VALUE ADDED COOPERATIVES–ISSUES FOR ORGANIZATION

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I. INTRODUCTION

Today, the American farmer is one of the most productive individuals in the world.

> At the beginning of the 20th century it took a large team of farmers and field hands weeks to plant and harvest one crop, and it took four farmers to feed 10 people. Today, machinery allows the entire mid-western corn crop to be planted in 10 days and harvested in 20; and one U.S. farmer can produce enough food to feed 97 Americans and 32 people in other countries.[1]

Still, the agricultural economy is once again experiencing tumultuous times. The latest round of uncertainty seems to be grounded, at least in part, in the aforementioned success and unheralded productivity of the American farmer.[2] There exists today the unique situation whereby many farmers, through efficiency and dedication, or perhaps through sheer size, have increased production (quality and quantity) only to see commodity prices plummet.[3] In simple terms, supplies have grown at the same time the domestic and foreign markets are in disarray.[4]

In response to this ironic and recurring problem, today's producers are searching for methods to effectively insulate their farming activities from the negative effects of the "global" market place while still attempting to take advantage of the positive aspects.[5] Recent efforts have focused on contract farming, vertical integration, services, and the production of specialized crops.[6] Until recently, however, little attention has been paid to one long-established and time-tested method that has been successful in providing farmers with a degree of protection from market and price fluctuation, and at least the hope of some control over their destiny—the cooperative.[7]

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1. National Academy of Engineering, *Agricultural Mechanization*, *at* http://www.greatachievements.org/greatachievements/ga_7_2.html (last visited Feb. 2, 2002).

2. *See* National Academy of Engineering, *Agricultural Mechanization*, *at* http://www.greatachievements.org/greatachievements/ga_7_2.html. (stating that "[f]arm mechanization has almost entirely replaced human and animal power in developed nations, and is now transforming agriculture in many developing areas . . . it has significantly altered food production and distribution throughout the world."); *see also* David Chesnick, *Financial Performance Declines For Largest Ag Cooperatives in '99*, RURAL COOPERATIVES, Jan./Feb. 2001, at 20.

3. See Donald Buckingham, *World Production Update: Why Agricultural Lawyers Need to Know About International Trade Law*, 4 DRAKE J. AGRIC. L. 5, 34 (1999).

4. *See id.*

5. *See* Michael R. Taylor, *The Emerging Merger of Agriculture and Environmental Policy: Building a New Vision for the Future of American Agriculture,* 20 VA. ENVTL. L.J. 169, 182-85 (2001) (discussing the changes in U.S. agricultural policy, including market liberalization, food security, and agricultural sustainability).

6. *See* Randall E. Torgerson, *A Critical Look at New-Generation Cooperatives*, RURAL COOPERATIVES, Jan./Feb. 2001, at 16-19.

7. *See* Therese Tuttle, *Defending, Adding, or Discovering Value: Another Look at*

II. TRADITIONAL COOPERATIVES

As of 1997, the USDA reported that there were 3,791 farmer cooperatives in the United States.[8] These include cooperatives providing an incredible variety of products and services, including cooperatives for dairy farmers and milk related products, cooperatives for grain farmers, bread, flour, pasta, ethanol, and cooperatives existing to provide seed, fertilizer, fuel and other supplies to producers as well as a multitude of other agricultural uses.[9]

Traditional cooperatives have been established to provide low-cost inputs, stability or product development when farmers observed a need that has otherwise gone unfulfilled.[10] Traditional cooperatives are generally organized to provide a market for the raw commodity of the producer, such as grain, or to provide inputs and services, such as feedstuffs, seed or fertilizer.[11] The traditional cooperative does business with the producers who are its members, but also does business with other producers who are non-members and the general public.[12]

A cooperative is different in many respects from a corporation, but does incorporate many of the common operating aspects of a corporation.[13] The most significant difference is the relationship between members and cooperatives as compared to the relationship between shareholders and a corporation.[14] In a corporation, the equity interest of the shareholder is related to the shares purchased and the shareholder's income is tied to the dividends generated on the shares held by the shareholder.[15] In a cooperative, especially value added cooperatives, members may initially purchase an equity interest in the cooperative that is likely of limited

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Cooperatives and Their Role in the Future of Family Farm Agriculture in California, Presentation at the American Agricultural Law Association Conference (Oct. 15, 1999) (unpublished manuscript, on file with the *Drake Journal of Agricultural* Law) (providing an excellent evaluation of the historical development of the cooperative system).

