

# APPLICATION OF THE FEDERAL SECURITIES LAWS TO EQUITY INTERESTS IN TRADITIONAL AND VALUE-ADDED AGRICULTURAL COOPERATIVES

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## I. INTRODUCTION

Although law schools rarely teach courses dealing with the cooperative form of business<sup>1</sup> and many books that purport to cover “business associations” fail to explicitly address the existence of cooperative organizations,<sup>2</sup> cooperatives are big business, particularly in agriculture.<sup>3</sup> In fact, cooperative enterprises have been part of the American economic landscape since the 1700s,<sup>4</sup> although the modern form of cooperative business<sup>5</sup> was not developed until the middle of the nineteenth century.<sup>6</sup>

1. An on-line survey of websites maintained by 156 ABA-approved schools, in January of 1999, indicated that there were seven law schools that offered courses which included some coverage of cooperatives, as compared with 149 schools that had no course listing or description which mentioned cooperatives. In addition, there were 24 schools that either provided no course listings on their websites or whose websites could not be accessed. Those schools that did offer a course covering cooperatives included: Fordham University (“Cooperatives and Condominiums”); Hamline University (“Cooperative Law”--then under development); Hofstra University (“Cooperatives, Condominiums, and Homeowner Associations”); University of Iowa (“Agricultural Law”); University of Miami (“Condominiums, Cooperatives, and Cluster Developments”); St. John’s University (“Condominiums, Cooperatives, and Homeowner Associations”); Thomas Jefferson (“Condominiums, Cooperatives, and Development Law”).

2. *See generally* CONRAD ET AL., AGENCY, ASSOCIATIONS, EMPLOYMENT AND PARTNERSHIP (4th ed., Foundation Press 1987) (dealing with cooperatives, this law school case book on business associations is the only one the author could find amongst those published by Aspen, Carolina Academic Press, Foundation Press, or West Publishing). *See also* Lori Lynch et al., *De-Emphasis on Cooperatives in Introductory Economics Textbooks*, 4 J. AGRIC. COOPERATION 89, 89 (1989) (noting that the cooperative form of business organization is under-represented in undergraduate textbooks).

3. The role of farm cooperatives is increasingly important in our national economy. “Over the years they have proved a major means for assisting farmers to meet the problems and opportunities of modern agriculture . . . . Farmer cooperatives are shining examples of the self-help pioneering spirit that has made this Nation great.” MARTIN A. ABRAHAMSEN, COOPERATIVE BUSINESS ENTERPRISE 472 (1976) (quoting Dwight D. Eisenhower). By 1995, the gross value business volume of American farmer cooperatives amounted to \$112.3 billion. *See* Charles A. Kraenzle, *Non-Patronage Business Reaches \$17.9 Billion*, RURAL COOPERATIVES 30 (Mar./Apr. 1997), available in <[http://www.wisc.edu/farmer/64\\_2\\_30.html](http://www.wisc.edu/farmer/64_2_30.html)>.

4. Ben Franklin opened a mutual fire fighting company in this country in 1735. *See* JOSEPH G. KNAPP, THE RISE OF AMERICAN COOPERATIVE ENTERPRISE: 1620-1920, at 7 (1969). This is widely regarded as the first example of an American cooperative, although there is also evidence of joint efforts in home construction in New England at about the same time. *See id.* at 5.

5. Modern cooperatives are generally characterized by the following four principle characteristics: (1) member/user ownership; (2) democratic control that usually translates to one vote per member regardless of how many shares or how much equity is owned; (3) payment of patronage dividends based on usage of the cooperative; and (4) limited return on capital, which is usually no more than eight percent. *See* EDWIN G. NOURSE, THE LEGAL STATUS OF AGRICULTURAL CO-OPERATION 12-20 (1928).

6. *See* KNAPP, *supra* note 4, at 39. A group of workers in Rochdale, England, are generally given credit for forming the first cooperative society using “modern” cooperative principles in 1844. *See id.* at 30. *See generally* Jon K. Lauck & Edward S. Adams, *Farmer Cooperatives and the Federal Securities Laws: The Case for Non-Application*, 45 S.D. L. REV. 62 (2000) (discussing the development of the agricultural cooperatives). For a list of sources tracing this development, see 14 NEIL E. HARL, AGRICULTURAL LAW § 133.01[2][a] n.23 (2000).

Consumers, agricultural producers, and workers have formed cooperatives.<sup>7</sup> While consumer cooperatives significantly outnumber agricultural and worker cooperatives,<sup>8</sup> in no arena has the cooperative form of business been more important than in agriculture.<sup>9</sup> In fact, it would be hard to over-emphasize the historical importance of this form of enterprise to agriculture. Farmers have always faced considerable economic uncertainties,<sup>10</sup> and by operating as cooperatives, many farmers have found a degree of protection from at least some external market forces.<sup>11</sup> At a

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7. See JERRY VOORHIS, *COOPERATIVE ENTERPRISE: THE LITTLE PEOPLE'S CHANCE IN A WORLD OF BIGNESS* 187-88 (1975). Consumer cooperatives have been organized around the provision of goods and services such as food, housing, child care, electricity and telephone services; worker cooperatives have been organized to conduct retail or wholesale operations or production; farmers and other producers have formed marketing and agricultural cooperatives. See Kathryn Sedo, *The Application of Securities Laws to Cooperatives: A Call for Equal Treatment for Nonagricultural Cooperatives*, 46 *DRAKE L. REV.* 259, 261-62 (1997).

8. See *id.* at 262 n.34 (citing personal interview and various internet cites that indicate there are 42,000 - 47,000 cooperatives, approximately 4,100 of which are agricultural cooperatives).

9. "The cooperative form of business is probably more important to agriculture than to any other sector of the American marketplace." Terence J. Centner, *Retained Equities of Agricultural Cooperatives and the Federal Securities Acts*, 31 *U. KAN. L. REV.* 245, 246 (1983) (hereinafter Centner, *Retained Equities*).

Whether the cooperative form of business will continue its preeminence in the agricultural sector has been questioned, however. See Terence J. Centner, *The Role of Cooperatives in Agriculture: Historic Remnant or Viable Membership Organization?*, 3 *J. AGRIC. COOPERATION* 94, 103-4 (1988). The advent of the limited liability company as an alternative membership business organization has at least the potential to erode the popularity of cooperatives. See Donald A. Frederick, *The Impact of LLCs on Cooperatives: Bane, Boon, or Non-Event?*, 13 *J. COOPERATIVES* 44, 51 (1998).

10. Farmers are at the mercy of the elements, and the commercial viability of farming also depends on a myriad of factors out of the individual farmer's control. This fact is not only an historical reality—farmers continue to face such economic uncertainty today. See generally Clair Howard, *'Freedom to Farm' Exposes Family to a Brutal Market; End of Subsidies Makes it Hard for Small Farming Operations to Stay in Business*, *PEORIA J. STAR*, July 18, 1999, at A1 (reporting the "lowest soybean prices in 30 years and the lowest corn prices in 12 years" and "[i]ndications [which] seem to point to even lower prices to come"); Scott Kilman, *Weaning Farmers: Crop Deregulation Is Put to the Test in New Rural Crisis*, *WALL ST. J.*, Nov. 9, 1998, at A1 (noting that corn prices have dropped 60% since 1996 and soybean prices have dropped about 33%).

To some extent, losses because of declines in commodity prices can be offset by other sources of income, such as government payments. Income transfers to farmers accounted for about \$23 billion in 1999. See *ECON. RESEARCH SERV., UNITED STATES DEP'T AGRIC., AIS-74, AGRICULTURAL INCOME AND FINANCE: SITUATION AND OUTLOOK REPORT 34* (2000). These payments are, however, subject to the vagaries of the political process, which also adds uncertainties to the financial position in which farmers find themselves.

11. See 14 *HARL*, *supra* note 6, § 133.01 [2][a]. One noted authority has commented that the motivating force behind the prevalence of cooperatives in the agricultural arena has been the "economic upheavals farmers faced in the orderly marketing of their products." *Id.*

For a general discussion of the economic functions of American cooperatives, see Randall E. Torgerson et al., *Evolution of Cooperative Thought, Theory, and Purpose*, 13 *J. COOPERATIVES* 1 (1998).

minimum, cooperative ventures enhance farmer bargaining power, often permitting them to preserve their economic independence.<sup>12</sup>

These concerns have traditionally been respected in the American political process, and it is easy to find early examples of congressional action favoring farmers' cooperatives. For example, when the Clayton Act was passed in 1914, the legislation specifically exempted non-stock agricultural cooperatives from the antitrust laws.<sup>13</sup> The Capper-Volstead Act strengthened this exemption by broadening its application beyond non-stock cooperatives.<sup>14</sup> The Cooperative Marketing Act generally promoted education and research applicable to such cooperatives,<sup>15</sup> and in 1929, the Agricultural Marketing Act established the Federal Farm Board as a vehicle for financing farmers' cooperatives.<sup>16</sup>

The Great Depression provided additional reasons to protect the agricultural community, and when Congress enacted the Securities Act of 1933 (the 1933 Act),<sup>17</sup> it carved out from the more onerous registration requirements securities offered by at least some agricultural cooperatives. The 1933 Act exempts from registration requirements any securities issued by farmers' cooperatives that are exempt from tax under section 521 of the Internal Revenue Code ("the Code").<sup>18</sup>

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It should probably be emphasized that there are a number of kinds of agricultural cooperatives, including supply, marketing, and bargaining cooperatives. New generation cooperatives are merely the most recent innovation in the agricultural arena. For a discussion of various issues affecting new generation cooperatives, including their potential for success in markets already dominated by investor-oriented firms, see Andrea Harris et al., *New Generation Cooperatives and Cooperative Theory*, 11 J. COOPERATIVES 15, 20 (1996); RICHARD SEXTON & JULIE ISKOW, *FACTORS CRITICAL TO THE SUCCESS OR FAILURE OF EMERGING AGRICULTURAL COOPERATIVES* 2-18 (1988).

12. See, e.g., *Burley Tobacco Soc'y v. Gillaspay*, 100 N.E. 89, 93 (Ind. App. 1912) (involving the efforts of tobacco farmers to pool their products for sale to "The Tobacco Trust"). The court approved the farmers' efforts, concluding that "[p]ublic policy does not ask those who till the soil to take less than a fair return for their labor." *Id.* at 94. The court also relied on an earlier case that explained the farmers' organizational problem in the face of powerful buyers:

The farmers, scattered all over the state, each acting independently and separately for himself, were unable to dispose of their crops at a fair and reasonable price. There was practically no competition among the purchasers of the crops. A combination and trust had been formed by the buyers to depreciate the value of the crops below the real value, and single handed, the producers were unable to compete or deal in terms of equality with these trusts and combinations that controlled the markets in which the farmer was obliged to dispose of his produce.

*Id.* at 93 (citing *Owen County Burley Tobacco Soc'y v. Brumback*, 107 S.W. 710, 715 (Ky. 1908)). For a list of sources examining the history of agricultural cooperatives, see 14 HARL, *supra* note 6, § 133.01[2][a] & n.23.

13. See Clayton Act, 15 U.S.C. § 17 (1994 & Supp. V 1999).

14. See Capper-Volstead Act, 7 U.S.C. § 291 (1994 & Supp. V 1999).

15. See Cooperative Marketing Act, 7 U.S.C. § 453 (1994).

16. See Agricultural Marketing Act, 12 U.S.C. § 1141(a) (1994).

17. See Securities Act of 1933, ch.38, tit. I, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. § 77 (1994 & Supp. IV 1998).

18. See Securities Act of 1933, 15 U.S.C. § 77c (1994).

Aside from the generally pro-cooperative political environment that then existed,<sup>19</sup> it is not entirely clear why Congress chose to include language that exempted securities issued by agricultural cooperatives from the federal regulatory scheme.<sup>20</sup> Dr. Neil E. Harl, a distinguished professor of agriculture and economics, has opined that there are three different reasons for this favoritism: (1) the economic realities of cooperative finance mean that financial benefit of cooperative activity accrue in relation to patronage rather than investment; (2) members and patrons of agricultural cooperatives do not need the disclosures that would be provided if the federal securities laws applied; and (3) the burdens of mandatory disclosure would place cooperatives at a competitive disadvantage with non-cooperative businesses.<sup>21</sup> The accuracy of this suggestion is hard to assess.

Even a detailed examination of the legislative history for the federal securities acts does not provide a definitive explanation as to why farmers' co-ops were singled out when the 1933 Act was enacted. It is clear that the 1933 Act was adopted at least partially in response to the widespread perception that abuses in the securities markets were a significant contributing factor in the stock market crash of 1929 and the resulting economic depression.<sup>22</sup> Because of the economic crises then facing the country, the 1933 Act was enacted into law without much debate.<sup>23</sup> On the House side,

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19. The foregoing discussion should not be taken as evidence that Congress no longer favors agricultural cooperatives. There are numerous examples of more recent congressional activity demonstrating continued legislative support for this form of business activity in the farm community. For example, agricultural cooperatives continue to receive favorable income tax treatment. See Garry A. Pearson, *The Farm Cooperative and the Federal Income Tax*, 44 N.D. L. REV. 490, 490 (1968). See also Daniel S. Welytok, *Doing Business as a Cooperative in the Face of Increased Challenges*, 84 J. TAX'N 37, 37 (1996) (explaining the current treatment of cooperatives). Farmer cooperatives were even afforded an exemption from compliance with the Interstate Commerce Act. See *Northwest Agric. Coop. Ass'n v. Interstate Commerce Comm'n*, 350 F.2d 252, 254 (9th Cir. 1965) (noting the congressional intention to "exempt from economic regulation under the Interstate Commerce Act trucking operations conducted by organizations which satisfy the definition of a 'cooperative association' in the Agricultural Marketing Act"). And, of course, the statutory exemption in the 1934 Act was not put into place until 1964. See Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565, 568 (1964).

20. The reasons for these exemptions for securities issued by farmers' cooperatives have been traced to political pressure exerted by these cooperatives. See Lewis D. Soloman & Melissa B. Kirgis, *Business Cooperatives: A Primer*, 6 DEPAUL BUS. L.J. 233, 251-59 (1994). See also 77 CONG. REC. 2924 (1933) (statements of Rep. Arens and Rep. Bulwinkle).

In addition, there are a number of public policy justifications that support special treatment for agricultural cooperatives. See Lauck & Adams, *supra* note 6, at 62. This form of business allowed farmers to counter the growing economic power of other sectors of the economy by increasing farmers' bargaining power and preserving their independence. See *id.* at 64-65.

21. See 14 HARL, *supra* note 6, §136.01[3] (1)-(3).

22. See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 1.2, at 7 (2d ed. 1996).

23. The speed with which the House acted on the proposed legislation is telling; debate on the 1933 Act was limited to five hours. See Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 442-49 (1990).

despite some comments that appeared to favor special treatment for agricultural cooperatives, the bill was originally passed without specific mention of any such exemption.<sup>24</sup> The Senate version of the 1933 Act did contain an exemption for securities issued by farmers' cooperatives,<sup>25</sup> and the final version of the Act as passed by both Houses essentially adopted the Senate bill's language.

A similar exemption appears in the Securities Exchange Act of 1934 ("the 1934 Act"), which allows brokers and dealers to sell equity securities in certain agricultural cooperatives without registration.<sup>26</sup> However, this exemption was not added until the Securities Acts Amendments of 1964.<sup>27</sup> Even without explicit language authorizing the exemption, however, the Securities Exchange Commission ("SEC") had generally declined to apply the provisions of the Exchange Act to equity interests in farmers' cooperatives.<sup>28</sup> Upon being told by the SEC that it proposed to exempt farmers' cooperatives by rule, Congress finally acted to make the exemption statutory.<sup>29</sup>

Over time, however, the nature of agricultural cooperatives has continued to evolve. As business needs and expectations have changed, the traditional cooperative has been forced to adapt. These adaptations have taken many forms and have been the subject of much discussion.

One change has been the relative decline of the tax-exempt cooperative.<sup>30</sup> At one time, most agricultural cooperatives were formed so as to fit within the relatively strict confines of section 521 of the Code.<sup>31</sup> These limitations eventually proved too burdensome for increasing numbers of cooperatives. Today, less than one-third of agricultural cooperatives claim tax-exempt status,<sup>32</sup> and it is possible that some of those associations claiming this status may in fact be ineligible for it.<sup>33</sup>

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24. The House bill contained no mention of cooperatives, although during the debate, Representative Arens of Minnesota did suggest an exemption for farmers' cooperatives. *See* 77 CONG. REC. 2924 (1933). *See also* 4 THE ECONOMIC REGULATION OF BUSINESS AND INDUSTRY: A LEGISLATIVE HISTORY OF U.S. REGULATORY AGENCIES 2633 (Bernard Schwartz ed., 1973) [hereinafter 4 THE ECONOMIC REGULATION OF BUSINESS]. Representative Rayburn also commented favorably upon the possibility. *See* 77 CONG. REC. 2925 (1933). In addition, other representatives opined that the 1933 Act already implied an exemption for securities issued by farmers' cooperatives. *See id.* at 2924.

