed liquidation" of the cooperative followed by a subsequent "re-organization" of the LLC by the former cooperative members. This characterization is used as the basis for taxing such a transaction even though the formal steps to complete the proposed conversion do not involve the liquidation of the cooperative, but a merger of the cooperative into the surviving LLC.

The impact of this tax characterization of a proposed conversion can be significant, particularly if the cooperative holds property that has appreciated in value. The analysis begins by calculating the tax that the cooperative as an entity is likely to incur if a conversion is completed. The amount of this tax is determined by comparing the fair market value of the cooperative's assets immediately before the conversion takes place with the cooperative's tax basis in those assets. If the fair market value is greater than the tax basis, the difference will be subject to tax at the entity level upon the conversion *even though the transaction does not generate any cash or other resources to pay the applicable tax.*

The second part of the tax calculation is to determine the gain, if any, that will be taxed to the coop's members upon the conversion. This amount is calculated by comparing the fair market value of the LLC units received by a coop member in the conversion with that member's tax basis in his or her equity interest in the cooperative. If the fair market value of the LLC units received by a member exceeds that member's tax basis in his or her cooperative interests, the difference will be subject to tax on the coop member, even though the transaction does not generate any cash distribution that the coop members can use to pay the tax imposed on them. The effect, then, is that tax can be imposed at both the entity level and at the member level when the proposed conversion is completed.

As the amount of tax is determined when the conversion is completed and because the transaction does not involve a sale of any cooperative assets for cash consideration, it is necessary for the cooperative to obtain the assistance of an appraisal firm or investment banker to provide an opinion as to the fair market value of the various elements of the tax calculation. (The appraisal firm typically prepares an estimate of those values that is included in the disclosure distributed to the cooperative

members; a definitive valuation is then completed as of the date that the conversion becomes effective.) Given the possibility of significant tax implications, it is essential that a cooperative's leaders obtain expert advice in estimating the potential tax liabilities and in comparing those tax costs with the expected benefits of the proposed conversion.

Conclusion

A cooperative considering the possibility of conversion to some other form of business enterprise must be aware that it is following a path that involves significant legal requirements and business uncertainties. The analysis necessary to thoughtfully pursue such a transaction must include a careful weighing of the expected benefits of the proposed conversion and the potential costs and risks associated with the possible conversion. A conversion will require a cooperative to comply with complex state, securities and tax laws. Given the challenges of such compliance, a cooperative conversion should not be adopted lightly, but should be pursued only after careful consideration of the best interests of the members and the business enterprise.

Chapter Five*
LAW OF COOPERATIVES
—A Question of Value Proposition and Capital Structure
in Search of a More Satisfying Approach—
Joel J. Dahlgren

I. Overview

This chapter will examine and challenge the policy that open membership, nonfederated, nonexempt agricultural cooperatives must (or even can) allocate all or nearly all patronage earnings to patrons each year and then be expected to redeem all that allocated equity, again and again with each passing generation of producers. Under that policy, agricultural cooperatives typically allocate 75 to 90 percent of all their patronage earnings, pay 20 TO 30 percent in cash, distribute the balance with qualified written notices of allocation (QNAs), and obtain the Subchapter T tax deduction for these allocations of patronage earnings. Producers pay income and self-employment taxes on these distributions each year, and they understandably expect that the resulting allocated equity will be redeemed as soon as possible.

This policy has the advantage of maximizing the Subchapter T tax deduction obtained for patronage earnings that are allocated to patrons in proportion to their use of the cooperative. The policy also accords with the agency theory of cooperation. It holds that patronage earnings belong to the patrons and not the cooperative. Obviously patronage earnings that belong to patrons should be allocated to those patrons, or so the theory holds.¹

The tendency of this policy, however, is to create a burgeoning, unwieldy capital structure² for the cooperative and a miserable value proposition³ for patrons. When all patronage earnings must be and are allocated, no control can be exercised over either capital structure or value proposition. Often allocated equity is not redeemed until patrons reach age 70 or die. Even if the Board is certain that allocating more patronage earnings will only contribute to greater patron disappointment with the Cooperative, the earnings must be allocated anyway. Think of this existing policy as the “Pay Later” plan.

This chapter will propose that boards of directors must use value proposition and capital structure as objectives (rather than “accept” them as conclusions under the existing “Pay Later” policy) to assist the Board in determining how to allocate patronage earnings. It is illogical to allocate any patronage earnings without knowing under the “Pay Later” plan whether allocations will fulfill or destroy objectives established by the

* An excerpt from *A Question of Value Proposition and Capital Structure: In Search of a More Satisfying Approach*, The Cooperative Accountant, Summer 2007, at 12. Copyright 2007 by National Society of Accountants for Cooperatives. Used by permission.

1 The principal failure is that this theory ignores the time value of money. With allocated co-op equity, nothing “belongs” to anyone until the equity is paid to the holder in cash.

2 As more equity is allocated, more earnings must be devoted to eventually redeeming equity. High allocated and low permanent equity = relatively weak structure. Low allocated and high permanent equity = relatively strong structure.

3 Sum of all pluses and minuses, either monetary (price, discounts, etc.) or nonmonetary (quality, people, knowledge, etc.), that result in the patron’s choice to choose one agricultural company over another one.

Board. In contrast, the proposed policy directs the Board of Directors to allocate only those patronage earnings that are consistent with the Board’s objectives for value proposition and capital structure. Think of this as the “Pay as You Go” plan.

Table 1 highlights four alternative scenarios through which the existing policy (“Pay Later”) will be compared and contrasted with the proposed policy (“Pay as You Go”) to show their effect, respectively, on value proposition and capital structure. Each alternative presents a situation where \$500 of patronage earnings must be distributed. The differences lie in (1) the percentage of patronage earnings that are allocated, (2) the percentage of allocated patronage earnings that are paid in cash, and (3) the number of years until the expected redemption of QNAs. This article will first evaluate these alternatives from the viewpoint of value proposition. Later in the article we will consider capital structure.

	“Pay As You Go”		“Pay Later”	
	Alt#1	Alt#2	Alt#3	Alt#4
Patronage Earnings	\$500	\$500	\$500	\$500
% Allocated	20%	30%	75%	90%
% Cash Patronage	100%	75%	40%	20%
# Yrs to Redemption	0	3	25	35

It should not be controversial that allocated equity affects the capital structure of agricultural cooperatives,⁴ that capital structure and value proposition are related, or that these are corporate objectives that require oversight and management. If members intended to dissolve the cooperative before the passing of a single generation of producers, no one would worry about capital structure or managing allocated equity because the redemption of equity would be financed from the dissolution of the cooperative. The co-op would operate until it dissolved, then its assets would be liquidated and debts paid off, and finally allocated equity would be paid to the extent possible from the remaining proceeds of the asset liquidation. Any excess proceeds would be allocated on the basis of historical patronage.

Most cooperatives, however, are formed to operate in perpetuity and Boards must create and manage capital structures and value proposition that are consistent with that intent. The more that a cooperative’s capital is tied up in long-lived assets, the more it must use permanent capital to finance those assets. If those assets are financed instead with allocated equity that patrons expect the cooperative will redeem before they die, it becomes increasingly more difficult for the cooperative to redeem that equity in a reasonable time. As allocated equity becomes tied up in long-lived assets and the redemption cycle lengthens, the value of allocated equity depreciates as its present value falls; hence, value proposition falls too. Obviously then value proposition and capital structure are interrelated, and both are tied to the

⁴ Take for example the NSAC’s integral role in expressing the co-op community’s concerns about FAS 150 and then working with FASB to develop a suitable approach.

distribution of patronage earnings. This article will compare the “Pay as You Go” with the “Pay Later” policies to demonstrate how the former provides a superior value proposition and a far more manageable capital structure than the latter policy.