8. *See* Ralph M. Richardson et al., U.S.D.A. *Farmer Cooperative Statistics, 1997*, 56 U.S.D.A. RURAL BUSINESS—COOPERATIVE SERVICE REP. v., *available at* http://www.rurdev.usda.gov/rbs/pub/sr56.pdf (last visited Feb. 12, 2002).

9. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/sr56.pdf (designating in the footnotes what types of cooperatives are encompassed in various services).

10. *See generally* Frank A. Taylor & Patrick A. Reinken, *Are Financial Instruments Issued by Agricultural Cooperatives Securities?: A Framework of Analysis,* 5 DRAKE J. AGRIC. L. 171, 173-177 (2000) (discussing the history of cooperatives).

11. *See id.*

12. *See generally id.* at 173 (stating agricultural cooperatives may be comprised of agricultural producers who organize in associations).

13. *See generally* Carol R. Goforth, *Application of the Federal Securities Laws to Equity Interests in Traditional and Value-Added Agricultural Cooperatives,* 6 DRAKE J. AGRIC. L. 31, 39-41 (2001) (discussing differences between cooperatives and corporations).

14. *See* Torgerson, *supra* note 6, at 15.

15. *See id.*

transferability.[16] However, additional equity interests and cooperative income thereafter may be based upon the member's patronage, or use of the cooperative, rather than the member's equity interest. The redemption of the equity position of a member is generally tied to the occurrence of a future event such as retirement.[17]

III. THE COMING OF AGE: VALUE ADDED CLOSED COOPERATIVES

As traditional cooperatives have grown and expanded, they have experienced many of the same problems as corporations and other businesses: concerns as to financing, management, marketing, and long term planning, among other things.[18] In an effort to seek out profitable business activities as core businesses suffered, many cooperatives expanded their operations into areas that were sometimes marginally related to the original purpose of the cooperative. This often resulted in a loss of focus, ineffective operations, or a lack of responsiveness to the special needs of certain groups of members.

During this same time frame, certain commodity segments, such as hog production, became increasingly integrated and concentrated, and producers began seeking alternatives to the "take it or leave it" contracts that markets offered.[19] The result was the formation of "value added" cooperatives dedicated solely to one or very limited purposes, such as the production of ethanol, truck crops, processed grain, meat products, or other focused activities.[20] These value added cooperatives have many common characteristics, the most basic being the attempt to create "value-added products" or "products that have increased in value because of processing."[21] Value added cooperatives are also usually characterized by limited membership (and are hence "closed" to other members), requiring that members make a substantial equity investment and further requiring that members agree to execute and abide by detailed delivery contracts.[22]

> Common characteristics of these new-generation cooperatives are that equity investment is a prerequisite to establishing delivery rights. These delivery rights are part of a

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16. *See id.*

17. *See id.*

18. *See generally id.* (taking a critical look at new-generation cooperatives in the wake of the Tri Valley Growers bankruptcy).

19. *See, e.g.*, J.W. Looney & Anita K. Poole, *Adhesion Contracts, Bad Faith, and Economically Faulty Contracts*, 4 DRAKE J. AGRIC. L. 177 (1999); *see also* Neil D. Hamilton, *Why Own the Farm If You Can Own the Farmer (and the Crop)?: Contract Production and Intellectual Property Protection of Grain Crops*, 73 NEB. L. REV. 48 (1994); Glenn A. Hegar, Jr., *Adhesion Contracts, Debt, Low Returns and Frustration-Can America's Independent Contract Farmer Overcome the Odds?,* 22 HAMLINE L. REV. 213 (1998).