25. *See* H.R. 5480, 73d Cong. (1933).

26. *See* 15 U.S.C. § 78l(g)(2)(E)-(F) (1994).

27. *See* Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565, 567 (codified at 15 U.S.C. § 78l(g)(2)(E)-(F)).

28. *See* 4 THE ECONOMIC REGULATION OF BUSINESS *supra* note 24, at 2692.

29. *See* H.R. Rep. No. 88-1418, pt. 2 (1964), *reprinted in* 1964 U.S.C.C.A.N. 3013, 3023.

30. "A decreasing number of cooperatives are attempting to qualify for section 521 exempt status because the burdens of meeting the qualifications outweigh the benefits received from 'exemption.'" JAMES R. BAARDA, UNITED STATES COOPERATIVES AND INCOME TAX POLICY 111 (1997).

31. "Changing economic conditions affecting the operation of cooperatives have decreased the number of cooperatives holding section 521 status." Jeffrey S. Royer, *Taxation, in* COOPERATIVES IN AGRICULTURE 287, 295 (David W. Cobia ed., 1999).

For a discussion of section 521 cooperatives, see RURAL BUS./COOP. SERV., U.S. DEP'T AGRIC., INCOME TAX TREATMENT OF COOPERATIVES: INTERNAL REVENUE CODE SECTION 521, at I-III (1996).

32. "In 1970, 62 of the 100 largest U.S. farmer cooperatives held section 521 status. In 1986,

An even more important recent innovation is the “value-added” cooperative, which has been credited with setting the stage for the “cooperative revival” or “co-op fever” marking the recent resurgence in the popularity of agricultural cooperatives.<sup>34</sup> These “new generation” cooperatives<sup>35</sup> allow members to develop new “value-added

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only 21 of the 100 largest cooperatives held section 521 status.” Royer, *supra* note 31, at 295.

33. Take, for example, the case of Minnesota Corn Processors, Inc. (“MCP”). On January 5, 2000, MCP sent an information statement and prospectus to members, seeking approval to begin converting from the cooperative form of business to a limited liability company. One of the primary reasons given for the proposed conversion was that members had increasingly been forced to buy corn for delivery to the cooperative, rather than growing it themselves. This, according to the prospectus, meant that MCP was “operating less like a cooperative” and was “at risk of losing its favorable single-level tax status under the Internal Revenue Code.” *Minnesota Corn Processors, Colorado Limited Liability Company: Information Statement—Prospectus* (last visited Feb. 17, 2001) <<http://www.sec.gov/Archives/edgar/data/10077133/0000897101-00-000014.txt>> [hereinafter *Minnesota Corn Processors*] (“Reasons for the conversion,” at 11 of the Statement in SEC File No. 333-71213). After conversion, members in the resulting limited liability company would not have any delivery obligations.

In reality, if members of the “cooperative” were not using the venture to market their own products but instead were simply buying corn on the open market for delivery to and resale by the company, then the venture was not really operating as an agricultural cooperative regardless of the label used by the enterprise.

For an example of a retroactive disqualification of a putative section 521 cooperative, see *Etter Grain Co. v. United States*, 462 F.2d 259, 265 (5th Cir. 1972).

34. One source traces this phrase back to a statement by Sarah Vogel, former North Dakota agriculture commissioner, at an event called the “Marketplace of Ideas” in January 1993. “Vogel described the vibrant interest in forming new cooperatives as ‘Co-op Fever.’ The media picked up the phrase and, in 1993, the Associated Press listed ‘Co-op Fever’ as one of the top 10 stories of the year.” William Patrie, *Fever Pitch: A First-Hand Report from the Man Who Helped Spark Co-op Fever in the Northern Plains*, RURAL COOPERATIVES, July/Aug. 1998, at 18, 20-21.

The phrase continues to be used by commentators in the press and other literature on the subject of agricultural cooperatives. See generally Lon Tonneson, *Are We Rich Yet? Farmers Ride the Value Added Investment “Roller Coaster.” One Co-op Generates 300% Gain: Others Bite the Dust*, 117 DAKOTA FARMER, Jan. 1999, at 8, 8-12 (discussing the success rate and economic impact of a cooperative approach to a value-added processing). See also LEE EGGERSTROM, *MAKE NO SMALL PLANS: A COOPERATIVE REVIVAL FOR RURAL AMERICA* 228-31 (1994); Dan Campbell, *Temperature Rising: Co-op Fever is Still Sizzling Across North Dakota But Will the First Cause it to Dissipate?*, FARMER COOPERATIVES, Aug. 1995, at 10-16; Lauck & Adams, *supra* note 6, at 69 (stating “[t]he successes of new cooperatives in recent years, especially value-added cooperatives, which process the farmer’s products, has triggered talk of ‘coop fever.’”); Randall Torgerson, *Co-op Fever—Cooperative Renaissance Blooming on Northern Plains*, FARMER COOPERATIVES, Sept. 1994, at 12.

35. A wide variety of sources have called such value-added enterprises the “new generation” of agricultural cooperatives. Harris, *supra* note 11, at 15. This terminology has been adopted in the popular press. See, e.g., Jerry Perkins, *Golden Eggs? Co-Ops Unite Farmers: Goal is to Add Value to Corn*, DES MOINES REG., Apr. 16, 2000, at 1D, available in 2000 WL 4955217 [hereinafter Perkins, *Golden Eggs*] (“Value-added, farmer owned enterprises also are known as ‘New Generation Cooperatives.’”); Jerry Perkins, *Pork Farmers May Try Processing*, DES MOINES REG., June 11, 1999, available in 1999 WL 7211094 (“A growing number of so-called “new generation” producer-owned cooperatives have been formed in the past 10 years to slaughter and process the livestock or crops of their member owners.”); Traci Carl, *Farmers Grow into the Food-Processing Business*, J. REC. (OKLA. CITY) (Mar. 11, 1977) available in

products” by participating in the processing and subsequent marketing of agricultural products. A very successful example of a value-added cooperative is the Dakota Growers Pasta Company, which takes the members’ durum and processes it into pasta, which is then marketed nationally.<sup>36</sup>

Technically speaking, a “value-added” co-op is any cooperative venture that attempts to provide members with the benefits of marketing a product that has been refined so as to add value to the raw commodity initially supplied by the farmer-members. The term “new generation co-op” incorporates additional attributes having to do with the way in which the co-op funds its operations and induces members to participate. However, describing these as “new generation” co-ops provides no information at all about what these co-ops actually look like, and will sooner or later be misleading when the next new thing in co-op law comes along. Moreover, the fact is that these new co-ops are value-added operations and, in the absence of any better terminology, this Article refers to the new co-ops as being value-added, even though this term is over-inclusive and does not really capture the essence of why the “new” co-ops are so different from what has come before.

As these value-added cooperatives have grown in popularity and prevalence, increasing attention should have been paid to understanding how they fit into the regulatory landscape applicable to cooperatives generally. In particular, some of the characteristics of the new value-added cooperatives raise difficult questions under the federal securities laws, especially because the number of such cooperatives eligible for tax-exempt status (and thus the statutory exemption under the 1933 Act) has dwindled.<sup>37</sup> Nonetheless, virtually nothing has been written about how the federal securities laws should apply to value-added cooperatives, and the existing case authority is far from helpful.

This Article focuses on that question, and in particular, upon the likely application of the securities laws to equity interests in such ventures. The first section of this Article provides an overview of traditional cooperatives and explains the ways in which the typical characteristics have changed in recent years with the advent of the value-added cooperative. The next section provides some background information about the federal securities laws and the current regulatory framework. This is followed by a more detailed consideration of how these securities laws have applied to

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1997 WL 14388141 (quoting University of Missouri Professor Mike Cook as saying that “[a]bout 100 of the ‘new generation’ cooperatives have sprung up across the nation.”). It has also been used in congressional testimony. See, e.g., *Agricultural Assistance Bill: Hearings Before the House Comm. on Small Business*, 106th Cong. 1 (2000), available in 2000 WL 11069472.

For a more detailed look at the structure and characteristics of these new generation cooperatives, see *infra* part II.B. of this article.

36. For a brief description of this cooperative, see Tonneson, *supra* note 34, at 8; Harris, *supra* note 11, at 17-18.

37. See BAARDA, *supra* note 30, at 111; Royer, *supra* note 31, at 295; RURAL BUS./COOP. SERV., *supra* note 31, at I; *Minnesota Corn Processors*, *supra* note 33 (citing materials contained in footnotes 30-33 and accompanying text).



equity interests in traditional cooperatives. The final section addresses how the applicable analysis is likely to be changed if the interests are being issued by value-added cooperatives instead of the more traditional cooperative venture.

By providing a systematic review and comparison of interests in traditional and value-added cooperatives and a detailed analysis of how the courts are likely to apply the federal securities laws to these interests (as well as analyzing how such laws *should* be applied), this Article is intended to provide a framework for regulators, courts, and practitioners interested in assuring appropriate compliance with securities regulations.

## II. COMPARING TRADITIONAL AND VALUE-ADDED AGRICULTURAL COOPERATIVES

### A. *Structure of Traditional Cooperatives*

Traditional cooperatives are often compared to corporations,<sup>38</sup> perhaps because co-ops were typically incorporated under state law.<sup>39</sup> As a starting point, consider the structure of a typical business corporation.

Persons wishing to become equity participants in a corporation buy stock. This stock gives the owners the right to elect directors, generally on the basis of the number of shares owned.<sup>40</sup> Share ownership also entitles the equity participants to share in earnings on a pro rata basis.<sup>41</sup> Absent agreement among the shareholders to the contrary, shares are freely transferable, and capable of appreciating in value. These are, in fact, the essential attributes of corporate “stock” identified by the United States Supreme Court in the context of determining when “stock” will be considered to be a security.<sup>42</sup>

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38. Not everyone, however, would agree that it makes sense to think about cooperatives and corporations together.

39. U.S. DEP'T AGRIC., COOPERATIVE PRINCIPLES AND LEGAL FOUNDATIONS 2 (reviewed and approved for reprinting 1993) (1977).

40. See LEWIS D. SOLOMON & ALAN R. PALMITER, CORPORATIONS: EXAMPLES AND EXPLANATIONS § 4.1.3 (3d ed. 1999). Corporations may also issue non-voting shares, but at least one class of shares must have equal voting rights. See MODEL BUS. CORP. ACT §§ 6.01(a), 6.02(c) (1984).

41. See SOLOMON & PALMITER, *supra* note 40, § 4.1.1. Again, it is possible that the corporation will issue multiple classes of shares, each with different participation rights. However, every share in the same class must entitle its owner to the same rights as are attributable to every other share in the same class. See *id.* §4.1.3. See also MODEL BUS. CORP. ACT §§ 6.01(a), 6.02(c) (1984).

42. See *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 (1985). The Court identified the characteristics “usually associated with common stock as (i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value.” *Id.* at 686 (citing *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 851 (1975)).

Cooperatives do not generally share these characteristics. First, cooperatives may or may not issue “stock” to their members; equity participation in a co-op can take many different forms. In addition, while members may be required to buy some sort of “membership interest” as a condition to joining the cooperative, the majority of a traditional cooperative’s equity comes from retained patronage dividends rather than external “investment.”<sup>43</sup> Finally, even where “stock” is purchased, its function is typically only to give members the right to use the co-op’s services and facilities. It does not determine voting rights or the right to share in profits from the venture, if any. Cooperatives generally operate on a one-vote per member basis, regardless of the relative investment of the members or the number of shares or membership interests owned.<sup>44</sup> Similarly, although members generally have equal voting rights in the cooperative, member income is based on patronage rather than equity ownership.<sup>45</sup> Distributions upon dissolution are also based on patronage rather than the members’ proportionate capital investment.<sup>46</sup> In addition, membership rights, however denominated, are not usually freely transferable and typically do not have the potential for appreciation.<sup>47</sup>

In evaluating the characteristics of a cooperative, it has been said that:

Any definition of a cooperative must account for four operationally-unique cooperative principles. First, cooperatives are owned and democratically controlled by the producers who use their services. Second, the cooperative distributes its net income to producers in proportion to their use of the cooperative. Third, returns on ownership capital are limited. Fourth, producers who use the cooperative substantially finance its operation.<sup>48</sup>

This litany of attributes makes for ready comparison with the traditional, for-profit corporate form. In the case of a corporation, shareholder-owners generally have

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43. See 14 HARL., *supra* note 6, § 131.04[2][e].

44. See JAMES BAARDA, STATE INCORPORATION STATUTES FOR FARMER COOPERATIVES 73 (1982).

45. See U.S. DEP’T AGRIC., INCOME TAX TREATMENT OF COOPERATIVES: PATRONAGE REFUNDS, at i (1993) [hereinafter PATRONAGE REFUNDS]. Thus, when a cooperative desires to return some of its net earnings to its patrons, it generally pays out patronage “dividends” in cash or other property. See I.R.C. § 1388(a) (1994). Earnings returned to persons using the cooperative may also be known as patronage refunds, but are labeled “patronage dividends” in the Internal Revenue Code. See *id.* For convenience, the term patronage dividend will be used in this article.

However, the cooperative often does not pay out all of its earnings when they are earned; rather, the typical cooperative will retain at least a portion of each member’s patronage dividends until a later date. See PATRONAGE REFUNDS, *supra*, at i (1993). Patronage dividends that are allocated to patrons but retained by the cooperative are generally known as a patronage retain or retained equities. See *id.*

46. See BAARDA, *supra* note 44, at 124. Statutes addressing the distribution of assets by an agricultural cooperative at dissolution apportion them in three ways: (1) according to property interests; (2) according to stock ownership; or (3) according to past patronage. See *id.*

47. See Solomon & Kirgis, *supra* note 20, at 244, 254.

48. Sharlene F. Roberts-Caudle, *Agricultural Cooperative Member Equity: You Don’t Have to Die for It!*, 7 SAN JOAQUIN AGRIC. L. REV. 1, 6 (1997) (citations omitted).

one vote per share, meaning that voting rights are held proportionately to each shareholder's equity investment in the enterprise. In addition, a shareholder's equity interest is typically acquired through investment in the stock itself, although the stock may (and hopefully will) appreciate in value. The investment may be recouped through dividends or upon sale of the appreciated stock on the open market. Most stock is not redeemable, nor is redemption the typical way in which the value of an investment in corporate stock is realized. In general, therefore, a stockholder's income is generally based on stock ownership, as is the stockholder's right to participate in distributions upon dissolution and liquidation. The shares are generally freely transferable, unless the shareholders have agreed to limit this right. Moreover, there is generally no requirement that the owners of a business corporation "use" the corporation's facilities or products.

Thus, none of the essential attributes of the cooperative form of business fit the traditional corporate model. This fact explains why some commentators have complained that "viewing a co-operative as a corporation distorts its true nature because an ordinary corporation may exist and operate from its own detached power base whereas a co-operative cannot exist apart from a body of people who are its members."<sup>49</sup>

#### B. *Value-added Agricultural Cooperatives*

Beginning in the early 1990s, commentators began to report on the spread of value-added cooperatives, often referred to as new wave or new generation cooperatives.<sup>50</sup> In some ways, these value-added cooperatives operate like traditional cooperatives. There are, however, some significant differences.

The purpose of these cooperatives is clear—"to develop new value-added products and to gain access to an increased share of the consumers' food dollar."<sup>51</sup> They have appeared "in virtually every sector of agricultural production," including so-

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49. *Id.* at 2 (quoting STUART BAILEY, UNIV. OF SASKATCHEWAN CENTRE FOR THE STUDY OF CO-OPERATIVES, ENCOURAGING DEMOCRACY IN CONSUMER AND PRODUCER CO-OPS 1 (1986)).

For a careful examination of the recently amended Colorado cooperative statute, see generally James B. Dean et al., *The New Colorado Cooperative Act: A Setting for a Business Structure*, 25 COLORADO LAWYER, at 3 (Dec. 1996), distinguishing cooperatives from investor-oriented corporations, providing a history of cooperatives, along with examples of their organization's characteristics, and discussing the Colorado Cooperative Act's elements.