The intent is not to discount the patronage deduction. Instead my point is that the deduction is too valuable and that using too much of the deduction causes the whole patronage proposition to implode on itself if the cooperative cannot keep up with equity redemptions on a reasonable cycle. Obviously nonfederated, nonexempt cooperatives will pay more income tax and use the patronage deduction less under the proposed policy. Frankly though, who will care if the policy creates a more attractive value proposition for patrons and stronger capital structure for the cooperative? In this context, the IRS’s view is irrelevant because the fiduciary obligations of the Board trump the IRS’s rather sterile concerns for how things look.

II. Value Proposition – A Comparison of the Two Plans

It should not be controversial that agricultural producers measure co-ops against each other and against private companies. We take it as given that the agricultural company (either private or co-op) with the most attractive value proposition wins in the marketplace against its competitors. Moreover, all companies in the marketplace continue to reexamine their value propositions for the purpose of increasing their odds of winning against competitors. Value proposition is always in play.

Obviously value proposition includes more than monetary considerations, but there is no getting around the value of a dollar to any producer who works hard and pays income and self-employment taxes on distributions of the cooperative’s patronage earnings. Producers are pretty jaded about the co-op issues of ownership and control so these notions only go so far in the value proposition mix. We take it as given that any producer’s value proposition calculus includes (but is not limited to) the speed with which net cash (that is, after taxes) is allocated to patrons in the form of cash patronage refunds or equity redemptions.

Table 2 illustrates the four alternative scenarios for distributing patronage earnings and the value propositions each alternative provides to patrons.

				Table 2
Patron’s Point of View – Value Proposition				
	Alt#1	Alt#2 – Best	Alt#3	Alt#4 – Worst
1099-PATR	\$100	\$150	\$375	\$450
Cash Patronage Refunds	\$100	\$112.50	\$150	\$90
Patron’s Income and Self-Employment Taxes	\$30	\$45	\$112.50	\$135

Cash + / - After Payment of Taxes	\$70	\$67.50	\$37.50	(-\$45)
Allocated Equity	\$0	\$37.50	\$225	\$360
Present Value of Allocated Equity	\$0	\$27.79 ^{3 yrs}	\$18.54 ^{25 yrs}	\$10.93 ^{35 yrs}
Net Present Value of All Cash Received from Co-op	\$70	\$95.29	\$56.04	(-\$34.07)

Consider the four alternatives in Table 2 above from the points of view of the time value of money and a hungry agricultural producer. The best deal for patrons is Alternative #2. The co-op allocates 30 percent of its patronage earnings and pays at least 75 percent of that distribution in cash and up to 25 percent with QNAs, which the Board aims to redeem within three years of issuance. In 35 years that cash will have grown into a sum of approximately \$2,850 because we assume the producer will put that cash to work in his farming enterprise.

Now consider the worst deal illustrated by Alternative #4. This alternative actually *consumes* \$34 of the patron’s financial resources. In fact, for the first 34 years after the patronage distribution, the patron is *under water to the tune of \$45*. It is not until the 35th year when the allocated equity is redeemed that nearly \$11 is recovered, reducing the patron’s loss to \$34. Unlike Alternative #2 where the distribution grew into \$2,850 in 35 years, here the patron will only receive the face amount of the QNAs that were allocated to her 35 years ago - \$360.

The “Pay as You Go” plan illustrates that Alternatives #1 and #2 obviously provide a far more attractive value proposition for patrons than the “Pay Later” plan as illustrated in Alternatives #3 and #4. *We can even imagine producers investing their own money in an equity offering by a farm supply and grain cooperative under Alternatives #1 and #2 above.*

Alternative #3 is a more hopeful situation than Alternative #4 under the “Pay Later” plan, but the cooperative will have a difficult time maintaining that value proposition because as this chapter will discuss next, the tendency of the “Pay Later” plan is to create overwhelming financial pressure on agricultural cooperatives that is difficult if not impossible to manage without undercutting or even destroying value proposition.

III. “Pay Later” Tendency to Create Debilitating Financial Pressure

The dynamic of the “Pay Later” plan—our present approach—is that the cooperative constantly allocates more patronage earnings than it redeems in allocated equity. The result is that net allocated equity grows unrelentingly, along with patrons’ expectations about redemption of all that equity some day. The rate of expenditure for redemption of allocated equity must also grow constantly as the Board tries to maintain a constant revolvment cycle (*i.e.*, value proposition). Unfortunately, the cooperative will not keep pace with its growing mound of allocated equity, in which case the Board of Directors must either lengthen

the revolvment cycle or borrow long-term debt to shore up and maintain the cooperative's liquidity position, both of which weaken value proposition for patrons.

The financial stress of this dynamic will be illustrated in the following example of a farm supply and grain cooperative. Consider the plight of a very successful farm supply and grain cooperative that is committed to a 15-year revolvment of allocated equity. This cooperative has \$130 million in sales, \$3.25 million of total earnings and \$2.75 million of local earnings. The cooperative has no long-term debt. Net working capital requirements are 10 percent of sales. It has a working capital surplus of \$2.0 million.⁵ The cooperative allocates 90 percent of its patronage earnings and allocates 30 percent in cash with the balance in QNAs. This cooperative has some over \$8.0 million of allocated equity and last year the cooperative redeemed \$535,000 of equity. At that pace, the cooperative has achieved a 15-year revolvment. The Board is committed to maintaining that 15-year cycle.

Graph #1 (see graph at end of chapter) shows how the allocation of patronage earnings creates the pressure that eventually requires annual expenditures for equity redemptions to be ratcheted up so excessively. The cooperative always allocates more patronage earnings than it redeems of previously allocated equity, so net allocated equity grows each year. At zero growth in sales and earnings, allocated equity *still grows* from \$8.0 million to \$20.0 million in 10 years. At a growth rate of 5 percent in sales and earnings, allocated equity *will triple* in size to a total of \$25.5 million in 10 years. And at a 10 percent growth rate, the cooperative's total allocated equity will increase by *a factor of four to a total of \$33.0 million* in 10 years. Imagine trying to maintain a 15-year revolvment as allocated equity grows each year.

Next Graph #2 (see graph at end of chapter) illustrates the pressure created by maintaining a 15-year revolvment cycle. Even if total earnings or sales do not grow but remain at \$3.25 million per year, this cooperative *must more than double* its annual rate of expenditure for equity redemptions from \$535,000 to \$1.3 million annually by 2015. If earnings and sales grow at a 5 percent annual rate, the cooperative *must triple* its annual rate of expenditure for equity redemptions from \$535,000 to \$1.6 million annually by 2015. And if the growth rate in sales and earnings is 10 percent, the annual rate of expenditure for equity redemptions *must quadruple* to \$2.0 million annually by 2015.

Notice that the cooperative does not have any wiggle room if it faces a weakening economy. In fact, it must count on a growing economy and/or the cooperative growing its sales and market penetration at the expense of a competitor *just to keep up* with equity redemptions. Notice also that if earnings do not grow fast enough, which is almost a certainty, this cooperative will not maintain a 15-year revolvment. It would not be unrealistic for the revolvment cycle to lengthen to 258 or 30 years, or even more.

⁵ When the cooperative is at its low point in receivables, inventories, and prepaid expenses, its seasonal financing is completely paid off and it is current with all supplier payables. In addition, the cooperative has a working capital surplus of \$2.0 million which is represented by \$2.0 million in savings that is spread out among several banks. For a cooperative of this size, \$2.0 million is an adequate surplus but it does not represent too aggressive of a position. Otherwise one could argue the cooperative should redeem some of its equity.