20. *See* Torgerson, *supra* note 6, at 15-16.

21. Committee on Agriculture, *A Glossary of Agricultural Terms, Programs and Laws*, *at* http://agriculture.house.gov/secgloss/vw.htm (last visited Feb. 2, 2002).

22. *See* Torgerson, *supra* note 6, at 15-16.

> producer marketing agreement (contract) that pools the delivery of products and links them to equity units purchased in the cooperative. If a grower is unable to deliver his agreed raw products, purchase of commodities is authorized by the cooperative for undelivered contract obligations. Delivery rights are allocated according to plant processing capacity. This closes membership at plant capacity.
>
> Delivery rights are in the form of equity shares that can be sold to other eligible producers at prices agreed to by the buyer and seller. The board of directors approves all stock transfers to assure that they are held by eligible producers. . . . The value of delivery rights (shares) may appreciate or depreciate in value depending upon the performance of the cooperative. High levels of cash patronage refunds are issued annually to producers since they have substantial risk capital invested in the organization.
>
> The advantage of the new-generation cooperative approach is that adequate equity capital is raised at the outset. The burden of capitalization is distributed equitably in proportion to future use of the marketing organization. Substantial up-front investment by members means that they want the business to succeed. And, assuming the business is performing adequately, exiting members can sell their invested equity at a value reflecting the cooperative's performance.[23]

Thus, in a value added cooperative, the members all agree to certain and often strict controls, limitations, rights and obligations between themselves.[24] As opposed to traditional cooperatives, little or no business is transacted with non-member producers or the public in general.[25] The goal of a value added cooperative is to provide an economic advantage to its members who, by themselves, are too small to effectively negotiate or participate in the marketplace or produce the value added product for which the cooperative is formed.[26]

IV. WHERE TO START?

First and foremost, everyone involved needs to understand the basic structure and operation of a cooperative. There can be no substitute for this knowledge, and it will be difficult to learn on an "as you proceed" basis. There are numerous publications available from the USDA, law journals, and the internet to anyone interested in initiating the cooperative development process to ensure that those involved will be fully informed. Once informed, efforts can be shifted to getting the process started.

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23. *Id.*
24. *See id.* at 15.
25. *See id.* at 18. In California, where some co-ops have begun to process non-member products, members are dissatisfied and the co-ops are criticized for treating members "as residual claimants rather than primary beneficiaries." *Id.*
26. *See id.* at 19.

The process can be best described as one of identification, deliberation, implementation, execution and evaluation.[27] This can be a two-year process. There will be thousands of small steps and decisions to be made, both by the initial development group and the potential members of the cooperative as progress is made. However, a few major steps can be gleaned from the process. The following are a few of these steps as outlined by the USDA:[28]

1. Identification: "Invite leading potential member-users to meet and discuss issues" and to identify the purpose(s) for which the cooperative might operate.[29]

2. Identification: Conduct an exploratory meeting with potential members. If the group votes to continue, select a steering committee.[30]

3. Identification: Survey prospective members to determine the potential use of a cooperative and schedule a second general meeting of all potential members and vote on whether to proceed.[31]

4. Deliberation: Conduct a needs or use cost analysis and discuss the results at a third general meeting. Vote (preferably by secret ballot) on whether to proceed with a detailed analysis and determine the method to fund further investigation and planning.[32]

5. Deliberation: Conduct a feasibility analysis and develop a business plan.[33]

6. Deliberation: Present results of the feasibility analysis and business plan at the fourth general meeting. If participants agree to proceed, decide whether to keep or change the steering committee members.[34]

7. Implementation: Have the legal documents prepared to incorporate and organize the cooperative.[35]

8. Implementation: Call a meeting of charter members and all potential members to review and adopt proposed bylaws, to elect a board of directors.[36]

9. Implementation: Convene the first meeting of the board and elect officers. Assign responsibilities, establish committees and move to implement the business plan.[37]

10. Execution: Establish a plan to acquire capital and develop a loan application package and conduct a membership drive.[38]

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27. *See* James Matson, *Cooperative Feasibility Study Guide*, USDA 1 (2000), *available at* http://www.rurdev.usda.gov/rbs/pub/sr/58.pdf (last visited Feb. 2, 2002).