50. *See supra* note 34. The USDA has published a guide to creating next generation cooperatives. *See* WILLIAM PATRIE, U.S. DEP'T OF AGRICULTURE, CREATING 'CO-OP FEVER': A RURAL DEVELOPER'S GUIDE TO FORMING COOPERATIVES (1998). So has the Illinois Institute for Rural Affairs. *See* MARK J. HANSON, ILLINOIS INSTITUTE FOR RURAL AFFAIRS, STARTING A VALUE-ADDED AGRIBUSINESS: THE LEGAL PERSPECTIVE (2000).

51. Harris, *supra* note 11, at 15.

called “niche markets” like bison processing, and more traditional arenas such as corn sweetener production, sugar beet processing, and pasta production.<sup>52</sup>

Like traditional cooperatives, these value-added co-ops operate on the traditional cooperative principle of one-member, one-vote.<sup>53</sup> Similarly, a very significant motivating factor in the decision to participate in a value-added cooperative is the desire to gain the benefits of membership—typically a guaranteed market for a particular commodity. In fact, membership in such ventures is “typically limited to one commodity group.”<sup>54</sup> Finally, as with traditional cooperatives, earnings in a value-added enterprise are also distributed to members on the basis of patronage.<sup>55</sup>

The differences between traditional and value-added co-ops, however, may be profound. First, membership in new generation cooperatives is generally “closed” or “restricted,” with total membership based on the volume of raw product that the cooperative can adequately process or refine.<sup>56</sup> The attributes of membership also differ from that in a traditional co-op because a member’s equity in a value-added enterprise will be based upon that member’s patronage, because a member is generally required to purchase not only a membership interest, but also delivery rights. These “rights,” which also entail an obligation to deliver a specified amount of the applicable commodity, may be assigned on the basis of the number of shares of common stock or may depend on the purchase of preferred shares.<sup>57</sup> The delivery rights and obligations may attach as a result of ownership of the stock pursuant to the terms of the cooperative’s organizational documents or may be separate from the stock as part of a contract entered into between the member and the co-op. In any event, however, the extent of each member’s delivery obligations is generally tied to that member’s investment level.<sup>58</sup> Thus, while it is true that a member in a value-added cooperative

52. *Id.*

53. See Robert Cropp, *New Generation Cooperatives Defined* (visited Jan. 24, 2001) <<http://www.wisc.edu/uwcc/info/bob.html>>.

54. Harris, *supra* note 11, at 24.

55. The difference, of course, is that patronage is itself typically linked to equity participation so that earnings in a value-added venture will vary directly with both patronage and investment. See *infra* notes 57-58 and accompanying text.

56. See Dennis A. Johnson, *Surfing the New-Wave Cooperatives*, 62 FARMER COOPERATIVES (Oct. 1995), available in <<http://www.wisc.edu/uwcc/info/farmer/627surf.html>> (claiming “[d]efined or selected membership rather than open membership” is a characteristic of new-wave cooperatives).

57. See *id.*; Ralph K. Morris, *Presentation to the New Generation Cooperatives Conference* (Apr. 1, 1996) available in <<http://www.wisc.edu/uwcc/info/morris.html>>.

58. See Johnson, *supra* note 56, (citing “[l]ong-term delivery rights and obligations . . . with investment level tied to delivery rights,” as a characteristic of new-wave cooperatives).

It is also worth mentioning that delivery obligations do not always guarantee that the member will in fact be delivering the member’s own produce. Some members’ agreements for new generation cooperatives expressly authorize the cooperative to buy on the account of the member commodities that the member fails to deliver. See, e.g., Golden Growers Cooperative Growers Agreement § 1(a) (on file with author). Such provisions, of course, mean that delivery obligations can be fulfilled with a cash payment. Also, consider the following discussion about the reasons that participants had for declining to purchase or for selling shares in Dakota Growers Pasta Company, a noted new generation cooperative:

will share in profits on the basis of patronage, it is equally accurate to say that the members' sharing ratios are fixed by their relative investments.

This difference is also reflected in the nature of a member's investment in a value-added co-op. Because processing most agricultural commodities is an expensive, capital-intensive proposition, "minimum capital requirement for [new generation cooperative] membership is often high."<sup>59</sup> In exchange for a greater initial capital investment, farmers hope for a greater rate of return. Thus, many successful value-added co-ops pay out much of their profits on an annual basis rather than retaining significant amounts.<sup>60</sup> In fact, expansion is "typically funded by new investment related to additional delivery or membership rights," not retained patronage dividends.<sup>61</sup>

In order to attract more funds upfront, value-added deals are generally structured so that the "delivery or membership rights have value and can be traded."<sup>62</sup> With this framework, there is no necessity to wait for redemption by the cooperative in order to recover the initial investment.<sup>63</sup> The market will determine the value of the interests,<sup>64</sup> and members have the potential to benefit from appreciation in value.<sup>65</sup>

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All participants agreed that the cooperative's success had exceeded expectations, but it was not clear at the beginning that this would be the case. Inability to raise durum was an important factor in the decision of two of the session participants. Also, there was discussion about the fact that disease problems in the area have made it difficult for farmers to raise durum that meets the standards of the plant. Even farmers who belong or have belonged to the cooperative have not been able to deliver durum they have produced. Rather, they have been forced to purchase elsewhere the durum they were obliged to deliver. Finally, there was some lively discussion about the fact that purchasing these shares is very much like purchasing shares in any business, especially in light of the problems members have in growing durum that can be delivered to the plant. One session participant noted that he might prefer to diversify his investments by purchasing stock in companies outside of the agricultural sector.

KIM ZEULI et al., DAKOTA GROWERS PASTA COMPANY AND THE CITY OF CARRINGTON, NORTH DAKOTA: A CASE STUDY, 28-29 (1998) (published as a report for the USDA Fund for Rural America).

59. Harris, *supra* note 11, at 19.

60. For example, Dakota Growers Pasta Company has paid out approximately two dollars per share since formation in 1992. See Tonneson, *supra* note 34, at 8. Minnesota Corn Processors paid members "\$.30 to \$1 per bushel from 1984 to 1995." *Id.* at 9. In 1996, another cooperative, Golden Oval Eggs, produced a return on investment of approximately 44%. See *id.* at 10. North American Bison Cooperative paid \$41.09 per head in 1998. See *id.*

61. Johnson, *supra* note 56.

62. *Id.* See also Harris, *supra* note 11, at 16-17 (talking about the transferability of delivery rights in most value-added cooperatives).

63. See Cropp, *supra* note 53.

64. See *id.*

65. See Ralph K. Morris, *Legal & Financial Aspects of New Generation Cooperatives: Legal Implications* (visited Jan. 24, 2001) <<http://www.wisc.edu/uwcc/info/morris.html>>. For a detailed discussion of changes in market value for some of the most and least successful value-added agricultural

On the other hand, just as there is an increased potential for profits, there is also increased risk. One farmer, who serves as a board member in a successful value-added co-op, has been quoted as saying that “investing in value-added ag processing ‘is just like investing in the stock market. You have to be in it for the long haul, and you shouldn’t invest money that you can’t afford to lose.’”<sup>66</sup>

The impact of the differences between the structure of traditional and value-added cooperatives should become clearer when one understands the way in which the federal securities laws have applied to equity interests in such enterprises. As a starting point, it is probably worth reviewing the general framework of the federal securities laws.

### III. THE FEDERAL SECURITIES LAWS

#### A. *Structure of the 1933 and 1934 Acts*

As mentioned briefly earlier, both the Securities Act of 1933 and the Securities Exchange Act of 1934 are relevant to any discussion concerning the regulation of securities issued by agricultural cooperatives.<sup>67</sup> Speaking generally, the 1933 Act regulates the initial offering of securities to the public and prohibits the sale of unregistered securities unless there is a suitable exemption.<sup>68</sup> The 1934 Act regulates securities trading, imposing registration requirements upon certain issuers of securities and also setting forth on-going reporting requirements once an issuer is required to register.<sup>69</sup>

In terms of how the Acts are structured, the 1933 Act defines securities,<sup>70</sup> then lists exempted securities<sup>71</sup> and exempted transactions.<sup>72</sup> If a particular interest fits within the statutory definition of a security, and there is no available exemption from registration either for the security or the particular transaction, that security must be registered with the SEC before it can be offered for sale.<sup>73</sup> Generally speaking, if there is an exemption, the security or transaction is exempt from the registration provisions of the 1933 Act but not the anti-fraud requirements of the statute.<sup>74</sup> Thus, whether or not an exemption from registration is available, the 1933 Act provides for civil and

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cooperatives in recent years, see Tonneson, *supra* note 34, at 8-12.

66. Tonneson, *supra* note 34, at 12 (citing Sandy Ludeman, Minnesota Corn Processors board member).

67. The introductory section of this Article references both of these statutes.

68. *See* Securities Act of 1933, 15 U.S.C. § 77f (1994).

69. *See* Securities Exchange Act of 1934, 15 U.S.C. §§ 78d, 78l, 78q (1994). The 1934 Act also regulates securities brokers and dealers, and security exchanges. *See id.* § 78o.

70. *See* Securities Act of 1933, 15 U.S.C. § 77b(1) (1994).

71. *See id.* § 77c.

72. *See id.* § 77d.

73. *See id.* § 77f.

74. *See id.* § 77l(a)(2).

criminal liability for untrue statements or omissions of material fact in connection with the distribution of securities.<sup>75</sup>

Similarly, the 1934 Act also contains a definition of “securities,” and imposes a number of ongoing reporting requirements once an issuer is required to register with the SEC.<sup>76</sup> The statutory obligations that are triggered once an issuer is required to register under the 1934 Act include periodic reporting requirements,<sup>77</sup> restrictions applicable to the solicitation of proxies,<sup>78</sup> and substantive limitations on insider trading.<sup>79</sup> Exemptions again insulate issuers from these substantive requirements,<sup>80</sup> but not the anti-fraud provisions of the 1934 Act.<sup>81</sup>

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75. *See id.* § 77l. Addressing civil liabilities arising in connection with prospectuses and communications as follows:

(a) In general.

Any person who-

(1) offers or sells a security in violation of section 77e of this title, or

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable, subject to subsection (b) of this section, to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

(b) Loss causation.

In an action described in subsection (a)(2) of this section, if the person who offered or sold such security proves that any portion or all of the amount recoverable under subsection (a)(2) of this section represents other than the depreciation in value of the subject security resulting from such part of the prospectus or oral communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount, as the case may be, shall not be recoverable.

*Id.* § 77l.

76. *See generally* HAZEN, *supra* note 22, at 514-15 (explaining securities registration requirements under the 1934 Act).

77. *See* 15 U.S.C. § 78m (1994).

78. *See id.* § 78n.

79. *See id.* § 78p.

80. *See id.* § 78l(g)(2).

81. *See id.* § 78. The most well known anti-fraud provision is section 10b and the corresponding rule 10b-5. *See id.* § 78j.

As mentioned earlier, both the 1933 Act and the 1934 Act contain provisions that exempt securities issued by certain agricultural cooperatives from many of the more burdensome provisions of the federal securities laws.<sup>82</sup> Some observers have contended that Congress never considered equity interests in such cooperatives to be securities<sup>83</sup> and that the exemptions in the 1933 Act were ultimately included as a precautionary measure.<sup>84</sup> On the other hand, one of the basic principles of statutory construction is that whenever possible, a statute should be construed so as to avoid rendering portions of the statute superfluous.<sup>85</sup> This precept supports the conclusion that absent the statutory exclusion, interests issued by these co-ops would have been subject to regulation.

This distinction may be quite significant. If the interests being issued are not securities, the federal statutes do not apply at all. There would, for instance, be no possibility of a cause of action under the federal securities laws for fraud or misrepresentation, although it is always possible that state securities laws or the common law might apply to the transaction. On the other hand, if the interests are classified as securities, at the very least the anti-fraud provisions of the federal securities laws will apply, even if the securities are technically “exempt.”<sup>86</sup> Beyond that, it is also possible that the registration and other requirements will be imposed, depending on whether the agricultural cooperative has complied with the often-demanding requirements of the applicable statutory exemptions.<sup>87</sup>

#### B. *Statutory Exemptions for Securities Issued by Agricultural Cooperatives*

Under the 1933 Act, the availability of the statutory exemption for agricultural cooperatives turns on whether the cooperative under consideration qualifies as tax

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82. Section 3(a)(5) of the 1933 Act provides that any security issued by a section 521 farmers' cooperative is exempt from the provisions of the Act, except as otherwise expressly provided. *See id.* § 77c(a)(5). Section 12(g)(2)(E) of the 1934 Act exempts all securities issued by cooperative associations, as defined by the Agricultural Marketing Act of 1929, from the registration requirements of section 12(g). *See id.* § 78l(g).

83. *See Centner, Retained Equities, supra* note 9, at 267 (citing *Mid-American Dairymen, Inc.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,110, at 87,841 (Feb. 2, 1977)).

84. *See id.* (citing Robert G. Taylor, *Problem Areas in Application Federal Securities Laws to Farmer Cooperatives*, in *COOPERATIVES AND FEDERAL REGULATIONS* 11, 11 (R. Wayne Robinson ed., 1976)).

85. The Supreme Court and a myriad of lower courts have articulated this principle over the years. *See, e.g.*, *United States v. Evans*, 333 U.S. 483, 486 (1948), *Halverson v. Slater*, 129 F.3d 180, 185 (D.C. Cir. 1997); *In re Butcher*, 125 F.3d 238, 242 (4th Cir. 1997); *United States ex rel. Harlan v. Bacon*, 21 F.3d 209, 209-11 (8th Cir. 1994); *Sutton v. United States*, 819 F.2d 1289, 1295 (5th Cir. 1987); *Jackson v. Kelly*, 557 F.2d 735, 740 (10th Cir. 1977); *United States v. Blasius*, 397 F.2d 203, 206 (2d Cir. 1968); *United States v. Korpan*, 237 F.2d 676, 680 (7th Cir. 1956).

86. *See HAZEN, supra* note 22, at 513.

87. *See* 15 U.S.C. §§ 77c(a)(5)(B)(i); 78l(g)(2)(E)-(F) (1994).



exempt under section 521 of the Code.<sup>88</sup> The Code requires a farmers' cooperative to be

organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.<sup>89</sup>

In addition, if the organization issues capital stock, the interest rate may not exceed the greater of

the legal rate of interest in the State of incorporation or 8 percent per annum . . . on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) . . . [must be] owned by producers who market their products or purchase their supplies and equipment through the association.<sup>90</sup>

Finally, the cooperative is limited in the amount of business it can conduct for non-members and non-producers.<sup>91</sup> The exemption will be available so long as the association does not market the products of, or purchase supplies and equipment for, nonmembers in an amount exceeding "the value of the products marketed [or supplies and equipment purchased] for members," provided also that "the value of the purchases made for persons who are neither members nor producers does not exceed fifteen percent of the value of all its purchases."<sup>92</sup>

Under the 1934 Act, there are two possible exemptions. One possibility is that the cooperative in question fits within the definition of a "cooperative association" as defined in the Agricultural Marketing Act.<sup>93</sup> This Act, in turn, defines cooperative association to mean:

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88. See 15 U.S.C. § 77c(a)(5)(B)(i) (1994) (exempting securities issued by any "farmer's cooperative organization exempt from tax under section 521 of [the Internal Revenue Code]").

89. I.R.C. § 521(b)(1) (1994).

90. *Id.* at § 521(b)(2).

91. See *id.* at § 521(b)(4).

92. *Id.* at § 521(b)(4).

93. See 15 U.S.C. § 78l(g)(2)(E) (1994) (exempting "any security of an issuer which is a 'cooperative association' as defined in the Agricultural Marketing Act, approved June 15, 1929, as amended [12 U.S.C. § 1141 *et seq.*], or a federation of such cooperative associations, if such federation possesses no greater powers or purposes than cooperative associations so defined").

any association in which farmers act together in processing, preparing for market, handling, and/or marketing the farm products of persons so engaged, and also means any association in which farmers act together in purchasing, testing, grading, processing, distributing, and/or furnishing farm supplies and/or farm business services: Provided, however, That such associations are operated for the mutual benefit of the members thereof as such producers or purchasers and conform to one or both of the following requirements:

*First.* That no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own therein; and

*Second.* That the association does not pay dividends on stock or membership capital in excess of 8 per centum per annum.