Finally, Graph #3 (see graph at end of chapter) shows how the increasing rate of expenditure for redemptions creates pressure on liquidity. If sales and earnings do not grow, the cooperative improves liquidity and its surplus grows over the next seven years but at a decreasing rate of growth. By the eighth year the cooperative is starting a slow burn of its working capital surplus, and from there its liquidity position will continue to deteriorate in the months and years ahead. At a 5 percent annual rate of growth, by 2015 the cooperative will burn up over two-thirds of its working capital surplus. And at a 10 percent rate of annual growth in sales and earnings, by 2015 the cooperative will borrow \$10.0 million of long-term debt to shore up a working capital shortage plus maintain a \$2.0 million surplus.

IV. A Manageable Capital Structure (“Pay as You Go”)

Our existing “Pay Later” plan obviously puts significant pressure on management and the Board of Directors to manage working capital requirements, expenditures, and earnings to keep pace with redemptions. The financial pressure consistently grows as the cooperative becomes more and more financially successful.

A few cooperatives prevail against these pressures with superior management and by obtaining near perfect efficiencies and still maintain a 10-year revolvment. The best explanation for these rarities might be that these cooperatives operate in a parallel universe. When one considers the issues outlined in this chapter, those few cooperatives that stand up or even flourish under this pressure are marvels to behold and appreciate.

Most cooperatives, however, cannot prevail against the persistent “Pay Later” pressures particularly when boards of directors and management attempt to balance all the needs of all their patrons, which understandably may include subsidizing businesses that are not as profitable as they should be. Some businesses may even lose money.

In addition to providing the most attractive value proposition, Alternatives #1 and #2 also illustrate how the proposed “Pay as You Go” plan creates a more manageable capital structure for the cooperative. This plan creates a far more manageable capital structure because it substantially reduces the cooperative’s total financial obligations (payment of income taxes plus cash patronage refunds plus equity redemptions). An attraction of the “Pay as You Go” plan is that the Board never gets too far ahead of itself, and redemption of equity occurs close in time to when the earnings are generated by the cooperative.

For example, Table 3 below illustrates how the cooperative’s total financial obligations under Alternative #1 are only 57 percent of the financial obligations of Alternative #4. The cooperative pays more income tax in Alternative #1 over Alternative #4 (\$168 versus \$21) but its obligation to redeem allocated equity is reduced by \$360. A similar conclusion occurs between Alternatives #2 and #3. The cooperative’s total financial obligations under Alternative #2 are 30 percent less than the obligations of the cooperative in Alternative #3.

Table 3

Cooperative's Point of View – Capital Structure				
	Alt#1 – Best	Alt#2	Alt#3	Alt#4 – Worst
Total Allocated Earnings and Equity	\$100	\$150	\$375	\$450
Cash Patronage Refunds	\$100	\$112.50	\$150	\$90
Allocated Equity	\$0	\$37.50	\$225	\$360
Taxable Earnings	\$400	\$350	\$125	\$50
Corporate Tax	\$168	\$147	\$52.50	\$21
Co-op's Total Financial Obligation	\$268	\$297	\$427.50	\$471

Parenthetically, the “Pay as You Go” plan does not shortchange patrons even though the plan increases the payment of taxes and reduces the total of all earnings that are allocated or redeemed in the ordinary course of business before the cooperative’s dissolution occurs, if ever. Recall that Table 2 above showed that the present value of cash distributions for either Alternative #1 or #2 are superior to Alternative #3 or #4. Consequently, Alternatives #1 and #2 provide both the best value proposition and capital structures over Alternatives #3 and #4. Value proposition and capital structure might seem like inconsistent concepts but here they work together.

V. Are Unallocated “Reserves” Illegal Under Subchapter T?

The policy argument recognizing the Board’s fiduciary obligation to create value propositions and capital structures favoring the cooperative and its patrons is an overwhelmingly powerful legal position opposing the IRS’s view that all earnings must be allocated. As near as I can tell, this position has never been asserted against the IRS. Moreover, nothing in the statute or legislative history cuts against or even fights with this policy argument.

Subchapter T does not require the allocation of all patronage earnings. Start with the statute first, and consider the definition of patronage refund. The relevant portions of this Treasury Regulation define patronage refund as *an amount* paid to a patron under a written obligation to pay the amount, which is determined *by reference to* patronage earnings.⁶ The determination could have been expressed in the regulation as “*all patronage earnings except reasonable and necessary reserves . . .*,” but the language of the statute is far broader and appears to allow broad discretion to determine *an amount*. The amount of the patronage refund is determined simply and only *by reference to* patronage earnings, which implies the amount paid could be less than all patronage earnings.

⁶ 26 C.F.R. §1.1388-1 Definitions and special rules.

Moreover, Congress knew how to require cooperatives to allocate *all* patronage earnings when it required the same of exempt cooperatives. Cooperatives exempt from taxation under Section 521 are permitted to establish reasonable reserves, but the clear inference for exempt cooperatives is that all other patronage earnings must be allocated. The absence of similar language in Subchapter T is significant.

The often-cited 1979 General Counsel Memorandum 38099 is not an obstacle to the “Pay as You Go” plan because unallocated retained savings are not “reserves.” The word “reserves” does not accurately describe permanent capital that by definition cannot be redeemed until the dissolution of the cooperative, which is why “retained savings” is a stronger description for this unallocated equity than “reserve.” Even if this permanent capital is a “reserve,” then it is *reasonable and necessary under the circumstances* because the capital management policy will require all available cash to be allocated to current patrons in the existing or near future, before the equity has lost more than one-third of its value. Nothing remains of cash flow to redeem anything else, unless and until the cooperative dissolves.

The IRS’s argument that all earnings must be allocated to operate at cost cannot stand in the face of the cooperative’s argument that the Board is a fiduciary given the power to allocate patronage earnings. Obviously the Board cannot allocate those earnings as a dividend on stock or equity and hope to claim the patronage deduction. Similarly, the Board cannot build up excessive cash balances or other working capital with unallocated retained savings but without explanation and hope to claim a deduction. However, if the Board is stripping out and distributing all available cash on a patronage basis, and if the cooperative does not have the capacity to redeem the balance of equity until the dissolution of the cooperative, surely the Board is not required to allocate those earnings in opposition to the collective wisdom of the Board of Directors.

It is true that using Non-qualified written notices of allocation avoids confrontation with the IRS’s mandate that all patronage earnings must be allocated, but there are good business reasons for nonfederated cooperatives to account for patronage earnings as unallocated retained savings. If the equity resulting from these earnings cannot realistically be redeemed until the dissolution of the cooperative, which might be 100 years from now, why allocate those earnings and either create expectations for redemption that cannot be met or invest ownership of equities in parties that must be transferred over and over to succeeding generations of families?

V. Concluding Comments

This chapter is buttressed by the fact that three of the most successful cooperatives I know have determined that the “Pay Later” plan is untenable. These Boards of Directors have drawn their conclusions independently of each other, and each is addressing these issues with a variety of approaches.