28. *See* Galen Rapp & Gerald Ely, *How to Start a Cooperative*, U.S.D.A. COOPERATIVE INFO. REP., vol. 7, (Rev. Sept. 1996), *available at* http://www.rurdev.usda.gov/rbs/pub/cir7rpt.htm (last visited Feb. 11, 2002).

29. *Id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7rpt.htm.

30. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7rpt.htm.

31. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7rpt.htm.

32. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7rpt.htm.

33. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7rpt.htm.

34. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7rpt.htm.

35. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7rpt.htm.

36. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7rpt.htm.

37. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7rpt.htm.

11. Execution: Hire a general manager.[39]

This is a formidable list, but one that is manageable and necessary to form a good foundation for any cooperative. From this point forward, the nature of the purpose will drive the roads taken by the board of directors and the project. Many of the next phases will be concurrent, and those individuals in the initial development group and on the steering committee must work diligently to move the project forward.

The chances of success are also increased by the election, appointment, or addition of individuals who are willing to take charge, as opposed to taking over, and to listen to the potential members and professionals retained to assist the group. These individuals should also be willing to serve on the steering or other committees, preferably without compensation or reimbursement for minor expenses, to ensure that the initial funds will be dedicated solely to the planning and organization of the cooperative, and to have an overall positive impact on the effort.

At the earliest stage possible, the initial development group should engage the services of experienced professionals to assist the producers with the various organizational issues that will be confronted.[40] An attorney, accounting firm, and banker, with experience in organizing and representing cooperatives will likely save the producers much more than their ultimate cost through the sharing of experience and counseling, which will avoid many mistakes and pitfalls which could delay during the organizational process.[41]

The retention of professionals may be funded by a grant or may require a small infusion of funds from each member of the group or a personal guaranty on a small loan.[42] As an alternative, the cooperative could be formed and membership fees established that would cover these preliminary costs. Alternatively, a pre-incorporation membership agreement could be prepared where interested parties agree to become members upon incorporation of the cooperative and further agree to pay for their membership up front. In such instances, it is of utmost importance to disclose the risk that there is no assurance that the venture will move forward or that the loans or the membership fees will be returned, either in whole or in part.

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38. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7rpt.htm.

39. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7rpt.htm.

40. *See generally id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7rpt.htm (stating "[a]ssistance from specialist in [varying fields] is critical during the business analysis phase.").

41. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7rpt.htm.

42. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7rpt.htm (explaining methods to acquire capital).

A. *Identify and Establish the Clear Goals of the Interested Producers*

Assuming the initial group of producers has determined to proceed with forming a new cooperative, a meeting should be held to elect a steering or organizational committee and establish a deadline for the committee to complete its preliminary work and report back to potential members.[43] The committee should be composed of highly interested potential cooperative members with diverse backgrounds who will provide a wide range of experience and practical knowledge during the decision making process. The committee will need to function collectively and in an organized fashion. The assistance of effective counsel and a strong but not overbearing committee chair at this juncture may be critical to keep the effort on course.[44] Common problems that may arise include the breakdown of discussions when disagreements arise. The effort may degenerate into other areas, such as complaints about the market, available capital, cash flow, the discussion of other matters that are not proper for at this early stage, or the inability of the committee to accept changes to the intended course of action.

The steering committee will answer the first and most obvious question: Why does the cooperative need to be organized and what scope of the operations will it undertake? This seemingly simple decision is not always as clear as one might think, and overlapping and potentially inconsistent objectives may exist. For example, if the cooperative is to provide low cost crop inputs, how far will the cooperative go? Will it purchase in bulk for its members? Will it provide storage? Will the cooperative provide credit, and if so, on what terms and under what policy? Will custom application be offered? Where will the base of operations be?