[And in any case to the following:]

*Third.* That the association shall not deal in farm products, farm supplies, and farm business services with or for nonmembers in an amount greater in value than the total amount of such business transacted by it with or for members. All business transacted by any cooperative association for or on behalf of the United States or any agency or instrumentality thereof shall be disregarded in determining the volume of member and nonmember business transacted by such association.<sup>94</sup>

The other possibility under the 1934 Act is for the security to meet the following requirements:

any security issued by a mutual or cooperative organization which supplies a commodity or service primarily for the benefit of its members and operates not for pecuniary profit, but only if the security is part of a class issuable only to persons who purchase commodities or services from the issuer, the security is transferable only to a successor in interest or occupancy of premises serviced or to be served by the issuer, and no dividends are payable to the holder of the security.<sup>95</sup>

These restrictions on the availability of exemptions from the federal securities laws are significant. At one time, most agricultural cooperatives were organized so as to comply with the requirements of section 521 of the Code.<sup>96</sup> These cooperatives also operated in a manner consistent with the Agricultural Marketing Act.<sup>97</sup> However, this is no longer the case. The restrictions imposed by these federal statutes are so limiting, especially as the number of farmers has decreased over the years, that it has become

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94. 12 U.S.C. § 1141j (1994).

95. 15 U.S.C. § 781(g)(2)(F) (1994).

96. See RURAL BUS./COOP. SERV., *supra* note 31, at I-II.

97. See *id.*

increasingly impracticable for all cooperatives to fit within these structures.<sup>98</sup> Thus, it has become increasingly necessary to analyze the individual interests issued by such cooperatives to determine which will be classified as securities.

The following section of this Article takes a more detailed look at the various kinds of equity interests typically issued by traditional cooperatives and evaluates whether these interests are subject to the federal securities laws.

#### IV. APPLICATION OF THE SECURITIES LAWS TO MEMBERSHIP INTERESTS IN TRADITIONAL AGRICULTURAL COOPERATIVES

##### A. *Background*

Generally speaking, members in a cooperative are required to make a financial investment upon joining the cooperative.<sup>99</sup> For agricultural cooperatives, membership is generally limited to those who produce the agricultural products that are the focus of the cooperative venture.<sup>100</sup>

A relatively small initial investment in the venture is usually required of members. For cooperatives with stock, this investment often takes the form of a mandatory purchase of common stock.<sup>101</sup> On the other hand, because cooperatives may be formed on a stock or non-stock basis, the initial investment by members may not result in the issuance of “stock,” and instead may take the form of a membership or initiation fee.<sup>102</sup> Even for cooperatives organized on a stock basis, membership or initiation fees may be required in lieu of a mandatory purchase of stock, or in addition to it. However, for the most part, these fees give rise to the same rights as purchasers obtain upon buying membership interests in the form of stock, and under the federal securities laws should not be subject to significantly different analysis.<sup>103</sup>

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98. *See id.*

99. Soloman & Kirgis, *supra*, note 20, at 242.

100. Lauck & Adams, *supra* note 6, at 69 (noting that “the purchase of equity is often limited by statute to the cooperative’s member-patrons . . .”).

101. *See generally* 14 HARL, *supra* note 6, § 136.01[1].

102. Soloman & Kirgis, *supra* note 20, at 239-45.

103. It is clear that the mere fact of calling an interest “stock” will not be determinative. *See, e.g.*, *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975).

In addition to this authority, several no-action requests from cooperatives have specifically referenced such fees rather than stock purchases. *See, e.g.*, AMSI Travel Alliance, Inc., SEC No-Action Letter (Feb. 7, 1980), *available in* 1980 WL 15594 S.E.C.; Southland Dealers Coop., Inc., SEC No-Action Letter (Oct. 22, 1979), *available in* 1979 WL 14450 S.E.C.; Yellow Cab Coop. Ass’n, SEC No-Action Letter (Apr. 6, 1979), *available in* 1979 WL 13528 S.E.C. Some cooperatives have also received favorable no-action responses for member financing through annual dues payments in addition to the initial membership fee. *See* Yellow Cab Coop. Ass’n, SEC No-Action Letter (Apr. 6, 1979), *available in* 1979 WL 13528 S.E.C.; Rural Television Coop. Ass’n, SEC No-Action Letter (Sept. 22, 1977), *available in* 1977 WL 11225 S.E.C.

Regardless of whether or not the initial purchase is in the form of stock, most of the equity<sup>104</sup> in a traditional cooperative is generated by the cooperative's retention of a portion of the sales price of goods sold through the cooperative or a portion of any savings realized as a result of purchases through the cooperative.<sup>105</sup> Members in the cooperative are normally entitled to receive shares of the cooperative's profit based on how much they use the cooperative's facilities or services.<sup>106</sup> Many agricultural cooperatives simply retain a portion of the amount that would otherwise be paid to the members for their product on a per unit basis.<sup>107</sup> This form of "investment" is often referred to as a patronage retain, and may or may not be represented by certificates.<sup>108</sup>

The prevalence of this as a method of financing is attributable to a number of factors. First, although cooperatives are required by federal tax laws and state incorporation laws to pay patronage dividends each year to their members,<sup>109</sup> they are not required to pay the entire dividend in cash. Federal tax laws require at least twenty percent be paid in money or by qualified check in order for the entire patronage dividend to be a deductible expense for the cooperative.<sup>110</sup> The amount not paid in cash is kept by the cooperative and credited to the member in one of several ways.<sup>111</sup> For example, a member may receive "stock," credit on a capital account, an equity

104. There are a number of reasons why farmers' cooperatives may be unable to raise sufficient capital by selling membership interests. "Since the purchase of equity is often limited by statute to the cooperative's member-patrons, however, this financing option can be limited. This option is especially limited in times of economic distress when farmers have very little working capital." Lauck & Adams, *supra* note 6, at 69.

In addition, the greater the capital needs of the cooperative, the less satisfactory equity financing may be as a source of operating funds. See RALPH W. DUTROW ET AL., UNITED STATES DEP'T OF AGRIC., ACS SERVICE REPORT NO. 2, FINANCIAL PROFILE OF 15 NEW AGRICULTURAL MARKETING COOPERATIVES 7 (1981).

One obvious alternative to equity financing is debt. Although beyond the scope of this Article, financing through debt can also raise difficult issues for cooperatives under the federal securities laws. One problem is that there are so many kinds of debt that may be used by such enterprises. For example, in addition to loans from commercial sources, members may make advance payments for supplies to be purchased later or outright cash loans evidenced by promissory notes. There are relatively few authorities dealing with the appropriate treatment of debt issued by cooperatives under the federal securities laws. For at least some kinds of debt, the staff of the SEC has apparently taken the position that the securities laws should apply. See *Southland Dealers*, SEC No-Action Letter (Oct. 22, 1979), available in 1979 WL 14450 S.E.C. Membership interests would not require registration, but proposed offering of preferred stock and debt securities "would involve the offering of securities." *Id.* at \*6 (emphasis added).

105. See FARMER COOP. SERV., U.S. DEP'T AGRIC., LEGAL PHASES OF FARMER COOPERATIVES 473-74 (1976).

106. See *id.* at 471-72.

107. See *id.* at 473-74.

108. See Mary Beth Matthews, *Current Developments in the Law Regarding Agricultural Cooperatives*, 1 DRAKE J. AGRIC. L. 173, 174 (1996). See also 14 HARL, *supra* note 6, § 136.01[1].

109. See I.R.C. § 1388 (1994). For a general discussion of patronage dividends, see PATRONAGE REFUNDS *supra* note 45; 14 HARL, *supra* note 6, §§ 135.01[1]-135.03[8]; *Taxation of Cooperatives*, Tax Mgmt. (BNA) No. 744 (1999).

110. See I.R.C. § 1388(c)(1) (1994).

111. See PATRONAGE REFUNDS, *supra* note 45, at i.

certificate, or some other evidence of his or her retained patronage in the cooperative.<sup>112</sup> Retained patronage dividends (however denominated) thus provide an easy way for members to contribute equity capital to the cooperative.<sup>113</sup> The principal manner of recouping these types of equity investment is through redemption of these interests by the cooperative, rather than by sale of the interests in a market.<sup>114</sup>

Unfortunately, there are relatively few authorities addressing when such equity interests, either in the form of initial membership interests or retained equity<sup>115</sup> are properly classified as securities.<sup>116</sup> It is clear that some of these interests should be classified as securities while other interests should not be subject to the federal securities laws.<sup>117</sup> A more detailed review of the applicable definitions of the term “security” indicates why both of these possibilities exist.

### B. Possible Approaches to the Problem

The definitions section of the 1933 Act provides in pertinent part: “[U]nless the context otherwise requires—the term ‘security’ means any note, stock . . . certificate of interest or participation in any profit-sharing agreement . . . investment contract . . . or, in general, any interest or instrument commonly known as a ‘security’ . . . .”<sup>118</sup> The definitions in the 1934 Act are, for all practical purposes, the same.<sup>119</sup>

112. See Centner, *Retained Equities*, *supra* note 9, at 246.

113. See *id.* at 247.

114. See generally AGRIC. COOP. SERV., U.S. DEP’T AGRIC., EQUITY REDEMPTION—ISSUES AND ALTERNATIVES FOR FARMER COOPS. (1982) (discussing issues relating to equity redemption and giving an overview of various potential equity redemption methods and plans focusing on improvement or facilitating redemption).

115. There are a number of no-action determinations from the SEC concerning the status of revolving equity plans designed to retire “retained dividends.” See, e.g., American Crystal Sugar Co., SEC No-Action Letter (Feb. 19, 1984), *available in* 1984 WL 45677 S.E.C.; Yellow Cab Coop. Ass’n, SEC No-Action Letter (Apr. 6, 1979), *available in* 1979 WL 13528 S.E.C.; Mid-America Dairymen, Inc., SEC No-Action Letter (Mar. 3, 1977), *available in* 1977 WL 11662 S.E.C.

116. Not all patronage retains have been classified as “equity” for all purposes. See, e.g., *In re Schauer*, 62 Bankr. 526, 531-32 (D. Minn. 1986) (noting that while “patronage dividends may be distributed in the form of capital stock or equity securities,” the patronage dividends at issue in that case were “not in themselves equity securities” under Minnesota law).

117. One particularly well-respected commentator has observed that, in his opinion:

Stock or a membership in a business cooperative may or may not be a security. Where a nominal amount is paid for a non-transferable interest with no appreciation potential, and where earnings are distributed in accordance with patronage volume rather than shareholdings, no security would be involved. But some cooperative stock has sufficient profit/loss potential to be a security.

RICHARD W. JENNINGS ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 341 (8th ed. 1998) (noting that most of the available authorities are non-binding no-action letters from the SEC).

118. 15 U.S.C. § 77(b)(1) (1994).

119. See *id.* at § 78c(a)(10). The Supreme Court has ruled that the definitions are “virtually

Membership interests in an agricultural cooperative might be treated as falling within any one or more of these categories.

One possibility is that membership interests might constitute “stock,” as such term is used in the federal securities acts. This possibility has some inherent plausibility, because cooperative membership interests are often evidenced by shares of “stock,” and technically represent equity participation in a corporate entity.<sup>120</sup> On the other hand, this type of membership interest does differ fundamentally from typical “corporate stock.”<sup>121</sup> Alternatively, these interests, if certificated, might be seen as evidence of participation in a profit sharing agreement. An even more likely alternative is that such interests, whether or not represented by certificates, might qualify as “investment contracts,” as such term is meant in the federal securities acts.<sup>122</sup> Finally, it is also possible that the interests might be “commonly understood,” to be securities because of public perceptions.

Even before these possibilities were addressed in the courts, some prominent legal scholars expressed the view that the securities laws should not apply to equity interests in traditional cooperatives because of the absence of a profit motive.<sup>123</sup> However, cooperatives could not rely on this conclusion with any degree of assurance. It was not until 1975, when the United Supreme Court decided *United Housing Foundation, Inc. v. Forman*,<sup>124</sup> that the federal courts squarely addressed the issue of whether cooperative membership shares constitute securities within the scope of federal securities laws.<sup>125</sup>

### C. United Housing Foundation, Inc. v. Forman

In *Forman*, shareholder-residents of a low-income and moderate-income cooperative housing development filed a class action lawsuit alleging, among other things, violations of the federal securities laws.<sup>126</sup> The defendants responded that the

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identical” and interchangeable. See *Tcherepnin v. Knight*, 389 U.S. 332, 342 (1967).

120. See David G. Burton, *What if a Cooperative*, in COOPERATIVES IN AGRICULTURE 1,7 (David W. Cobia ed. 1989).

121. For a more detailed discussion of how corporations and cooperatives differ, see *supra* part II of this Article.

122. See, e.g., 15 U.S.C. § 77(e)(20) (1994).

123. See 1 LOUIS LOSS, SECURITIES REGULATION 489-94 (2d ed. 1961); ISRAEL PACKEL, THE ORGANIZATION AND OPERATION OF COOPERATIVES 275-86 (4th ed. 1970); Walter W. Miller, Jr., *Cooperative Apartments: Real Estate or Securities?*, 45 B.U. L. REV. 465, 496 (1965). “So long as profit does not mean benefit (as it has not) and so long as profit is the often unspoken but essential element of motivation in securities sales and purchases, federal securities law should not apply. The problem is: no one is absolutely certain.” *Id.* (citing Professor Loss).

124. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975).

125. See *id.* at 840. Even then, the cooperative at issue was not an agricultural cooperative. See *id.*

126. See *id.* at 837, 844-45. The plaintiffs asserted federal jurisdiction under: (1) the fraud provisions of the federal Securities Acts of 1933, as amended, § 17(a), 48 Stat. 84, 15 U.S.C. § 77q(a); (2) the Securities Exchange Act of 1934, as amended, § 10(b), 48 Stat. 891, 15 U.S.C. § 78j(b); and (3) state

federal courts lacked jurisdiction because the interests purchased by the plaintiffs, although called “stock,” were not in fact “securities.”<sup>127</sup>

The important facts of *Forman* are relatively easy to state. The plaintiffs had been required to purchase shares of “stock,” which then entitled them to residence in the cooperative housing project.<sup>128</sup> The shares reflected a number of principles characteristic of cooperative membership interests: (1) ownership of shares entitled the holder to occupy a residential apartment in the project and only share-owners could occupy an apartment;<sup>129</sup> (2) the required capital contribution was based on the size of the apartment;<sup>130</sup> (3) regardless of the number of shares owned, each share-owner had a single vote in electing directors and deciding cooperative issues;<sup>131</sup> (4) transfer of shares was restricted;<sup>132</sup> and (5) no dividends were paid and the stock could not appreciate in value.<sup>133</sup> The plaintiffs contended that these shares were covered by the securities laws either because: (1) shares of “stock” were issued, and the federal securities laws explicitly include “stock” in the definition of security; or (2) the shares represented investment contracts under the test articulated in *Securities & Exchange Commission v. W.J. Howey Co.*<sup>134</sup>

With regard to the argument that the cooperative membership interests were “stock,” and therefore within the literal terms of the federal securities laws, the Court found that “Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto.”<sup>135</sup> After noting that the primary congressional purpose behind the federal securities laws was to protect the integrity of the capital markets, the Court contrasted the sale of securities

financing agency under the Civil Rights Act of 1871, 42 U.S.C. § 1983. *See id.* at 845.

127. *See id.* at 845 (denying the substance of federal jurisdiction and moving to dismiss the complaint on the ground that shares of stock were not “securities” within the definitional sections of the federal securities acts).

128. *See id.* at 842.

129. *See id.*

130. *See id.* at 843.

131. The shares could not be transferred, pledged, or encumbered to a non-tenant. *See id.* at 842. In addition, they could descend at death only to a surviving spouse. *See id.* at 842. Upon termination of occupancy, the cooperative possessed a right of first refusal to repurchase the shares. *See id.* at 842. If the cooperative did not repurchase the shares, the sale could only be made to an eligible prospective tenant. *See id.* at 842-43.

132. *See id.*

133. *See id.*

134. *See id.* at 846. *See also* Securities & Exch. Comm’n v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (“[A]n investment contract for purposes of the Securities Act means a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . .”).