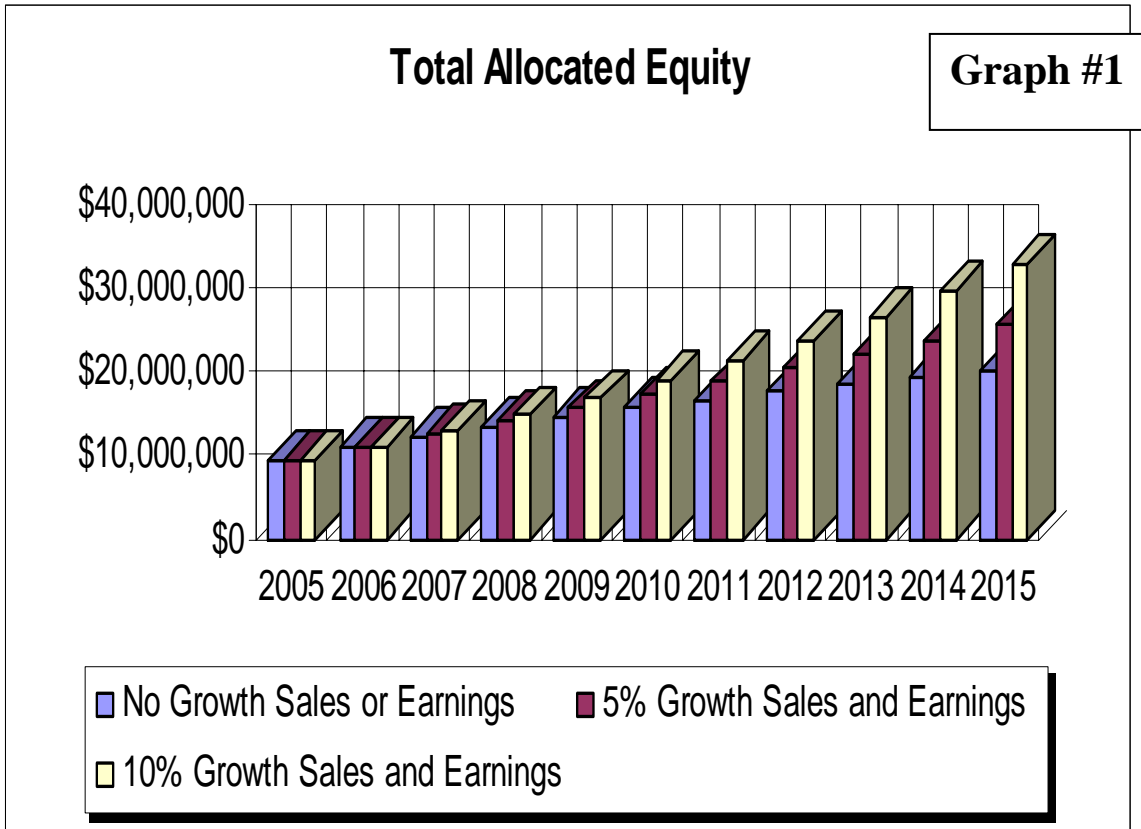
Cooperative #1. In 2004, this cooperative had redeemed all of the patronage earnings that it allocated prior to 1992. The cooperative appeared to be in an enviable position at first glance. From where the

cooperative was situated, it was only twelve years back on its redemptions. Things, however, were not as they seemed.

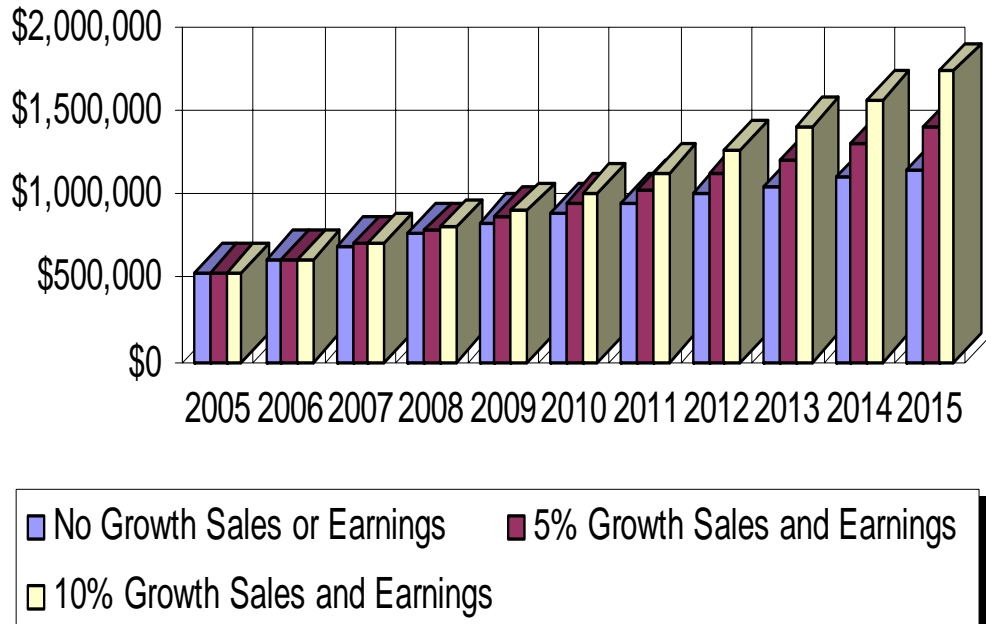
Year	Cumulative Allocated	Allocated by Year
1992	\$1,082,794	\$1,082,794
1993	\$1,720,350	\$637,556
1994	\$2,453,636	\$733,286
1995	\$3,002,938	\$549,301
1996	\$3,155,440	\$152,502
1997	\$3,783,877	\$628,437
1998	\$4,463,211	\$679,334
1999	\$5,098,879	\$635,668
2000	\$5,634,855	\$535,976
2001	\$6,385,159	\$750,304
2002	\$7,591,191	\$1,206,032
2003	\$8,746,321	\$1,155,130

It was obvious the cooperative could not maintain a 12-year revolvment. The cooperative was redeeming an average of \$300,000 of allocated equity annually, and the Board and management saw nothing that encouraged them to believe the annual expenditure could be significantly increased. At \$300,000 of redemptions annually for the foreseeable future, the reality this Board and management faced was that the cooperative was really 30 years back rather than only 12 years. And it appeared the cooperative would continue to fall behind even further. The cooperative's value proposition was already weakening, and it would weaken further if the Board and management continued on the same path.

This cooperative has now abandoned its equity redemption policies. Instead, the cooperative will periodically convert allocated equity to preferred equity at a discount. Rather than redeem equity, the Board and management will seek to pay a strong enough dividend on the preferred stock that patrons who own preferred stock will trade it between them. You may argue this cooperative is still on the "Pay Later" plan, but if so, the plan has been dramatically reconfigured.

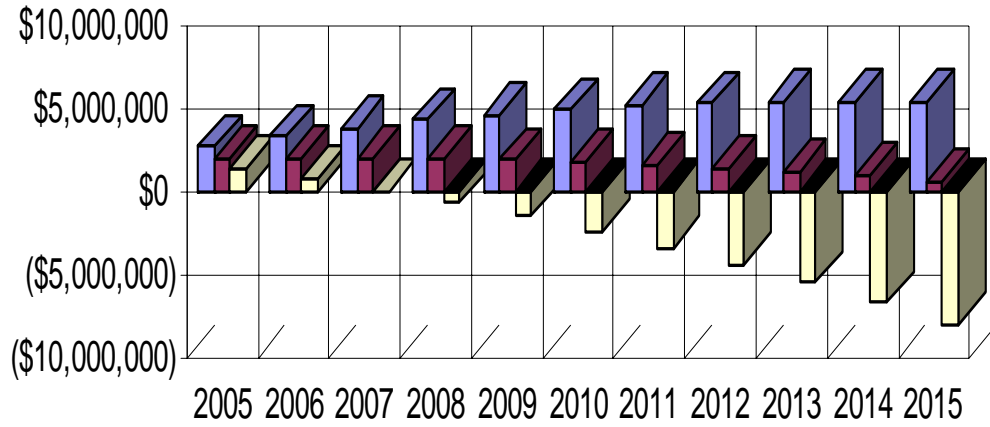


Annual Redemptions to Maintain 15 Year Cycle **Graph #2**



Evaluation of Liquidity - W.C. Surplus or Shortage

Graph #3



■ No Growth Sales or Earnings ■ 5% Growth Sales and Earnings
■ 10% Growth Sales and Earnings

Chapter Six
LAW OF COOPERATIVES
—The Changing Boardroom for Cooperatives—
Mark J. Hanson

The boardroom has changed more in the last four years than it has in the last 50 years. Until the 1990s, changes occurred so slowly in the boardroom that few persons, even directors, noticed the change. In the past, we read books by professors about boardroom changes between business eras. Today, boardroom changes are reported in the daily newspapers, and every month business journals try to analyze and summarize the impacts. While in earlier times changes occurred so slowly that they were almost unnoticeable, today boardroom changes are occurring so quickly that they are difficult to assess, much less implement.