135. *Forman*, 421 U.S. at 849.

for the purpose of raising capital by promising profits to the investors with purchases motivated by a desire for personal use.<sup>136</sup> The Court opined that:

Common sense suggests that people who intend to acquire only a residential apartment in a state-subsidized cooperative, for their personal use, are not likely to believe that in reality they are purchasing investment securities simply because the transaction is evidenced by something called a share of stock.<sup>137</sup>

Examining the economic realities of the transaction, the Court concluded that the cooperative shares possessed none of the characteristics typical of corporate stock.<sup>138</sup> The shares lacked: (1) the right to receive dividends contingent upon an apportionment of profits, (2) negotiability, (3) the ability to be pledged or hypothecated, (4) voting rights in proportion to the number of shares owned, and (5) the possibility of appreciation in value.<sup>139</sup> With regard to the plaintiffs' alternate basis for invoking the protection of the federal securities laws, the Court similarly declined to find that the cooperative shares were "investment contracts" under the *Howey* test.<sup>140</sup> *Howey* requires: (1) an investment, (2) in a common enterprise, (3) with the expectation of profits, (4) solely from the efforts of others.<sup>141</sup> A cooperative is clearly a common enterprise, but the Supreme Court concluded that the shares at issue in *Forman* were not investment contracts because they did not involve any investments,<sup>142</sup> there was no "expectation of profits",<sup>143</sup> and any possible economic benefits would not result from the managerial efforts of others.<sup>144</sup>

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136. *See id.* at 849-50.

137. *Id.* at 851. The Court noted that in the case before it, "the inducement to purchase was solely to acquire subsidized low-cost living space; it was not to invest for profit." *Id.*

138. *See id.* at 851.

139. *See id.*

140. *See id.* at 852.

141. *See Securities & Exch. Comm'n v. Howey Co.*, 328 U.S. 293, 301 (1946).

142. *See Forman*, 421 U.S. at 857 (observing that the purchases of cooperative shares were not intended as an investment, but were intended to provide essential services for the residents of the cooperative).

143. *Id.* at 852. The Court recognized some potential economic benefits that might accrue to purchasers of the cooperative shares, but determined that, on the facts before it, the possibility of such income was "far too speculative and insubstantial" to bring the transaction within the securities laws. *See id.* at 856.

144. *See id.* at 847-52. The *Howey* requirement that profits arise solely through the efforts of others would not normally be satisfied in the case of cooperatives for three reasons: (1) because there are no profits paid on capital, the benefits of cooperative membership can arise only through use of the cooperative by the member (through direct patronage); (2) the economic savings to cooperative members arise primarily as a consequence of the nonprofit relation between the co-op and its members, rather than through the managerial efforts of others; and (3) where, as is often the case, cooperative members retain control over important decisions and participate in its business affairs, the 'solely through the efforts of others' test could not be met. *See id.* at 848-51.



Although commentators originally suggested that *Forman* might be narrowly construed,<sup>145</sup> *Grenader v. Spitz*<sup>146</sup> marked the beginning of the end of such speculation. In *Grenader*, the Second Circuit Court of Appeals re-emphasized that when purchasers are motivated by a desire to use or consume the item purchased or to develop it themselves, the federal securities laws will not apply.<sup>147</sup> Although there were a number of factors that could have been used to distinguish *Grenader* from *Forman*,<sup>148</sup> the Second Circuit focused on the issue of investment intent as the determinative factor.<sup>149</sup> Despite several factual distinctions that might have been relevant in determining whether the “shares” at issue in the two cases were the attraction, in neither instance were the purchasers motivated primarily by a desire to seek profits.<sup>150</sup> Therefore, the federal securities laws did not apply in either situation.

D. B. Rosenberg & Sons, Inc. v. St. James Sugar Coop.

This is also the approach that the federal courts have taken in the context of interests in agricultural cooperatives. In *B. Rosenberg & Sons, Inc. v. St. James Sugar Coop.*,<sup>151</sup> the district court, citing *Forman*, found that membership stock in a cooperative sugar marketing association was not a “security” within the meaning of the federal securities laws, holding:

The stock certificate here denotes nothing more than membership in the cooperative. It has none of the characteristics associated with the concept of a

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145. See Note, *Shares in Privately Financed Cooperative Apartment Corporations and the Federal Securities Laws After Grenader v. Spitz*, 30 RUTGERS L. REV. 432, 433 (1977) (stating federal securities laws were originally not applicable to investment transactions in state-subsidized cooperative housing projects). Commentators seeking to apply the federal securities laws to cooperative housing projects generally contended that the facts of *Forman* were unique. See *id.* at 442 (concluding the Court narrowly framed the issue limiting it to cooperative developments that imposed restrictions on investor-tenant access to pecuniary gain). Not only was the cooperative project in *Forman* a non-profit organization that was publicly financed under state supervision, the shares possessed no possibility of capital appreciation on resale. See *id.* at 449 (pointing out the Court’s refusal to consider the capital risk theory in relation to *Forman*). Arguably, this could be materially different from projects where capital appreciation is possible. See *id.*

146. *Grenader v. Spitz*, 537 F.2d 612 (2d Cir. 1976).

147. See *id.* at 617-19.

148. See *id.* at 614-16. Characteristics of the *Grenader* situation which could have distinguished it from the facts of *Forman* included: (1) the project was privately sponsored; (2) the cooperative’s bylaws permitted the payment of dividend distributions; (3) shareholder voting power was proportional to the number of shares owned; (4) there was potential for capital gains, and (5) reserve funds of the cooperative were invested in financial markets, arguably resulting in a participation in profits as a result of the use of investors’ funds. See *id.*

149. See *id.* at 619-20.

150. See *id.* at 618.

151. *B. Rosenberg & Sons, Inc. v. St. James Sugar Coop.*, 447 F. Supp. 1 (E.D. La. 1976).

security. It is non-negotiable, bears no dividends, can only be owned by a member, and can only be transferred with approval of the board of directors.<sup>152</sup>

The court also concluded that the stock was not an “investment contract” under *Howey* because it was not motivated by a prospect of receiving profits on the money invested from the efforts of others.<sup>153</sup> In reaching this conclusion, the court discussed the way in which members in the sugar cooperative earned a return on their “investment.”<sup>154</sup>

Equity credits or patronage dividends are not profits similar to income from ordinary stock investments but are rebates or refunds to members based solely on patronage and not on the amount of money invested in the stock. A member accrues no equity credits if he produces no cane or if the association sustains a loss . . . .<sup>155</sup>

The court was also persuaded by the fact that the investors were not likely to have believed that they were purchasing “investment” securities:

It is readily apparent that local sugar cane farmers purchasing shares of stock in the defendant cooperative did not believe that they were purchasing investment securities. The inducement to purchase was membership in an association that would provide the sugar cane farmer with services he might not otherwise obtain—that is, the assurance of a place to process and market the fruits of his labor. The cooperative member did not participate for the purpose of obtaining profits from investment securities.<sup>156</sup>

#### E. SEC No-Action Letters

Since *Forman*, the SEC has received numerous requests from traditional cooperatives seeking no-action determinations that their membership shares are not securities within the meaning of the 1933 Act.<sup>157</sup> The SEC has generally granted<sup>158</sup> the no action requests made by traditional cooperatives requesting determinations that the

152. *Id.* at 3.

153. *See id.*

154. *See id.* at 4.

155. *Id.*

156. *Id.*

157. “No action” determinations do not constitute the formal position of the SEC, but rather represent the views of the Commission’s staff. They are informal rulings under 17 C.F.R. § 202.1(d), and provide assurance that a contemplated action will not lead to an enforcement proceeding by the Commission. *See* 14 HARL, *supra* note 6, § 136.01[3].

158. *See* 14 HARL, *supra* note 6, § 136.01 [3]. This was not the case prior to *Forman*. “Prior to the decision in . . . [*Forman*] the S.E.C.’s Division of Corporation Finance generally took the position in no-action letters that cooperatives which allowed their members to share in their earnings or savings were issuers of securities.” *Id.*

SEC will not recommend enforcement of the federal securities laws on the grounds that the co-op has illegally sold securities without complying with federal law.<sup>159</sup>

In these no-action letters, the staff most commonly notes that the cooperative's stock or other membership interests merely evidences a membership interest in the cooperative, and does not possess most of the characteristics of a security, such as ordinary dividend rights, unrestricted transferability, or the potential for significant appreciation in value.<sup>160</sup> In at least some cases where one or more of these enumerated characteristics are present, the SEC has acquiesced in the view that the interests *are* securities.<sup>161</sup>

On the other hand, the absence of other traditional hallmarks of the cooperative form of enterprise has not deterred the SEC from granting no-action requests. For

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159. See, e.g., Veterinary Products, Inc. SEC No-Action Letter (1998), available in 1998 WL 48754 S.E.C.; NBF Acquisitions, Inc., SEC No-Action Letter (1997), available in 1997 WL 157493 S.E.C.; Cap Rock Telephone Co., Inc., SEC No-Action Letter (1994), available in 1994 WL 617592 S.E.C.; Peer Marketing Associates, Inc., SEC No-Action Letter (1993), available in 1993 WL 28727 S.E.C.; Kentucky Pharmacy Services Corp., SEC No-Action Letter (1991), available in 1991 WL 176913 S.E.C.; Producers Feed Co., SEC No-Action Letter (1990), available in 1990 WL 286768 S.E.C.; Associated Grocers, Inc., SEC No-Action Letter (1988), available in 1988 WL 233663 S.E.C.; American Crystal Sugar Co., SEC No-Action Letter (Feb. 19, 1984), available in 1984 WL 45677 S.E.C.; California Ammonia Co., SEC No-Action Letter (1983), available in 1983 WL 28255 S.E.C.; AMSI Travel Alliance, Inc., SEC No-Action Letter (1980), available in 1980 WL 15137 S.E.C.; Salon Owners' Cooperative, SEC No-Action Letter (1980), available in 1980 WL 15594 S.E.C.; It Co-op (avail. Oct. 1, 1979); Mid-America Dairymen, Inc., SEC No-Action Letter (Mar. 3, 1977), available in 1977 WL 11662 S.E.C.

160. See No-Action Letters cited *supra* note 159. See also Steve F. Brault, *Equity Financing of Cooperatives: Advantageous Federal Securities Law and Tax Treatment*, 21 WILLAMETTE L. REV. 225, 243-49 (1985) (for a discussion of the SEC's general position on this issue).

161. In *Calavo Growers of California*, one of the cooperative's subsidiaries began doing a substantial portion of its business with non-members. See *Calavo Growers of California*, SEC No-Action Letter (Oct. 23, 1996), available in 1996 WL 762983 S.E.C. That subsidiary earned substantial profits, which were in turn distributed to the cooperative's members. See *id.* The cooperative treated those payments as the equivalent of taxable dividends, and further acknowledged that these payments meant that members had an expectation of receiving distributions that would not be dependent upon the efforts of the members. The cooperative relied on these facts in claiming an exemption from the securities laws based upon an exchange of securities solely to existing security holders (1933 Act, § 3(a)(9), codified at 15 U.S.C.A. § 77c(a)(9)), and the staff acquiesced, issuing the requested no-action letter. *Id.*

Similarly, in *Associated Grocers Coop., Inc.*, each member of a cooperative that supplied groceries and other products to its members purchased shares of stock and a buying deposit. See *Associated Grocers Coop., Inc.*, SEC No-Action Letter (June 8, 1984), available in 1984 WL 45337 S.E.C. The price of a buying deposit was based upon the number of stores owned by the member that were supplied by the cooperative and the amount of business that the member transacted with the cooperative. See *id.* The buying deposits obligated the cooperative to pay interest at the rate of five percent per annum without any regard to the member's own efforts. See *id.* When the cooperative proposed to exchange new stock for the existing shares, counsel asserted that the 5% annual interest converted the shares into securities, thus rendering the proposed transfer exempt under section 3(a)(9) of the 1933 Act. See *id.* The SEC issued the requested no-action letter. See *id.*

example, the SEC has not generally required co-ops to abide by the traditional principle of one vote per member.<sup>162</sup> In fact, it has issued several no-action letters concerning membership shares in “cooperatives” where membership rights were not shared equally, but rather were allocated on the basis of capital contributions,<sup>163</sup> or the number of shares held.<sup>164</sup>

There has, however, never been any guarantee that courts will follow the rather limited approach taken by the SEC in these no-action letters instead of the inquiry into investment intent suggested by the *Forman* court.<sup>165</sup> The most recent federal court opinions suggest that the federal courts are still inclined to emphasize the question of whether the purchasers bought their membership interests as an investment, and in connection with that inquiry, are likely to weigh a variety of relevant factors.<sup>166</sup>

F. Great Rivers Cooperative of Southeastern Iowa v.  
Farmland Industries, Inc.

The dispute in *Great Rivers Cooperative of Southeastern Iowa v. Farmland Industries, Inc.*<sup>167</sup> can be traced back to a decision by Farmland Industries, the nation’s largest cooperative, to amend its bylaws to authorize the conversion of outstanding

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162. See Brault, *supra* note 160, at 234.

163. In *Independent Producers Marketing Corp.*, there were two classes of shares, M and E. See *Independent Producers Marketing Corp.*, SEC No-Action Letter (Dec. 18, 1981), available in 1981 WL 25551 S.E.C. Class M shareholders were entitled to elect one-third of the board of directors. See *id.* Class E shareholders elected the remaining directors. See *id.* Class E shareholders held some Class M stock, but had also “contributed substantial additional capital in order to acquire their Class E [shares].” *Id.* Class E shareholders possessed sole voting power over transactions such as mergers, sales of assets, liquidations, and other matters, as well as having exclusive rights to dividends declared from non-patronage earnings of the business. See *id.* The no action letter was requested only with regard to the Class M stock. See *id.*

In *AMSI Travel Alliance, Inc.*, majority control of the board of directors was retained by the incorporating “parent” trade organization which issued to itself all of the common stock of the cooperative. See *AMSI Travel Alliance, Inc.*, SEC No-Action Letter (Feb. 2, 1980), available in 1980 WL 15594 S.E.C. “Members” of the cooperative purchased preferred shares, which entitled them to elect one less than a majority of the board of directors. See *id.*

In *California Ammonia Co.*, there were also two classes of owners. See *California Ammonia Co.*, SEC No-Action Letter (May 27, 1983), available in 1983 WL 28255 S.E.C. Farmers owned class A stock while ammonia producers owned class B shares. See *id.* The farmers, as class A shareholders, were entitled to elect a majority of the board of directors, while the bylaws guaranteed to the owners of class B stock the right to elect at least one director. See *id.*

164. See *American Hardware Supply Co.*, SEC No-Action Letter (Jan. 9, 1984), available in 1984 WL 44919 S.E.C.

165. For example, consider the Second Circuit’s opinion in *Grenader v. Spitz*. In that case, none of the SEC’s three conditions were met: the shares were transferable, dividends on capital were not prohibited, and capital gain on resale of the membership interest was permitted. See *Grenader v. Spitz*, 537 F.2d 612, 617 (2d Cir. 1976). Nonetheless, the court found that the membership shares were not securities. See *id.* at 619.

166. See *infra* Part IV.F.

167. *Great Rivers Coop. v. Farmland Indus., Inc.*, 198 F.3d 685 (8th Cir. 1999).

shares of common stock owned by inactive or ineligible members into “capital credits,” a form of non-voting equity.<sup>168</sup> Once this bylaw provision was in place, Farmland converted a number of shares of common stock held by persons ineligible to be members in the cooperative into capital credits.<sup>169</sup> This eventually led to the filing of a class action lawsuit alleging securities fraud and a variety of related claims.<sup>170</sup> The district court dismissed the federal securities claims “on the ground that the capital credits are not ‘securities’ within the meaning of the federal securities laws.”<sup>171</sup> The plaintiffs appealed.<sup>172</sup>

Before the Eighth Circuit Court of Appeals, the plaintiffs-appellants argued that the capital credits should be classified as securities under the federal acts under either the “family resemblance” test enunciated by the Supreme Court in *Reves v. Ernst & Young*,<sup>173</sup> or the investment contracts test of *S.E.C. v. W.J. Howey Co.*<sup>174</sup> In support of this position, the class identified a number of characteristics allegedly demonstrating why the credits should be securities:

(1) the capital credits are transferable; (2) the capital credits represent retained equities and are issued by Farmland in an effort to raise, or retain, capital; (3) members gave value for the capital credits either in the form of equities given up or in the form of a deferred-cash, dollar-valued entitlement that the capital credits represent; (4) capital credit holders expect and receive distribution of Farmland’s earnings; (5) Farmland profits that benefit equity holders, including capital credit holders, are derived from the managerial efforts of others; (6) capital credits give the owner the right to purchase common stock of Farmland; (7) capital credits evidence Farmland’s retention of monies ultimately owed by Farmland to the member—which is a debt; and (8) a majority of the capital credit holders had the credits because their common stock had been converted to capital credits. Additionally, the class points out there is no other regulatory scheme that protects holders of capital credits, other than the federal security laws.<sup>175</sup>

Farmland responded that the federal “securities laws do not apply to stock that reflects cooperative membership,”<sup>176</sup> and even though Farmland had registered the instruments as securities, it had done so only out of an over-abundance of caution.