In cooperatives, the Board governs the cooperative, and the business and affairs of the cooperative are managed by the CEO or general manager.

I. Director Duties and Responsibilities

The director has a responsibility to the cooperative to discharge his or her duties in good faith in a manner that the director believes to be in the best interests of the cooperative, with the care an ordinary prudent person in a like position would exercise under the same circumstances. Directors have a duty of care and loyalty to the cooperative and are entitled to rely on the business judgment rule in making decisions, typically to the same extent as a director of a Delaware corporation. Each director is required to devote the time necessary to govern the business and affairs of the cooperative, and outside of that may serve other businesses or enterprises so long as the other business is not a competitor of the cooperative.

In summary, directors must:

- discharge their duties in good faith
- take actions in the best interests of the cooperative
- devote the time and attention necessary to make informed decisions

Board Authority, Director Responsibility, and Liability. Although each director has the above duties, the authority to govern the cooperative and to make decisions relating to that governance lies solely with the Board. The concept is important but frequently misunderstood.

Director Represents Cooperative, Not Individual Members. Directors may be elected by groups or by all members, but their duty of loyalty is to the cooperative and its members as a whole, not to any particular electorate. (A director does not represent any particular member or group of members regardless of how elected.)

Only Authority to Act as Board, Not as Director. Other than by delegation or, if the chair, for procedural matters, a director does not have individual authority relating to the cooperative. Only the Board acting collectively has authority to govern. A director acting under individual authority does so at his or her individual liability.

Individual Director Responsibility. On the other hand, each director has the responsibility individually to carry out the duties of a director regardless of how the Board proceeds collectively.

Individual Director Liability. A director has personal liability for not discharging his or her duties in good faith regardless of how the Board acts.

Conflict: Director Duties and Board Actions. On certain issues, individual directors will find themselves at odds with a majority of the Board. The process of analyzing and taking appropriate actions relating to the conflict is fact- and circumstances-specific. If there is fraud or illegal activity on the part of management or the Board, each director has a duty and obligation to object and have the objection noted in the minutes of the meeting, not only for that decision but for each decision that furthers the fraud or illegal activity. In addition, if the cooperative is a Securities and Exchange Commission reporting company, reporting obligations may arise.

If the action or decision is one of business judgment upon which there is no one right answer, the appropriate process is for the directors to discuss and analyze the issue and for the Board majority to reach a decision. Each director has a duty to support the governing authority of the Board to make business decisions even though the director may not personally support a particular decision. The minutes reflect the Board deliberations and decisions. Directors must not undermine the authority of the Board by repeating confidential Board discussions or business information outside the boardroom. Although minutes need to reflect the Board process, directors should note the truism that “minutes are most often and most carefully read by your enemies.” A director accepts the structure and Board authority of the cooperative when the director accepts the director position.

In between fraud and criminal actions and business decisions are actions and decisions that the director may believe threaten the cooperative or will damage the interests of the members collectively. Facts and circumstances will dictate the response, but a dissenting director has a duty to present his or her view to the Board, have the dissenting view and his or her dissenting vote noted in the minutes, and, if the action is significant enough that the director believes the other directors are derelict of their duties, the dissenting director should consider resignation from the Board, among other things.

II. Increasing Liability for Directors

Three general areas have had an impact on increasing potential director liability to members in situations in which there is a business loss to the cooperative: the Sarbanes-Oxley Act, Delaware case law, and directors and officers insurance.

Sarbanes-Oxley. The Sarbanes-Oxley Act and related rulemaking (collectively “SOX”) enhance the risk of liability. Although SOX does not modify duties or standards of director conduct, SOX requires the financial auditing and corporate obligations that are becoming “standards” against which to measure appropriate conduct. SOX also allows private causes of action for violations and lowered the requirement for the Securities and Exchange Commission to bar a director from serving on a board by determining the director to be “unfit.”

Although much of SOX does not apply to cooperatives, regardless of size, it is likely that the liability concepts of SOX will be argued in common-law actions in state courts that will impact cooperatives. SOX has had the subtle effect of influencing state fiduciary requirements and setting into effect increasing expectations of directors.

Delaware Law. Delaware law traditionally shielded directors from liability through exculpatory or liability waiver provisions. The bylaws of a cooperative generally eliminate personal liability of directors for duty-of-care violations and decisions within the business judgment rule.

Traditionally, directors would only face liability if they personally misled or defrauded the company or personally profited at the expense of the company. This is referred to as a “breach of loyalty” to the company. Cooperatives do not indemnify directors for actions involving these types of breaches of loyalty. Today, however, Delaware courts are raising the expectations, and as a result the potential exposure, of directors in the area of “good faith,” which is required of cooperative directors in discharging their duties. The Chief Justice of the Delaware Supreme Court has stated that directors of Delaware companies will be held liable for lack of good faith and that directors, among other things, should:

- embrace best practices in the governance process
- have a reasonable corporate understanding of the company’s business, competitive environment, financial controls, and financial disclosures
- actively engage in Board discussions and deliberations with healthy skepticism and constructive criticism
- resist a culture of complacency when things are going well
- rely in good faith on well-chosen experts

The judge’s comments in conjunction with three higher-profile court decisions have eroded some of the expectations of liability protection for directors.

Disney. Directors allegedly violated fiduciary duties by spending less than one hour reviewing the hiring of an executive and approving a \$120 million employment agreement for barely one year of service. Delaware court ruled that the “process” used suggested a lack of good faith and that directors may not be protected by liability limitations and indemnifications in company articles and bylaws.

Abbott Laboratories. Directors allegedly knew about Food and Drug Administration violations for years and did nothing about it. Court held directors could be held personally liable because of conscious disregard of known risks, which is bad faith.

WorldCom. Federal securities law case with somewhat lower burden of proof involving \$108 million directors and officers insurance policy with threat of rescission by the insurer. Financial directors had pleaded guilty. Ten outside directors settled for \$36 million from directors and officers insurers and \$18 million from the directors' personal assets (20 percent of directors' personal nonexempt assets). Lead plaintiff made personal payment by directors a requirement for settlement.

Enron. The case involved Securities Act § 11 claims and directors and officers insurance with \$350 million limits. The parties settled for \$168 million, of which \$13 million was from personal assets of outside directors, representing 10 percent of pre-tax payouts from sale of Enron stock during period of fraudulent financial statements.

Directors and Officers Insurance. Directors customarily rely on directors and officers ("D&O") insurance for financial protection against D&O claims. With larger, "headline" cases, carriers have rescinded or threatened to rescind policies based on fraudulent financial information when the policy was acquired. In a recent case, a D&O carrier argued to rescind a D&O policy after the company's former CFO pleaded guilty to conspiracy to commit securities fraud. The carrier argued that the Form 10Q submitted with the insurance application overstated revenues. In the initial case, which was later appealed, *the court found that the policy could be rescinded even to innocent directors and officers who did not know about the fraud.* In other cases director coverage was jeopardized because initial claims against management or aggregate limits limited director recovery.

In general, Delaware law does not allow indemnification of directors for expenses or the cost of settlement if a director did not act in good faith to the company.