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168. *See id.* at 691-92.

169. *See id.* at 692.

170. *See id.* at 696-97.

171. *Id.* at 697.

172. *See id.*

173. *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

174. *See Sec. Exch. Comm’n. v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

175. *Great Rivers*, 198 F.3d at 697-98.

176. *Id.* at 698-99.

After noting that Congress intended a “broad” definition of the term “security,”<sup>177</sup> the Eighth Circuit also pointed out that Congress had never intended to cover all fraud claims within the ambit of the federal securities laws.<sup>178</sup> The court then analyzed whether the capital credits in fact contained “the essential characteristics of securities” as required by *Forman*.<sup>179</sup>

The court first rejected application of the *Reves* test,<sup>180</sup> and instead turned to a consideration of whether the capital credits at issue could be properly characterized as investment contracts.<sup>181</sup> In concluding that the federal securities laws should not apply, the court began by noting that “the class members enter into the cooperative relationship not in expectation of the profits . . . but instead to reap the benefits of that relationship.”<sup>182</sup> The court also concluded that there was no “valuable return on an investment normally expected from the purchase of a security” because the credits were not interest bearing and were not readily convertible into cash.<sup>183</sup> The court then considered a number of specific characteristics applicable to the credits: all credits represented equity interest originally obtained as an incident of membership in the cooperative; the credits were not issued by Farmland out of any intent to raise money for general business operations; there was no common trading of the interests for speculation; and “the capital credits are not fundamentally an investment.”<sup>184</sup> Applying the investment contract analysis of *Howey* to these specific facts lead the court to conclude that the capital interests were not investment contracts because there was “no investment of money in the traditional sense,”<sup>185</sup> and no expectation of profits from the efforts of others. This latter conclusion was compelled because, under Farmland’s cooperative structure, any distributions would be in the form of “patronage refunds, i.e., a price or cost adjustment, resulting from the member’s own transactions . . . .”<sup>186</sup>

The one countervailing factor emphasized by the plaintiff class (that at least some of the owners believed the capital credits represented an investment covered by the securities laws) was not enough to change the result.<sup>187</sup>

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177. *See id.* at 698 (citing *United Hous. Found., Inc., v. Forman*, 421 U.S. 837, 847-48 (1975)).

178. *See id.* (citing *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982)).

179. *Id.* at 699.

180. *See id.*

181. *See id.* (“The *Reves* approach is not applicable here because ‘capital credits’ are not specifically included in the statutory definition of ‘security.’”).

182. *Id.*

183. *Id.* (citing *Co-Operative Grain & Supply Co. v. Commissioner of Internal Revenue*, 407 F.2d 1158, 1163 (8th Cir. 1969)) (“Advantages which accrue to a member of a cooperative accrue primarily because of his patronage with the association and not because of any financial investment he may have made therein.”).

184. *Id.* at 699-700.

185. *Id.* at 700.

186. *Id.* at 701.

187. *See id.* at 700.

G. *Conclusions About Equity Interests in Traditional Co-ops*

Two commentators, while applauding the result reached by the Eighth Circuit in *Great Rivers*, have nonetheless criticized the opinion as being too weak and “vulnerable to reversal.”<sup>188</sup> Their principal complaint seems to be that the court should not have relied “solely on the text of the securities statutes and the judicial tests for determining what constitutes a security.”<sup>189</sup> Instead, they offer a persuasive series of public policy justifications for the result, which they would apparently have had the court consider in its analysis.<sup>190</sup>

Realistically, the public policy justifications that can be offered as support for the ultimate result in *Great Rivers* are likely to be used by the courts as that: support for a result which is reached by virtue of the statutory language and application of traditional judicial tests.<sup>191</sup> Moreover, as far as predictive validity goes, *Great Rivers* seems to be well reasoned and thoroughly analyzed.<sup>192</sup> While it does not limit itself to the rigid three-factor approach generally taken by the SEC’s staff in considering requests for no-action letters, the result is consistent with the position routinely taken by the Commission.<sup>193</sup>

Thus, for purposes of predicting how common stock or other membership interests in traditional agricultural cooperatives are likely to be treated under the federal securities laws in future cases, the absence of investment intent, in that the benefits of membership in the cooperative are primarily responsible for the stockholder’s purchasing decision, is likely to be of primary importance. This determination will, in turn, depend on the presence or absence of the kinds of facts that the court focused on in *Great Rivers*.<sup>194</sup> This means that the following questions should be relevant in determining whether a particular interest has been purchased with investment intent and therefore qualifies as a security: Does the membership or other interest entitle the owner to regular dividends or interest payments? Are the interests readily convertible into cash? Are the interests capable of appreciation in value? Are they traded for speculation? Was the co-op’s purpose in issuing the interests to raise funds for general

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188. See Lauck & Adams, *supra* note 6, at 79.

189. *Id.* Their concern seems to be predicated on the fact that the definition of “security” has changed over time, and that relying exclusively on the traditional statutory analysis provided insufficient support for the court’s ultimate conclusion. There is some merit to their observation about the changing boundaries of federal securities law. For a general discussion of this issue, see generally Kyle M. Globerman, *The Elusive and Changing Definition of a Security: One Test Fits All*, 51 FLA. L. REV. 271 (1999) (discussing the issue of changes in federal securities laws).

190. See Lauck & Adams, *supra* note 6, at 90-92.

191. See, e.g., *Great Rivers Coop.*, 198 F.3d at 685.

192. See *id.*

193. See *id.*

194. See *id.*

operations? And finally, did the “investor” acquire the interests in order to obtain some other benefit, such as the right to membership in the co-op itself?

An analysis of the capital credits that were at issue in *Great Rivers* clearly indicates that those interests shared the typical characteristics of equity issued by traditional cooperatives.<sup>195</sup> The case should therefore offer a great deal of comfort to traditional cooperatives concerned about the issuance of membership interests, whether or not those interests are called “stock.” However, value-added cooperatives may find less comfort in the opinion.

V. APPLICATION OF THE SECURITIES LAWS TO MEMBERSHIP INTERESTS IN  
VALUE-ADDED AGRICULTURAL COOPERATIVES

A. *Special Features of Membership Interests in  
Value-added cooperatives*

As described above,<sup>196</sup> there are several characteristics that can be used to distinguish between traditional and value-added cooperatives. One possible list<sup>197</sup> of the distinguishing characteristics of such value-added enterprises is as follows:

1. Substantial equity investment by members;
2. Closed or restricted membership;
3. Delivery rights or obligations tied to equity investment;
4. Recognition of the transferability of delivery rights;
5. Value-added payments made to members as they are earned;  
and
6. Expansion funded by new investment rather than patronage  
retains.

These characteristics create a very different type of equity investment than that made in connection with traditional cooperatives.

First, there is the dollar amount at stake. Value-added cooperatives face potentially significant problems in raising sufficient equity because a “tremendous amount of capital is required for modern agricultural processing and marketing facilities, so even maximum effort by the farmer-members of new cooperatives is unlikely to generate sufficient equity funds to construct and operate these facilities initially.”<sup>198</sup> Because lenders expect equity investors in such enterprises to contribute

195. *See id.* at 690-97. *See also* Brault, *supra* note 160, at 226-27 (explaining the Rochdale Principles of Cooperative Businesses).

196. *See supra* discussion Part III.B.

197. The list is an amalgamation of items taken from lists of distinguishing characteristics suggested by Ralph K. Morris, Esq., of Doherty, Rumble & Butle in Minnesota, and Dennis A. Johnson, President and CEO of the St. Paul Bank for Cooperatives. *See* Morris, *supra* note 57; Johnson, *supra* note 56.

198. DUTROW ET AL., *supra* note 104, at 7.



between approximately fifty percent of the total capital requirements of the venture,<sup>199</sup> this means that initial investments in value-added cooperatives are often quite substantial.<sup>200</sup>

Second, the members' earnings will depend on the total investment in the enterprise because delivery rights or obligations are tied to equity investment. A value-added cooperative typically ties the delivery rights and obligations of each member to the number of shares acquired by that member. Thus, although payments to the member may be on the basis of patronage (i.e., the volume of commodities delivered), the payments will also reflect the dollar investment made in the business. This makes the payments look much more like traditional dividends, which are tied only to the amount invested and not at all to the level of patronage. Contrast this with the traditional co-op, where payments reflect the level of patronage and are unrelated to the level of investment.

Third, there is a general recognition that the delivery rights in a value-added co-op have a value. This value comes about because membership in a value-added enterprise is generally "closed," or in other words, limited to a pre-determined number of investors. The total volume of crops or other agricultural goods that can be processed by the co-op determines the number of investors. Once investors have purchased the right to deliver that volume of the relevant commodity, the only way to join the cooperative is if an existing member agrees to sell delivery rights or if the cooperative decides in the future to expand and sell additional membership and delivery rights at that time. If a particular enterprise is successful, the right to have a

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199. See Cindy Thyfault, *Developing New Generation Co-ops: Getting Started on the Path to Success*, RURAL COOPERATIVES, July-Aug. 1996 at 1, 1. One source has estimated that "most financial institutions will require at least 40 to 60 percent equity from the owners." *Id.*

Another source suggests that most value-added cooperatives "raise between 30 and 50 percent of their total capital requirements" by selling such shares. Harris, *supra* note 11, at 16. The same source suggests that "[r]emaining capital requirement are met through debt or the issue of preferred shares." *Id.*

200. See Dan Campbell, *Show me the Dough*, RURAL COOPERATIVES, May-June 1997, at 1, 1. Consider, for example, Mountain View Harvest, a value-added cooperative designed to assist wheat growers by purchasing a bakery and transforming the produce "into a value-added food." *Id.* "To join Mountain View Harvest, a grower had to purchase at least one share in the co-op for \$12,500. They also had to pay a \$500 membership fee and agree to deliver 900 bushels of wheat to the co-op for each share purchased." *Id.*

Similarly, Dakota Growers Pasta Company set an initial share price of \$3.90, and members were required to purchase a "minimum of fifteen hundred shares at the initial share price during the cooperative's equity drive." Harris, *supra* note 11, at 17. This translates to a minimum equity investment of \$5850 for wheat growers wishing to participate. An equivalent minimum investment of \$5,000 was required for investment in 21st Century Alliance Inc. by wheat farmers looking for the opportunity to sell their product as flour. See Carl, *supra* note 35.

The New Horizon Cooperative permits members to deliver corn to the co-op, which is then fed to chicken that lay eggs to be sold on the market. Shares in this co-op were first offered in February of 1999 at \$3,000. See Perkins, *Golden Eggs*, *supra* note 35.

guaranteed market for produce and the right to receive value-added payments may be quite valuable. Allowing these delivery rights to be sold on the open market means that there is the possibility of appreciation over the initial cost of investment.

Further enhancing the possibility of appreciation is the fact that most value-added co-ops do in fact pay out profits as they are earned. Unlike traditional cooperatives where the bulk of equity financing comes from patronage retains, a value-added co-op runs primarily on paid-in capital. If the co-op decides to expand, selling additional equity interests rather than retaining a portion of the business's earnings finances these operations. This practice makes purchase of an interest in a value-added enterprise more attractive and, if the enterprise is profitable, enhances the price that interest will bring on the market.

#### B. *The Problem of Investment Intent*

Assuming that the framework of the courts as announced in *Forman* and *Great Rivers* will be applied to membership interests in value-added cooperatives, the primary inquiry will be whether the interests were purchased as an investment. This is actually a very difficult question.

First, it is clear that the purchase of such equity interests does include the present right to membership in the cooperative enterprise. In the case of an agricultural co-op, the obvious benefit of this membership is that the purchaser will acquire a guaranteed market for the agricultural product used by that co-op. Thus, if the purpose of the co-op is to turn raw corn into eggs, membership in the co-op carries with it a guaranteed market for a certain amount of corn. If the co-op is involved in converting durham into pasta, membership includes the right to sell the durham to the enterprise.

The significance of these membership benefits should not be underestimated. The Supreme Court admonished in *Forman* that "when a purchaser is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply."<sup>201</sup> However, the Court also cautioned in a footnote that "[i]n some transactions the investor is offered both . . . [something] for use and an expectation of profits."<sup>202</sup> The Court concluded that "[t]he application of the federal securities laws to these transactions may raise difficult questions that are not present in this case."<sup>203</sup> Thus the question of investment intent and the extent to which the purchase of a membership interest in a value-added co-op is driven by the desire to "use" the benefits of membership rather than to seek profits from the efforts of others is likely to be pivotal.

Because there is no clear answer to the question of whether such purchases are motivated by a desire to "invest," courts are likely to turn to the specific factors that have been explicitly considered in opinions such as *Great Rivers*<sup>204</sup> to help them decide whether equity interests in value-added enterprises will be governed by the securities

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201. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 852-53 (1975).

202. *Id.* at 853 n.17.

203. *Id.*

204. *See Great Rivers Coop. v. Farmland Indus., Inc.*, 198 F.3d 685, 697-98 (8th Cir. 1999).

laws. Unfortunately, a consideration of such factors does not lead to a consistent or certain result.

Some factors, for example, suggest that such interests should not be treated as securities under the federal laws. For example, the first factor mentioned by the Eighth Circuit Court of Appeals in *Great Rivers* was that the capital credits at issue in that case could all be traced back to an initial purchase required to be made in order for the purchaser to obtain the benefits of membership in the cooperative.<sup>205</sup> As the court stated, the purchasers “enter into the cooperative relationship . . . to reap the benefits of that relationship.”<sup>206</sup> This analysis could certainly apply to persons who invest in a value-added co-op, lending support to the conclusion that such equity interests should not be securities.

Similarly, the *Great Rivers* court, in looking at the absence of any profit motive, focused on the fact that the capital credits were “non-interest bearing, and thus do not provide the valuable return on an investment normally expected from the purchase of a security.”<sup>207</sup> Equity interests in a value-added co-op can be set up so that they do not carry any right to interest or dividend payments, and it is certainly true that a member’s return in a value-added cooperative will depend on patronage just as in a traditional co-op.<sup>208</sup> This also suggests that equity interests in a value-added cooperative should not generally be classified as securities.<sup>209</sup>

On the other hand, there are also factors that would appear to support the conclusion that interests in value-added cooperatives are securities under the federal laws. For example, the court in *Great Rivers* also focused on the fact that the capital credits in that case were not “issued to raise money for the general business use of Farmland or to finance substantial investments.”<sup>210</sup> A value-added co-op frequently does raise such funds by selling equity interests. This is therefore one factor that might support a judicial determination that such interests are securities.

Another factor explicitly addressed in *Great Rivers* was the fact that the interests “were not readily convertible into cash.”<sup>211</sup> Rather, the only way for owners of the capital credits to recoup their investment was for the co-op to redeem the interests. In a typical value-added cooperative, equity interests can be converted to cash by sale

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205. *See id.* at 699.

206. *Id.*

207. *Id.*

208. *See id.* at 700.

209. *See id.* at 699. On the other hand, the economic reality is that patronage returns in such co-ops are tied to the level of investment as well as the level of patronage, because delivery rights are tied to investment. *See id.* Thus, a court could conclude that a profit motive is inextricably linked to equity investment in such ventures. *See id.* at 699-700. For a discussion of how these aspects might be de-linked, see *American Grain Ass’n v. Canfield, Burch & Mancuso*, 530 F. Supp. 1339, 1343-46 (W.D. La. 1982).

210. *Great Rivers Coop.*, 198 F.3d at 699-700.

211. *Id.* at 700.

on the open market. This might make it look like the interests in such a cooperative are securities.

Finally, at least one factor that was emphasized by the Eighth Circuit in *Great Rivers* could be argued either way in trying to ascertain the appropriate classification of equity interests in value-added co-ops. The final factor explicitly relied upon by the court in *Great Rivers* was that the capital “credits were transferable only with the consent of . . . [the co-op’s] Board.”<sup>212</sup> This requirement, embodied in the co-op’s articles of incorporation,<sup>213</sup> was apparently enough for the court to find that the interests were not freely transferable, even though the co-op admitted that it had tried to create a secondary market for the capital credits.<sup>214</sup>

Thus, the question might arise as to whether interests in a value-added co-op are “freely transferable.” The usual practice is for the board in such ventures to retain the right to approve or disapprove the transfer of interests, and certainly only persons who meet the eligibility requirements for membership in the co-op will be allowed to purchase the interests.<sup>215</sup> Thus, an argument could be made that such interests are not “freely transferable.” This would mean that the interests in question look less like a security. On the other hand, the evidence in *Great Rivers* apparently showed that the interests in question were, in fact, not easily sold.<sup>216</sup> This is a fact that is likely to be noticeably absent in a profitable value-added cooperative. If purchasers are led to “invest” based on the expectation that a market will develop, this might lead a court to conclude that the interests should be regulated as securities.