III. Will Corporate Actions Affect Cooperatives?

The names of Enron, WorldCom, Abbott Laboratories, and Disney may make the above issues seem remote and not applicable to cooperatives. Small and mid-cap companies and cooperatives have not been in the spotlight, but the liability trends are being established with the large-cap companies. Commentators have suggested that small and mid-cap companies are becoming increasingly attractive to plaintiffs' lawyers, which suggests cooperatives may also be attractive. They reason that large-cap cases drag out for years, and cases against small and mid-cap companies take less time to settle or try, making those companies attractive targets. In addition, almost half of the financial restatements, a leading indicator of ensuing securities litigation, have been made by companies with less than \$100 million in revenue (Huron Consulting Group, 2003 Annual Review of Financial Reporting Matters).

Liability Affecting Producer-Owned Companies. For producer-owned and -controlled companies, liability trends that parallel the large corporate cases are also emerging. Although the following two cases were settled on different grounds, the initial suits show corporate-type claims that can be made against cooperative directors.

Minnesota Corn Processors. In the Notice of Class Action Settlement, the plaintiff members and members filed a class action alleging that former Minnesota Corn Processors (“MCP”) officers and the chair of the Board breached fiduciary duties and were unjustly enriched, and the wrongful conduct resulted in inadequate consideration to MCP members. The defendants agreed to pay \$5.75 million to settle the allegations, which would be paid to members with the right to vote, but *excluding the MCP directors who voted for the merger* and the named defendants.

Farmland Industries Inc. A lawsuit filed by the liquidating trustee accused 29 former directors and officers of breaches of fiduciary duties through gross negligence, disregard of duty, and acts of corporate waste as part of entering into ill-conceived transactions, which showed an overwhelming abdication of their duties and led to the company’s collapse. The first count alleged the Board approved a \$300 million fertilizer complex after inadequate due diligence and no investigation of alternatives to and risks of the transaction. Two similar counts related to an acquisition that included an assumption of \$100 million in debt, and assumption of catastrophic levels of debt to focus on growth over profitability. The fourth count was based on the approval of a \$700,000 bonus for the CEO when the CEO’s primary duty was to work for the merged entity and no merger took place, and the CEO failed to meet written performance goals set by the Board for the CEO.

IV. Guidance for Directors

The job and position of director has and will continue to change with more responsibility and greater potential liability for mistakes. The first issue for existing or new directors is to evaluate the cooperative and the job of being a director. The Chief Justice of the Delaware Supreme Court estimates that 100 hours per year for ordinary board activities is not unreasonable. For many cooperatives, two hours per week is probably not enough time for a director to:

- understand the strategic business plans of the cooperative and fundamental structural changes in the industry in which the cooperative operates
- understand the nature and type of the cooperative’s competition
- understand and monitor the cooperative’s business plan, management’s implementation of the business plan, and the operations of the cooperative
- review and understand the financial information of the cooperative
- act in good faith on each transaction and comply with the law
- use good-faith reliance on consultants, advisors, and management, which will require reading and understanding

Notwithstanding the court decisions cited, the law continues to protect conscientious directors who exercise due care, good faith, and independent judgment in the best interests of the company. The business judgment rule is still the best protection for a Board making careful, good-faith decisions, even if those decisions turn out wrong.

The interest of the cooperative's members will be advanced if directors assess risks, rewards, costs, and benefits to obtain the highest available risk-adjusted returns. Directors must take into account and accept that some business decisions will be wrong but that process will protect them from liability.

With increased awareness of director liability, directors need to be aware of limits and limitations of liability and indemnification under the articles and bylaws of the cooperative and under applicable D&O policies. Some companies are separating director and officer policies, and considering director endorsements and order-of-payment language.

As directors move forward in the changing boardroom environment, directors must know their cooperative, and its business and its management, and assess the commitment necessary to provide the oversight and direction their company requires.

The three primary challenges for producer-owned businesses will likely be areas of potential liability: capital, liquidity, and enterprise value. Producer-owned businesses are less accustomed to assessing enterprise value, and thinly traded equity interests reflect disparate member and shareholder assessment of value compared to how the market would assess enterprise value. These different views of value are a prime driver in member or shareholder suits and present vexing problems for directors and management as they govern and manage the company.

Directors and management are expected by members to lead their cooperatives to financial success. Good-faith, reasonable decisions, even if they are wrong, have not drawn director liability.

In summary, evaluate the demands, responsibilities, and liabilities of being a director. Understand the limits of D&O insurance. Insist on good corporate governance practices for the cooperative and use good-faith reliance on consultants, management, and advisors.

Joel J. Dahlgren

Law Practice

Joel Dahlgren practices in the firm's Corporate group. He provides general corporate representation to cooperatives and agribusinesses in the Midwest and throughout the United States. He tracks the issues and trends of interest to farmers and members of the cooperative community. His extensive experience assisting cooperatives with law matters includes formation and dissolution, loan financing, debtor/creditor, annual meeting, unification, and employment.

As a loan officer at the Saint Paul Bank for Cooperatives, he helped cooperatives in North Dakota, Minnesota, and Wisconsin secure capital. He chaired the Grand Forks, North Dakota office's delegated loan committee. As a representative of the Cenex/Land O'Lakes joint venture, he assisted cooperatives in southern Wisconsin with salary administration programs, employee policy handbooks, strategic and long-range business plans, board planning retreats, general manager evaluations, and related marketing and delivery services.

Prior Legal Experience

Attorney, Lindquist & Vennum PLLP.

Professional Activities

National Society of Accountants for Cooperatives; American Agricultural Law Association; Agricultural Law Section, American Bar Association.

Community Activities

Legal, Tax and Accounting Committee, National Council of Farmer Cooperatives; Minnesota Association of Cooperatives; Advisory Committee, Center for Cooperatives, University of Wisconsin-Madison; Wisconsin Federation of Cooperatives.

Publications

"A Question of Value Proposition and Capital Structure in Search of a More Satisfying Approach," in Chapter 6 of *The Law of Cooperatives* (Stoel Rives); author, "Challenge of Aligning Ownership with Use," *The Cooperative Accountant* (fall 2003); coauthor, "Joint Venturing Made Easier," *The Cooperative Accountant* (winter 1999); "Patron Credit Balances—A Liability Trap for Everyone," *The Cooperative Accountant* (winter 1998).

Presentations

"The Wyoming Processing Cooperative" (Feb. 2002); "Key Office Staff Meeting," Eau Claire, Wisconsin (Jan. 2002); "Making Tough Decisions," Bismark, North Dakota (Dec. 2001); "Joint Venture Update," Billings, Montana (Nov. 2001); "Co-op Structure Issues," Minneapolis (Sept. 2001).



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Education

J.D., University of Wisconsin Law School
B.S. cum laude, University of Minnesota

Admissions

State bars of Minnesota, Iowa,
North Dakota, and Wisconsin

Debra H. Frimerman

Experience

Debra Frimerman practices in the Corporate group. Debra assists both public and private renewable energy clients in a variety of areas. Her work includes mergers and acquisitions, business entity structuring, exempt and registered securities offerings, and ongoing general corporate governance and securities compliance. Debra dedicates a significant portion of her practice to emerging green and renewable technologies. She also has experience working with clients in agribusiness, finance manufacturing, medical devices, and insurance industries.

Prior to joining Stoel Rives LLP, Debra was an attorney at Lindquist & Venum PLLP.

Representative Work

Capital Raising

- Founders, seed and primary equity offerings ranging from \$1 million - \$100 million to provide funding for renewable energy projects.
- Preferred stock offerings by cooperative associations to provide financing to build biofuels production facilities.
- Counsel clients on possible capital structures and best practices to raise necessary project funds.
- Agent's counsel in registered securities offering of approximately \$5 million.

Mergers, Acquisitions and Exit Strategies

- Merger of two ethanol companies, which created one of the nation's largest publicly traded ethanol production companies, with complimentary grain, agronomy, feed, fuel, and ethanol marketing and distribution operations.
- Sale of 60% interest in ethanol production facility for \$100 million.
- Asset sale to private equity fund by closely-held business providing owner exit strategy and ongoing fee-based consulting arrangement.
- Merger of two public companies by tender offer of over \$100 million.