The question of whether equity interests in a value-added co-op are freely transferable may be fact specific, and is unlikely to provide a clear resolution to the issue of whether such interests are securities.

Because arguments can be made both ways about whether equity investment in a value-added co-op should be classified as a security, it is not surprising that such interests are often registered with the SEC.<sup>217</sup> This fact alone, however, should not be

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212. *Id.*

213. *See id.*

214. *See id.* at 701. The court did not say whether the co-op had ever refused a request to transfer the credits to an outside purchaser.

215. Of course, since delivery rights for a given commodity are generally tied to the equity interests in one form or another, it is unlikely that anyone not appropriately involved in agriculture would be interested in investing in the enterprise.

216. *See id.* at 699-701.

217. *See, e.g.*, American Crystal Sugar Co., Form S-1, Registration Statement filed July 28, 1997, available in 1997 WL 97646544; Harvest States Cooperatives, Form S-1, Registration Statement filed January 24, 1997, available in 1997 WL 97510798. *See also* Minn-Dak Farmers Cooperative, Form 10-K filed November 30, 1998, available in 1998 WL 98760782 (incorporating by reference Form S-1 Registration Statement declared effective Sept. 11, 1995); Dakota Growers Pasta Co, Form 10-K405, filed Oct. 28, 1998, available in 1998 WL 98731933.

In some instances, value-added co-ops have apparently decided to de-register some of their equity interests. For example, National Grape Cooperative Association, Inc. requested a no-action determination from the SEC when it sought to de-register its membership interests and marketing agreements. *See*

taken as proof that the interests are in fact securities. The capital credits in *Great Rivers* had been registered by the co-op out of an abundance of caution but the court ultimately concluded that they were not securities.<sup>218</sup>

### C. Existing Authority

There is at least one reported case dealing with the appropriate securities classification of equity interests in what appears to be a value-added cooperative. In *Ripplemeyer v. National Grape Cooperative Association*,<sup>219</sup> the United States District Court for the Western District of Arkansas considered a lawsuit brought by grape growers against two non-stock agricultural cooperatives, National Grape Cooperative Association (“National”) and Welch Foods, Inc. (“Welch”).<sup>220</sup> The plaintiffs had all entered into membership and marketing agreements with National “in order to gain access to a nationwide market” for their grapes, typically after processing by Welch, a wholly owned subsidiary of National.<sup>221</sup> After National terminated the membership agreements in question, a group of growers sued on a number of theories, including claims under the 1934 Act.<sup>222</sup> The defendants responded that the marketing agreements were not securities.<sup>223</sup>

The court applied the *Howey* test, and concluded as follows:

The court does not believe the marketing agreements themselves constitute investment contracts within the meaning of *Howey*. National is run for the mutual benefit of its members as producers not as investors. Advantages accrue to a member because of his patronage and not because of any financial investment he has made.<sup>224</sup>

Unfortunately, the case does not describe whether patronage was tied to investment in a manner that appears to be typical of value-added cooperatives. Nor

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National Grape Cooperative Association, Inc., SEC No-Action Letter (Oct. 29, 1984), *available in* 1985 WL 51983 S.E.C.

218. *See Great Rivers*, 198 F.3d at 701.

219. *Ripplemeyer v. National Grape Coop. Ass’n, Inc.*, 807 F. Supp. 1439 (W.D. Ark. Dec. 3, 1992).

220. *See id.* at 1444.

221. *Id.* Although the court never classified National as a value-added cooperative, the classification appears appropriate because the grapes provided by the members were typically processed before sale to the public. *See id.*

222. *See id.* at 1452-54.

223. *See id.* at 1452.

224. *Id.* at 1454. Although the defendants limited their brief “to the issue of whether the marketing agreements themselves constitute securities,” the plaintiffs also made arguments about the appropriate classification of allocation certificates and capital credits. *Id.* at 1444, 1453. Thus, the court declined to grant the defendants’ motion for summary judgment. *See id.* at 1448.

does the court focus on the value-added nature of the cooperative venture, apart from noting that Welch “processed grapes grown by National’s members . . . into finished goods such as Welch’s Grape Jelly.”<sup>225</sup> Thus, the case is of limited predictive value.

There are, of course, a few cases dealing with the securities classification of equity interests issued by agricultural cooperatives. For the most part, however, these opinions are not particularly helpful in predicting how equity interests in value-added co-ops will be treated under the securities laws.<sup>226</sup> A few cases, however, offer some potential clues.

*Great Rivers* and *St. James Sugar Coop.* have already been discussed in some detail. In addition to those two decisions, the District Court for the Western District of Louisiana, in *American Grain Association v. Canfield, Burch & Mancuso*,<sup>227</sup> considered whether farmers who had participated in a soybean-marketing cooperative had acquired securities when they elected to participate in certain marketing programs.<sup>228</sup> The court in that case considered the application of the *Howey* investment contract test.<sup>229</sup> One of the major issues for the court was whether the farmers expected profits solely from the efforts of others.<sup>230</sup>

The farmers contended that they depended on the efforts of the commodity trader who arranged for sales of the pooled soybeans.<sup>231</sup> The defendants claimed that the business operated “as a cooperative agricultural marketing venture which relied as much on the labor of the farmer in planting, growing, harvesting and delivering his crop” as on the efforts of the trader.<sup>232</sup> The court acknowledged that both farmer participation and the trader’s efforts were important in determining each farmer’s ultimate returns.<sup>233</sup> However, the court found that once the soybeans had been placed into the pool, it was the trader who expended “essential managerial efforts” affecting the failure or success of the enterprise.<sup>234</sup>

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225. *Id.* at 1444.

226. For example, the United States District Court of Colorado considered whether Farmland Industry’s capital credits should be classified as securities in *Consumers Gas & Oil, Inc. v. Farmland Indus., Inc.*, 815 F. Supp. 1403, 1410 (D. Colo. 1992). The court concluded that because Farmland had registered its capital credits, the co-op had “admitted” that the interests were securities. In addition, the court concluded that “[e]ven if Defendant’s admission is insufficient, we believe that the capital credits involved in this case fall within the broad definition of ‘security’ . . . .” *Id.* (no further analysis was supplied).

However, as described earlier in this Article, even opinions that describe in detail the underlying rationale for classifying interests issued by traditional co-ops are not particularly helpful in the context of value-added co-ops. See *supra* part IV.E. (discussing *Great Rivers Coop. of Southeastern Iowa v. Farmland Indus., Inc.*, 198 F.3d 685 (8th Cir. 1999)).

227. *American Grain Ass’n v. Canfield, Burch & Mancuso*, 530 F. Supp. 1339 (W.D. La. 1982).

228. *See id.* at 1342-43.

229. *See id.* at 1343-45.

230. *See id.* at 1345.

231. *See id.*

232. *Id.*

233. *See id.*

234. *Id.*

While this analysis is not quite the same as might be required in the context of interests in a typical value-added enterprise, it is certainly similar. Consider how the reasoning of *American Grain* might be applied in the value-added context. Suppose a farmer who grows corn participates in a value-added co-op that takes the corn, feeds it to chickens, and markets the chickens' eggs. The farmers' returns will depend on how much corn they deliver to the co-op. However, the returns will also depend on how well the co-op fairs at raising chickens and selling eggs. Under the rationale of *American Grain*, the farmers' efforts are over once their corn is delivered to the co-op.<sup>235</sup> The ultimate profit of the enterprise will turn on the efforts of someone other than the farmers. Thus, the third prong of the *Howey* test would be met.<sup>236</sup>

Although this analysis may be helpful in some cases, it does not go to the heart of the issue likely to arise in most value-added co-op cases, which is whether there is an investment in the first place. In *American Grain*, the answer to this question turned on whether the farmers contributed any money at all,<sup>237</sup> which is not likely to be the case in any value-added co-op scenario. Thus, this case leaves open what will probably be the central inquiry in most cases involving value-added cooperatives—whether the farmers have chosen to make an “investment” in the enterprise rather than participating for non-investment reasons.<sup>238</sup>

This particular issue was the focus of the district court's opinion in *Van Huss v. Associated Milk Producers, Inc.*<sup>239</sup> In that case, the District Court for the Northern District of Texas was faced with the issue of whether a farmer's purchase of “base” (described by the court as “a marketing privilege similar in concept to what a rationing system does for buyers when supply is short”)<sup>240</sup> involved an investment and therefore a security.<sup>241</sup> “Base” determined the total volume of milk that a farmer could sell to the co-op at the highest market price, reserved for “Class I milk.”<sup>242</sup> All milk in excess of the volume authorized by the farmer's base would be purchased by the co-op at lower prices.<sup>243</sup>

The facts in *Van Huss* were that the farmer in question had purchased two thousand pounds of base at a price of \$20 per pound from another member of the co-op.<sup>244</sup> The farmer's widow alleged that the selling farmer was an insider in the cooperative and that he had advance knowledge of amendments to the co-op's

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235. See *id.* at 1345.

236. See *id.*

237. See *id.* at 1344.

238. See *id.* at 1343-44.

239. *Van Huss v. Associated Milk Producers, Inc.*, 415 F. Supp. 356 (N.D. Tex. 1976).

240. *Id.* at 359.

241. See *id.* at 360.

242. See *id.* at 359.

243. See *id.*

244. See *id.*

marketing plan, “which had the predictable effect of lowering the market value of base.”<sup>245</sup> She sued under the federal securities laws, and the co-op responded that “base is not a security, and therefore the federal securities laws do not pertain to base transfer transactions.”<sup>246</sup>

In analyzing this issue, the court noted that “farmers may engage in activity that resembles speculation in the buying and selling of base.”<sup>247</sup> The court also noted that members of the milk producers’ co-op “were aware of the fact that base had a market value, albeit in a limited market.”<sup>248</sup> However, the court was convinced that “the principal reason for buying base is not for investment purposes . . . [but to] insure a higher price for the farmer’s milk production.”<sup>249</sup> Although the court noted that speculation was possible, it concluded that “the fact that one may speculate in the trading of a given commodity does not automatically stamp that commodity as a security.”<sup>250</sup>

In concluding that the purchase of base was not motivated by investment intent, the court emphasized certain specific factors.<sup>251</sup> First, transferability of base was limited to other co-op members.<sup>252</sup> Second, the base plan was subject to amendment and therefore lacked the “stability characteristic of ownership of other property interest which may fairly be called securities” was also persuasive.<sup>253</sup> Third, base was initially issued by the co-op without any capital investment by the members, so that the co-op received no income from the sale of base.<sup>254</sup> Fourth, base was never offered by the co-op to the public.<sup>255</sup> After weighing these factors, the court concluded that base was not a security, because “to realize any value from its purchase the buyer must be engaged in the activity which most directly affects its value.”<sup>256</sup>

A similar analysis might be helpful in the context of value-added co-ops. Just as in *Van Huss*, agricultural producers are likely to be motivated to purchase membership interests in a value-added enterprise in order to find a guaranteed market for their produce.<sup>257</sup> Speculation in profits might be a factor in their decision, but is not likely to be the sole justification for a purchase decision because most of these co-ops require that the member actually provide a specified amount of agricultural produce as

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245. *Id.*

246. *Id.*

247. *Id.* at 361.

248. *Id.* at 361-62. Under the terms of the membership agreements, members could sell base only to other co-op members. *See id.* at 360.

249. *Id.* at 362.

250. *Id.*

251. *See id.*

252. “In its effort to tie base to milk production, AMPI [the co-op] limits transfers of base to milk producers, and transfers are voidable.” *Id.* at 362.

253. *Id.* at 362.

254. *See id.*

255. *See id.* at 363.

256. *Id.*

257. *See generally id.* (explaining why milk producers purchase interests in co-operatives).



a condition of membership. Similarly, just as “base” was transferable to a limited class of persons in *Van Huss*, delivery rights are likely to be transferable to a limited class of persons in most value-added co-ops.<sup>258</sup> In fact, in most cases, the value-added co-op will likely retain the right to approve or disapprove of any transfer.

On the other hand, persons who purchase membership and delivery rights in a value-added co-op will be making a capital investment in the business. In addition, the delivery obligation is usually set at a specified amount, and if the member fails to satisfy such obligations, the co-op is generally permitted to buy the relevant commodity on the open market and charge the member’s account for that expense. Thus, it is not certain that profits from membership in a value-added co-op will be tied to the farmer’s own efforts in all instances. Thus, even cases like *Van Huss*, which give some potential insights into how membership interests in value-added cooperatives might be treated, do not offer a clear resolution to the issue.<sup>259</sup>

The SEC’s no-action determinations in the area are similarly unhelpful in providing guidance as to how the securities laws are likely to be applied. While the SEC has received a limited number of no-action requests from value-added agricultural cooperatives, there are few conclusions that can be drawn from the staff responses.

When National Grape Cooperative Association, Inc. requested a no-action determination with regard to its decision to discontinue registration of its membership and marketing agreements in 1985, counsel to the co-op emphasized a number of factors.<sup>260</sup> First, the request recited that members paid no consideration for their membership and marketing agreements and that no stock or other certificate was issued to evidence membership or patronage status.<sup>261</sup> The original request for a no-action letter also emphasized that members in the co-op would each have one vote, regardless of the level of participation, and that membership and marketing agreements were not transferable.<sup>262</sup> Finally, counsel highlighted the fact that “[a] grower looks to National as a purchaser of his grapes, not a depository for his money from which he expects growth.”<sup>263</sup> In response to this request,<sup>264</sup> the SEC apparently indicated that it would not issue the requested no-action letter unless National promised to provide prospective members with a copy of the most recent prospectus prepared by the co-op in connection with other interests which is was going to continue to register.<sup>265</sup> Thus, the

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258. *See id.*

259. *See id.*

260. *See* National Grape Coop. Assoc., SEC No-Action Letter (Jan. 21, 1985), *available in* 1985 WL 51983 S.E.C. National also indicated in this request that it would continue to register allocation certificates, permanent equity capital credits and promissory notes that it would be issuing. *See id.* at \*1.

261. *See id.* at \*2.

262. *See id.*

263. *Id.*

264. The original request was dated October 29, 1984. *See id.* at \*1.

265. In a follow-up letter to the SEC, National states that is understood that the SEC was conditioning its no-action recommendation on this requirement. *See id.* at \*3.

final no-action letter specifically states that the SEC “particularly not[ed the co-op’s] . . . representation that a prospectus will be delivered to members prior to the time that they enter into a Membership and Marketing Agreement . . . .”<sup>266</sup> The staff provide no other rationale or explanation as to why they decided to grant the no-action request.

When American Crystal Sugar Company requested a no-action determination in connection with a decision to discontinue reporting under the 1934 Act on the grounds that its common and preferred stock were not securities,<sup>267</sup> counsel similarly emphasized a number of factors. First, the common stock was issued on the basis of one share per member, with each member being limited to a single share having a single vote.<sup>268</sup> The preferred stock was non-voting and was issued as a basis for determining “the number of acres on which such shareholder can grow sugar beets for sale” to the cooperative.<sup>269</sup> No dividends were payable on either common or preferred shares and the sale or transfer of the stock was restricted by the co-op’s bylaws.<sup>270</sup> Finally, counsel to the co-op concluded that the absence of any possibility of appreciation, severe restrictions on transferability, and the fact that any earnings would be distributed to shareholders on the basis of patronage, meant that “an expectation of profits . . . was not the motivating factor underlying the decision of the shareholders . . . to purchase . . . stock.”<sup>271</sup>

In this case, the SEC’s staff fell back on the analysis that it often used in connection with no-action requests by traditional cooperatives and emphasized three factors: (1) the lack of dividends and the fact that payments to members are based on patronage; (2) the restrictions on transferability; and (3) the benefits of stock ownership derive from “the assurance that shareholders will have a purchaser (Crystal) to whom they can deliver their sugar beets.”<sup>272</sup> However, the staff also went out of their way to note that “the question of whether . . . [the] preferred stock constitutes a ‘security’ is not free from doubt . . . .”<sup>273</sup> Thus, the continued viability of this approach is somewhat suspect.

Counsel for North Mississippi Paper Mill, an agricultural cooperative involved in processing and marketing timber products, took a different approach to the issue of whether the co-op had to register its employees as broker/dealers before they sold stock in the enterprise.<sup>274</sup> In this case, one of the primary arguments on behalf of the co-op was that the stock to be sold should be exempt from any registration requirements

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266. *Id.*

267. *See, e.g.,* American Crystal Sugar Co., SEC No-Action Letter, at \*1 (Feb. 19, 1984), available in 1984 WL 45677 S.E.C.