Ongoing Corporate Advice

- Negotiate engineering, procurement and construction (EPC) agreements for wind development projects.



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Education

University of Minnesota Law School, J.D.,
2005, *magna cum laude*

Editor, *Journal of Law & Inequality*

University of California, Santa Barbara,
B.A., economics, 2002

Admissions
Minnesota



Debra H. Frimerman

- Offtake and supply agreements.
- Licensing agreements between biomass technology providers and projects for cutting-edge technologies.

Professional Honors and Activities

- Member, American Bar Association
- Member, Minnesota State Bar Association
- Member, Hennepin County Bar Association

Publications

- Coauthor, "Renewable Energy: Trends in Finance and Business Structures," *The Law of Cooperatives, Business, Structure and Legal Issues*, Stoel Rives LLP, 2007
- Author, "Minnesota Adopts 2002 Uniform Securities Act," *Hearsay*, September 2007
- Coauthor, "Design, Engineering, Constructions," *The Law of Ocean and Tidal Energy, A Guide to Business and Legal Issues*, Stoel Rives LLP, 2007

Civic Activities

- Board member, Purusha Project

Mark J. Hanson

Experience

Mark Hanson is a member of the firm. Clients seek to engage Mark to structure and develop new businesses and transition existing businesses. Mark utilizes a team approach of bringing over twenty years of experience to management and the boardroom and firm wide legal and business expertise to provide tailored solutions to client issues. His practice in commercial transactions and business development has focused on client agribusiness, renewable energy, cooperatives, and food processing with a business approach to solving client problems. Mark has facilitated business solutions for clients soliciting investment, and debt and equity financing, starting new businesses, negotiating contractual agreements for project financing, developing greenfield projects through commercial production, and structuring business entity conversions, mergers, acquisitions and divestitures, and related commercial transactions. Client solutions require identification of the problem and application of the right expertise and resources in a cost effective manner. Mark utilizes the resources and personnel of all of Stoel Rives' offices to bring the face of over 350 attorneys to the client as needed.

Prior to joining Stoel Rives, Mark was senate counsel, Minnesota Legislature; attorney shareholder, Doherty, Rumble & Butler, P.A.; and attorney partner, Lindquist & Vennum PLLP.

Representative Work

Agribusiness and Food Processing

- Representation of Golden Oval Eggs, LLC in sale of egg processing business. \$123 million.
- Representation of U.S. Premium Beef, LLC in acquisition of majority interests of National Beef Packing Co. \$204 million.
- Represented 400 member conversion of rancher cattle delivery cooperative to limited liability company. \$85 million.
- Represented 750 member farmer corn delivery for poultry feed cooperative to limited liability company.
- Represented private acquisition of oat processing and food manufacturing facility through joint venture ethanol production facility. \$70 million.
- Represented liquid egg processing company in \$68 million acquisition of brand rights, five facilities in four states.



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Education
William Mitchell College of Law, J.D., 1983
University of Minnesota, M.S.C.E., 1980
Dickinson College, B.S., 1977

Admissions
Minnesota
Wisconsin



Mark J. Hanson

- Represented controlling owner in sale of ownership interests in beef processing company for foreign publicly traded company. \$560 million.

Biofuels

- Representation of over 20 ethanol and biodiesel production facilities throughout the country through various stages of structuring, development, equity financing, feedstock, operational, construction, and product marketing contracts, acquisition and divestiture, including 100 MGY \$200 million projects, structuring and financing plant expansions of 30 to 100 MGY.
- Represented first commercial scale 30 MGY soybean biodiesel processor in United States.
- Representation of partial divestiture of 60% of an ethanol production facility. \$100 million.
- Representation of controlling seller in sale of ownership interests in an ethanol production facility. \$135 million.

Commercial Transactions

- Represented owners of beneficial use rights to supplemental Colorado River water in transactions with municipalities selling the beneficial water use rights and granting interruptible water use rights. Secured favorable IRS revenue ruling relating to transaction proceeds. \$70 million.
- Representation of buyer in acquisition of mineral processing facility. \$100 million.
- Represented grain merchants in 260 derivative contract litigation cases in seven states.

Professional Honors and Activities

- Hennepin County Bar Association
- Minnesota State Bar Association
- Wisconsin Bar Association
- Federal Bar Association
- American Agricultural Law Association
- Minnesota Super Lawyer, MSP Communications, 2002-2004
- Minnesota Cooperative Leadership Award

Publications

- Author, Starting a Value-Added Agribusiness: The Legal Perspective
- "Cooperative Organization for Value-Added Agribusinesses," in *A Cooperative Approach to Local Economic Development*
- "Legal Framework of Cooperative Development," in *Cooperatives and Local Development: Theory and Applications for the 21st Century*

Ronald D. McFall

Law Practice

Ron McFall practices in the firm's Corporate group, providing securities and corporate advice to a variety of producer-owned organizations in the renewable fuels, food processing, and agribusiness sectors. In particular, Ron has extensive experience in securities offerings seeking equity investment for ethanol production facilities; Ron's involvement in such efforts has spanned more than 20 years of his legal career. Ron has also been a leader in the value-added cooperative movement, advising such organizations with respect to securities offerings and with respect to subsequent restructurings. He has represented clients both in offerings exempt from registration under federal and state securities laws and in registered offerings.

Ron has also represented various businesses in a wide range of restructuring and merger and acquisition transactions. Ron also provides guidance regarding ongoing federal and state securities law compliance.

Representative Clients

Dakota Growers Pasta Company, Inc.	U.S. Premium Beef, LLC
Organic Valley (CROPP Cooperative)	Minn-Dak Farmers Cooperative

Representative Transactions

Midwest Grain Processors LLC's sale of a 60 percent interest in its ethanol business to Global Ethanol, LLC for \$100 million.

U.S. Premium Beef, LLC's acquisition of a majority ownership interest in National Beef Packing Company, LLC.

Dakota Growers Pasta Company's restructuring to convert from a cooperative to a North Dakota corporation.

Golden Oval Eggs' conversion from a cooperative to a Delaware limited liability company.

Several registered securities offerings by Dakota Growers Pasta Company, Inc., as well as private placements of shares by Dakota Growers to institutional investors.

U.S. Premium Beef, Ltd.'s restructuring to convert from a cooperative to a Delaware limited liability company.



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Education

J.D., University of Chicago Law School, 1983
B.A., University of Iowa, 1979

Admissions

State bar of Minnesota

Kevin R. Prohaska

Experience

Kevin Prohaska is a member of the firm. His practice includes representing developers, owners and lenders in the renewable energy, agricultural and real estate sectors. He has participated in the startup, development, acquisition and financing of projects totaling more than 750 million gallons per year of fuel-grade ethanol production capacity. His renewable energy clients are involved in biofuels, biomass and wind developments. His renewable energy client experience includes representation in transactions involving registered and private exempt securities offerings, issuances of private company tax exempt and corporate bonds, mergers and acquisitions, negotiations of real estate development agreements and related easement, lease and title documents, senior construction and term debt facilities, subordinated debt and convertible debt facilities, and risk management agreements. He has also counseled investors, off-take marketers and credit enhancers to such projects.

Mr. Prohaska's agribusiness representation includes owners and investors in livestock ventures, including swine, poultry/egg processing and beef production facilities, as well as grain and feed cooperatives and businesses. Kevin has advised agribusiness clients in joint ventures, asset and stock acquisitions and sales, grain and commodity contracting and hedging activities, negotiations of debt facilities, and development agreements. In addition, prior to his law career, he spent six years with two international seed and chemical companies in various research, sales and management capacities, and has used that experience to advise seed companies and seed certification entities on various matters.

Mr. Prohaska has represented developers of commercial office and retail space, as well as owners of resort developments and residential subdivision projects. He also has and continues to provide pro bono advice to, or involvement with, several nonprofits, community colleges and high schools.

Prior to joining Stoel Rives, Mr. Prohaska was a partner at Lindquist & Venum, PLLP.



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Education

Iowa College of Law, J.D., 1988, with distinction

Iowa State University, B.S. & M.S., 1980, with high honors

Admissions

Minnesota

Iowa



Kevin R. Prohaska

Representative Work

- Advised multiple clients in the structuring, capitalization, and development of ethanol projects in several states, including assistance in all phases of equity and debt raising, contract negotiations, and related development activities.
- Advised ethanol client in merger transaction with another ethanol company.
- Advised biodiesel development company in its negotiations with technology provider and construction contractors; continuing to advise in negotiations with oil company, real estate site owners, prospective investors and lenders for anticipated construction and operation of facility.
- Advised large swine production clients in liquidation and restructuring of its debt facilities and corporate structures including negotiations with senior and subordinated lenders, trade creditors, partners and other entity owners, guarantors, and a court appointed receiver.
- Represented grain elevator in joint venture negotiations with large agricultural commodities processing company.
- Represented agricultural lender in negotiations and closings of construction, term and working capital debt facilities for three ethanol plants with an approximate aggregate loan value of \$225MM, and advised lender in its related negotiations with participating lenders to the debt facilities.
- Advised ethanol marketing and distribution company in its negotiations with multiple ethanol developers for equity investments, marketing and off-take contracts, and provision of working capital and letter of credit facilities to the ethanol developments.
- Advised wind energy developer in the sale of its interest in wind energy project in Texas.
- Representing wind energy developer in its developments in South Dakota.
- Advising client in a waste-to-energy development involving large waste haulers and landfill owners.
- Advised client in development of contracts for purchase and resale of landfill biogas and associated RINs.
- Advising client in development of soy crush facility for production of high quality protein feedstock for dairy and beef, and high grade oil to market to the food, feed and biodiesel industries.
- Advised commercial real estate developer in connection with development of office towers and retail space.
- Advised residential home developer in the acquisition and development of multiple tracks of land for subdivision and home building.
- Advised client in formation of purchasing entity, and the acquisition and financing of large northern Minnesota lakeside resort business and associated properties.

Professional Honors and Activities

- Member, Iowa Bar Association
- Member, Minnesota State Bar Association
- Member, Hennepin County Bar Association
- Member, American Bar Association

Joe R. Thompson

Experience

Joe Thompson is a member of the Energy and Telecommunications practice group. Renewable energy and agribusiness clients engage Joe to assist with strategic business entity structuring, project development matters, private and public equity capitalization, debt financing, federal and state regulatory compliance, and ongoing general corporate representation.

Joe works closely with project leaders in the development and operation of ethanol, biodiesel, and other bioenergy production facilities, in the development of community wind opportunities, and in the acquisition and operation of livestock facilities. He has extensive experience with feedstock aggregation and delivery systems, fuel and other product marketing agreements, and construction contracts. Joe also assists clients with joint ventures, mergers, acquisitions, divestitures, and related commercial transactions.

Representative Work

- Represented 900+ farmer-member cooperative in its development, capitalization, and ongoing operation of a combination soybean crush and 30 mgy biodiesel facility.
- Represented 300+ farmer-member cooperative and its partially-owned subsidiary in the development, financing and ongoing operation of a food and 50 mgy ethanol production facility.
- Representing 1,000+ farmer-member cooperative in its capitalization and ongoing development of a combination soybean crush and 60 mgy biodiesel facility.
- Representing landowner groups assessing community wind opportunities.
- Representing project leaders developing cellulosic ethanol technology and its strategic commercial implementation.
- Representing 20+ ethanol and biodiesel production facilities throughout the United States and Canada in various stages of structuring, development, capitalization, construction, feedstock procurement, offtake agreements, and other contractual and transactional matters.

Professional Honors

- Minnesota Rising Star, *Law & Politics*, 2007

Professional Activities

- Member, Minnesota State Bar Association (Council Member of Agricultural Law Section)



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Education

University of Iowa College of Law, J.D.,
1998

Iowa State University, B.S., Agricultural
Business, 1993

Admissions

Minnesota

Iowa



Joe R. Thompson

- Member, American Bar Association
- Member, Hennepin County Bar Association
- Member, Iowa Bar Association
- Member, American Agricultural Law Association

Panel Discussions

- "Impacts of RPS and Other Initiatives on Project Development in the Midwest," *Opportunities in Midwest Renewable Energy*, Oct. 2008
- "Biomass to Power - Fossil Fuel Plant Conversions and Traditional Biomass-to-Power Project Developers," *Biomass Finance & Investment Summit*, Jan. 2008

Presentations

- "Wind Leases and Community Wind Projects," Agricultural & Rural Law Institute, Mar. 2008
- "Community Ownership Models: Keeping Local Dollars Local," Harvesting Clean Energy, Jan. 2008
- "Production Risk and Marketing Opportunities for Next Generation Ethanol Facilities," BBI Biofuels Workshop & Trade Show Series, Oct. 2007
- "Structuring Your Biofuels Business," 2007 International Fuel Ethanol Workshop and Expo, June 2007
- "Offtake Agreements," Biodiesel Finance & Investment Summit, Pre-Summit Workshop, April 2007
- "Structuring Your Biofuels Business," 2006 BBI Biofuels Workshop & Trade Show Series: Eastern Region, Nashville
- "Project Finance," Biodiesel Finance & Investment Summit, Minneapolis, Oct. 2006
- "Selected Issues Related to a Cooperative's Extension of Credit," Minnesota Association for Cooperatives, Credit Issues Conference, Minneapolis, Feb. 2005
- "New Patron Investment Cooperative Laws," College Conference on Cooperatives, Minneapolis, Feb. 2004
- "Farm Business Development and Funding—The Attorney's Role," 24th Annual Educational Symposium of the American Agricultural Law Association, San Antonio, Oct. 2003
- "Liability Issues Concerning Special Use Corn," 25th Annual Seed Technology Conference, Ames, Iowa, Feb. 2003

Publications

- "Community Wind," *The Law of Wind*, Chapter 10, 4th Edition, Stoel Rives 2008
- "Financing Your Biofuels Project," *The Law of Biofuels*, Chapter 1, 2nd Edition, Stoel Rives 2008
- "Renewable Energy: Trends in Finance and Business Structure," *The Law of Cooperatives*, Chapter 3, 1st Edition, Stoel Rives 2007

Civic Activities

- Habitat for Humanity Volunteer; Crisis Nursery Volunteer



Stoel Rives Supports Renewable Energy

Stoel Rives purchases Renewable Energy Credits known as RECs or “green tags” to offset 60 percent of its firmwide electricity usage. The carbon emissions that are avoided through this green power purchase is roughly equivalent to parking a car for 4,986 months or approximately 414 years, or not driving 5.2 million miles. We purchase our RECs from firm clients 3Degrees and Bonneville Environmental Foundation. With our green power purchase commitment, we are one of the first law firms nationwide to qualify as a member of the U.S. EPA Green Power Partnership’s Leadership Club and the ABA-EPA Law Office Climate Challenge programs.



The Law of COOPERATIVES

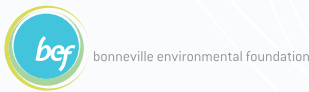
Business, Structure, and Legal Issues



The Law of Cooperatives will be updated periodically, but to stay informed of developments in the industry before the next edition, please sign up for our alerts at www.stoel.com/subscribe. You can also visit our Renewable + Law blog at www.lawofrenewableenergy.com.

Stoel Rives is a leading business law firm with focused experience in the areas of energy and environmental law and nearly 400 attorneys in eight states.

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