268. *See id.*

269. *Id.*

270. *See id.* at \*2.

271. *Id.* at \*4.

272. *Id.*

273. *Id.* at \*5.

274. *See* Letter from North Mississippi Paper Mill to SEC, at \*7 (Mar. 14, 1981) available in 1981 WL 26228 S.E.C.

because the co-op qualified as tax-exempt under the Internal Revenue Code.<sup>275</sup> Counsel apparently assumed that the stock would be securities under the federal law and the SEC did not appear to dispute this assumption.<sup>276</sup>

The same kind of analysis was applied by the SEC in an earlier no-action letter to Minn-Dak Farmers Cooperative, another value-added cooperative.<sup>277</sup> The co-op's counsel and the SEC both appeared to assume that stock in the cooperative would be securities under the federal acts and that the exemption provided for securities issued by tax-exempt co-ops in the 1933 Act could properly be invoked.<sup>278</sup>

These no-action letters suggest that the SEC has taken inconsistent approaches to the issue of when equity interests, whether or not called "stock," in value-added cooperatives will be considered securities.<sup>279</sup> Certainly the SEC appears willing to acquiesce if the co-op's own counsel characterizes the interests as securities. However, in at least some cases, the staff at the SEC has been willing to issue no-action letters indicating that they would not recommend any enforcement actions if the interests in question were not registered. Unfortunately, these letters offer little in the way of guidance as to how the no-action determination is actually reached.<sup>280</sup>

#### D. *How the Securities Laws Should be Applied*

In deciding how the securities laws should apply to value-added cooperatives, it makes some sense to reconsider congressional objectives in enacting the securities laws and in providing exemptions for some farmers' cooperatives.

The primary justification for enactment of the federal securities laws was a need to respond to perceived abuses in the capital markets.<sup>281</sup> As explained by the Supreme Court:

The primary purpose of the Acts of 1933 and 1934 was to eliminate serious abuses in a largely unregulated securities market. The focus of the acts is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are

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275. *See id.*

276. *See id.* The no-action letter specifically referenced reliance on the opinion of counsel that the exemption of Section 3(a)(5) of the 1933 Act is available, and further classified the interests as securities. *See id.*

277. *See, e.g.,* Minn-Dak Farmers Coop., SEC No-Action Letter (Oct. 20, 1972), *available in* 1972 WL 7641 S.E.C. Minn-Dak described itself as having been organized "for the purpose of processing and marketing sugar beets to be grown by its members." *Id.* at \*1.

278. *See id.*

279. *See* Minn-Dak Farmers Coop., SEC No-Action Letter (Oct. 20, 1972), *available in* 1972 WL 7641 S.E.C.

280. *See id.*

281. *See* HAZEN, *supra* note 22, § 1.2.

traded, and the need for regulation to prevent fraud and to protect the interest of investors.<sup>282</sup>

The solution posed by both the 1933 and 1934 Acts was to provide mandatory disclosures and penalties for material misstatements and omissions.<sup>283</sup> Because of this focus, it seems logical to make sure that the securities laws apply when the purpose of a particular transaction is to raise capital for a profit-making enterprise, particularly where investors are induced to participate in the venture on speculation that the efforts of others will produce a profitable return on that investment.<sup>284</sup>

At least one commentator has suggested that the purchase of equity interests in traditional agricultural cooperatives is far different from investment in securities and that these differences explain why the securities laws should not apply to co-op financing.<sup>285</sup> This approach does indeed seem viable in the case of traditional co-ops. One such difference is that farmers usually buy into a traditional agricultural co-op not because they expect the co-op to produce of profit for them, but because they want a guaranteed market for their agricultural produce. The market produces “profits,” not the co-op managers. A second difference between membership interests in a traditional cooperative and typical security is that co-ops reward patronage rather than investment. A good argument can be made that there is no need to protect persons who choose to participate in a joint business enterprise in the same way that there is a need to protect passive players in the capital markets.

These differences help explain why membership interests in such co-ops are not usually treated as securities—they lack the essential attributes of an “investment” seeking “profits,” and instead are more in the nature of a purchase for use. A consideration of these differences, however, also points to the potential problems posed by the case of value-added co-ops, where the distinctions between investment and purchase for use are blurred.

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282. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975).

283. *See* 15 U.S.C. §§ 77(a)-(b); 78(a)-(l) (1994 & Supp. IV 1998).

284. This comports fully with the approach of the U.S. Supreme Court in cases like *Sec. Exch. Comm'n. v. W. J. Howey Co.*, which focused on the meaning of the phrase “investment contract” in the statutory definition of the word “security.” *See* *Sec. Exch. Comm'n. v. W.J. Howey Co.*, 328 U.S. 293, 297 (1946). Although the *Howey* test, which asked whether a particular transaction involved an investment premised on the expectation of profits from the efforts of others, was originally proposed only in this limited context, the Court has also suggested that this focus may be appropriate whenever there is a question about the applicability of the federal securities laws:

This test [the *Howey* test], in shorthand form, embodies the essential attributes that run through all of the Court’s decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

*Forman*, 421 U.S. at 852.

285. Professor Neil Harl has suggested that there are specific factors that explain why the federal securities laws exempt securities issued by at least some agricultural co-ops. *See* 14 HARL, *supra* note 6, § 136.01[3].

A value-added co-op often does seek substantial sums of money in the form of equity contributions. The purpose of such fundraising is to finance operations out of which a profit is expected. Farmers may decide to join such a co-op out of a desire to share in those potential profits, in addition to the desire to gain a market for their produce. Although the farmers' earnings are technically tied to patronage, the rate of return will also be proportionate to their total investments and dependent to a large extent on the efforts of others. For example, in a value-added co-op that turns sugar beets into processed sugar, the efforts of the co-op's managers in operating the processing plant and marketing the refined product will determine whether the venture is ultimately successful or an economic failure. Thus, ownership interests in this kind of venture have, to some extent, the hallmarks of securities.

The question in a given case may come down to whether farmers who make a decision to participate in such a venture need or could benefit from the protection of the securities laws. To answer this question, it will be important to look at how the co-op has marketed its membership interests and the rights that ownership gives the farmers. The reality is that value-added co-ops have certain choices that should make it more or less likely that membership interests will be securities to which the federal laws apply. The practicality of such options, however, is such that they may be of limited usefulness.

The first step that a cooperative wishing to avoid application of the federal securities laws should take is to encourage farmers to buy into the business in order to obtain the usual benefits of cooperative membership. This can be done in a number of ways. First, promoters should emphasize the various benefits of participation in the cooperative, including having a guaranteed market for a specified amount of agricultural produce and related benefits that will flow from acting with other farmers. For example, these benefits would include any economies of scale that might arise if farmers store their products together or increased bargaining power as sellers or purchasers for farm supplies. The potential for value-added profits should not be used as the primary inducement for farmers to participate.<sup>286</sup> If members are induced to participate in order to achieve the benefits of membership rather than in an attempt to recover profits, this will make the decision to acquire a membership interest less like investment in a security.

The reality, of course, is that farmers who choose to invest in a value-added cooperative *are* likely to be thinking of the possibility of appreciation as well as the potential benefits of guaranteeing a ready market for their agricultural produce. Even if this interest is not expressed, it is always likely to be within the private contemplation of the parties. On the other hand, if the potential benefits of appreciation are made

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286. Not only should promoters be cautioned to take this approach when discussing the benefits of joining the cooperative with potential members, but any promotional literature should follow the same approach.

paramount in the marketing efforts, it is *much* more likely that a decision to participate will be viewed as tantamount to “investing” in the enterprise and that much more likely to be treated as a security.

In addition, if it is understood that the participants will not even be marketing their own produce, but instead will be supplying the cooperative with raw materials purchased elsewhere, the only viable motive becomes desire to participate in the anticipated profits from the venture. In this case, it would be hard to argue with the conclusion that the securities laws, as currently written and interpreted, require such interests to be treated as investment contracts. Certainly it is a good idea for co-ops wishing to avoid application of the securities laws to make every effort to see that members are expected to market their own produce in the co-op and that external supplies will be utilized only in unusual circumstances. This should be made clear in all promotional materials. Thus, the way in which the interests are marketed can be quite significant to the issue of whether the securities laws should apply to the transaction.

A second option that may be possible in the case of some value-added cooperatives is to take steps to un-link a member’s return from the investment. While value-added co-ops typically require participants to buy delivery rights stock as a form of capital contribution to the enterprise, it may be possible to require members to buy “membership stock” (as distinguished from “delivery rights stock”) for more than a nominal price. For example, suppose a value-added co-op requires a relatively significant membership fee or purchase of membership stock, which would entitle but not obligate members to buy delivery rights in the form of stock or otherwise. First, the cost of the membership fee itself is completely independent of the farmer’s level of patronage and therefore the farmer’s ultimate share of any profits. Second, depending on the relative cost of the membership fee as compared with the cost of acquiring delivery rights, a member’s share of profits would not necessarily be proportionate to that member’s total investment in the enterprise.<sup>287</sup> This type of arrangement could therefore distinguish participation in this type of venture from a typical investment in securities.

On the other hand, this alternative also involves some potentially significant drawbacks. Researchers at the Centre for the Study of Co-operatives at the University of Saskatchewan have outlined some advantages derived from the unique structure of new generation cooperatives and the sale of delivery rights in particular.<sup>288</sup> For example, they have explained how this type of structure facilitates capital acquisition by providing economic incentives to investment, including investment in long-term projects.<sup>289</sup> This benefit is achieved first and foremost by linking a member’s return to

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287. Of course, if every member purchases an equal volume of delivery rights, there would be no disparity between each member’s total investment and his eventual share of profits. This option does, however, provide at least the possibility that investment in a value-added cooperative would not be directly tied to the level of investment.

288. See Harris, *supra* note 11, at 16.

289. See *id.* at 18-19.

the total investment, the very attribute that makes this type of interest resemble a security.<sup>290</sup> It is also achieved by allowing appreciation of the interests once purchased, which allows the enterprise to raise money for long term projects—an economically essential characteristic that also makes the underlying interest look more like a security.<sup>291</sup>

For these reasons, un-linking investment from the ultimate rate of return may have economic costs that make this option undesirable, even at the risk of rendering the sale of interests in the enterprise subject to regulation as securities.

A third alternative would be to limit the transferability of whatever interests are being sold. While delivery rights in a value-added co-op may have intrinsic value, allowing free trading in such interests is likely to make them look a lot like securities. Thus, steps to limit the resale of such interests might make a court hesitate about classifying the interests as securities. In order to achieve this result, the co-op's board should retain full power to approve or disapprove transfers and the cooperative's organizational documents should carefully limit the purchase to persons who are either already members in the co-operative or persons who are eligible for membership and willing to purchase a membership either from the co-op or a selling member. While this will not necessarily prevent trading from happening,<sup>292</sup> it is likely to be considered by any court faced with the issue of whether the interests in question should be regulated as securities.

Again, however, this strategy has potentially negative economic consequences. If the restrictions of transferability are so significant that they actually place a meaningful limitation on the ability of participants to sell their interests at an appreciated price then the interests will be significantly less attractive at the outset. One of the intrinsic benefits to participation in a new generation cooperation is that participants are able to realize a return on their investment through the sale of appreciated interests; without this potential advantage, there is little economic incentive for the type of long-term projects required in order to make value-added processing economically viable. One reasonable approach might be to limit resale only to members who actually have a history of producing the desired commodity. This type of limitation may be regarded by the courts as meaningful, without the negative economic consequences of restricting transferability too greatly.

Another possibility, and one with fewer immediately obvious adverse economic consequences, is for the co-op to encourage members to participate in management decisions as a *sine qua non* of membership. To the extent that the farmers who join the cooperative are active in making decisions about how the co-operative is

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290. See *id.* at 16.

291. See *id.* at 17.

292. See generally *Van Huss v. Associated Milk Producers, Inc.*, 415 F. Supp. 356 (N.D. Tex. 1976) (explaining the existence of a limited market for base, and the court's decision that significant restrictions on transferability prevented the application of securities laws to the sales in question).

to proceed, an argument can be made that even if they have “invested” in the enterprise, they are not expecting profits from the managerial efforts of others, as distinguished from their own involvement. However, there are practical problems with this option.

As a cooperative grows in size, active participation by participants in day-to-day management becomes less and less feasible. At some point, the group of members will simply become too diverse and too unwieldy to function efficiently. Moreover, while it may be reasonable to expect farmers to be “experts” on issues such as ordinary farm management, they may not be particularly experienced at operating a processing facility or in handling the marketing and distribution end of a value-added business. Thus, while this is an option that should be considered when establishing a value-added cooperative, it is likely that this option will be of limited usefulness in many situations.

The inevitable conclusion that must be drawn is that once the structure of a new value-added cooperative is agreed upon, the legal advisor should take a careful look to see how closely any equity interests in the enterprise will resemble securities. Is it reasonable to believe that the primary reason for joining the enterprise is the desire to recoup profits from the processing operations? Will a member’s eventual return be directly linked to the dollar amount of that member’s contributions? Do the organizers believe that a substantial secondary market will develop for the equity interests? Is the nature of the enterprise such that most participants will essentially be passive participants? If the answers to these questions are all in the affirmative, a prudent advisor is likely to suggest compliance with the securities laws. This means registration or compliance with an appropriate exemption.

In connection with any such decision, the co-op’s organizers should be advised that a decision to register or treat equity interests as securities may or may not be viewed by the court as a binding admission that the securities laws should apply. The Eighth Circuit Court of Appeals held in *Great Rivers* that registration did not amount to an admission that the interests were securities,<sup>293</sup> but the United States District Court of Colorado has reached the opposite result.<sup>294</sup>

Finally, it should again be emphasized that, once a determination has been made that the securities law are likely to apply, compliance with the registration or exemption requirements will not insulate the cooperative from claims of securities fraud. The civil liability provisions for material misstatements and omissions apply even if the issuer has complied with the requirements of one or more exemptions, or if the security has been registered with the SEC.

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293. See *Great Rivers Coop. v. Farmland Indus.*, 198 F.3d 685, 699 (8th Cir. 1999).

294. See *Consumers Gas & Oil, Inc. v. Farmland Indus.*, 815 F. Supp. 1403, 1410 (D. Colo. 1992).



## VI. CONCLUSION

The reality is that it is hard to predict how the securities laws will apply to equity interests in value-added cooperatives. The SEC has not been entirely consistent in its no-action determinations, and even where no-action requests from value-added cooperatives have been granted, the SEC rarely explains its reasoning in sufficient detail to predict its ultimate position on the issue of whether such interests should be regulated as securities.

There is very little case law directly on point and decisions dealing with membership interests issued by traditional agricultural cooperatives suggest that the most likely analysis will not always be easy to apply to value-added operations. Finally, while there are steps that value-added co-ops can take to make it less likely that the securities laws will eventually be found to apply, no certainty can be offered until the courts actually face the issue.

The fact is that policy arguments can be made that would appear to support a regulatory regimen that consistently exempts interests in value-added cooperatives from the federal securities laws.<sup>295</sup> It is absolutely indisputable that compliance with the securities laws will result in increased costs for those interested in forming or investing in this type of agricultural enterprise.

On the other hand, the same kind of economic argument can be (and has been) made with regard to many other types of enterprises,<sup>296</sup> and the best arena for resolving these policy issues is likely to be Congress rather than the courts.

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295. See, e.g., Lauck & Adams, *supra* note 6, at 62-93 (arguing reasons for exemption of value-added cooperatives from federal securities laws in this article).

296. A number of commentators have argued that the costs of the type of mandatory disclosures currently required by the federal securities laws exceed the benefits, even for interests that are widely traded on public markets to large numbers of essentially passive investors. See, e.g., ROBERTA KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA 38-46 (1982); HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 8-12 (1979); SUSAN M. PHILLIPS & J. RICHARD ZECHER, THE SEC AND THE PUBLIC INTEREST 112-14 (1981); George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132, 152-53 (1973); George J. Benston, *The Value of the SEC's Accounting Disclosure Requirements*, 44 ACCT. REV. 515, 531 (1969); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 707-14 (1984); Gregg A. Jarell, *The Economic Effects of Federal Regulation of the Market for New Security Issues*, 24 J. L. & ECON. 613, 668 (1981); David J. Schulte, *The Debatable Case for Securities Disclosure Regulation*, 13 J. CORP. L. 535, 546-48 (1988); George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117, 124 (1964).