The agricultural cooperative statutes of most states grant agricultural cooperatives broad discretion in establishing the scope of their intended business.[45] For example, the Illinois Agricultural Co-operative Act outlines the many purposes for which agricultural cooperatives can be organized, some of which include "the producing, marketing, or selling of agricultural products" and "the harvesting, preserving, drying, processing, canning, packing, grading, storing, warehousing, handling, shipping, or utilizing such products . . . or the by- products thereof."[46] As this language reveals, the Illinois legislature clearly intended that the scope of activities for which agricultural cooperatives could be organized should be quite broad, thus providing new cooperatives with the ability to engage in and develop those business purposes which will most effectively serve their members.

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43. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7rpt.htm.

44. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7rpt.htm (discussing legal considerations).

45. For an analysis of the various state statues, *see* James Baarda, *State Incorporation Statutes for Farmer Cooperatives*, U.S.D.A./ACS, Cooperative Information Report No. 30, § 11.01, T. 11.01 (Oct. 1982).

46. 805 ILL. COMP. STAT. § 315/4 (2001).

Some of the more common reasons for which cooperatives are organized are to provide access to markets, reduce costs, increase net income, stabilize cash flow, and reduce the costs of operation.[47] However, every business purpose will have its own unique issues that the producers proposing to form the cooperative will need to address, discuss, and evaluate. This process should be open, blunt, and as objective as possible.

The primary objectives and preliminary goals must be established early in the development of the cooperative so as to provide the best guide for moving the project forward. That is not to say that changes will not be made as the cooperative progresses toward its goal (because they will or the venture will not succeed), but an initial perspective will be important during the discovery of the fluid and ever-changing landscape of both anticipated and unanticipated issues to follow. This is especially true in value added cooperatives, as the closed nature of the enterprise will cause the fortunes of all members to rise and fall in unison.[48]

Once the steering committee has determined where it believes the efforts should go, the results of their efforts should be put in writing and circulated for review. Once all committee members give final approval, the committee should schedule a meeting to make a recommendation to all potential members and get approval to move forward. These informational stages are critical if the project is to retain the interest of potential members. They should focus on the purposes being proposed for the cooperative, the general business and operations planned, and the path proposed to get the cooperative to the objectives and goals established.

Note that no references to the cost of the project proposed, the organization of the cooperative, or the equity contributions that may be required, should yet be made to avoid any possible securities law violations and the dissemination of incorrect financial information for the future. For example, once the potential members believe that the new plant to be built will cost $6 million, it may be difficult to explain why it is now projected to cost $7.2 million based upon a cost analysis and feasibility study. Organization will be a long process and additional information, market fluctuation, interest rates, inflation, changes to the objectives, and many other factors will take a toll on early projections.[49]

V. Can The Cooperative Be Successful?

Once the preliminary discussions as to the purpose are completed and the decision is made to proceed, the board of directors will need to complete a feasibility study, prepare a business plan to guide them, and begin to pull together the financial

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47. *See* Rapp & Ely, *supra* note 28, *available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm.

48. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm.

49. *See generally id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm (explaining that starting a cooperative is a complex project).

projections and costs that will influence their decisions from this point forward.[50] Feasibility studies and business plans are costly, time consuming projects that typically require (both for their knowledge but also for an "air of independence") the services of experts or consultants in the area being considered as the business of the cooperative.[51] Further, these documents will normally be required by any lender from whom financing is sought, and are generally mandatory where the lender is CoBank or where USDA loans or loan guaranties are being sought.[52] Therefore it is important to contact the lender early in the process to determine the scope the feasibility study and business plan must encompass and the independence each must have.[53] It is critical that the cooperative conduct a feasibility study and work out a plan that will meet the requirements of the lender.[54]

The feasibility study will focus on nearly all aspects of the proposed business of the cooperative.[55] Among the feasibility issues that need to be addressed are:

1. Economic feasibility: This analysis will address such factors as availability of resources (sufficient water, gas, electricity, labor, community support, etc.) at the location of the intended business of the cooperative. Site location has become more difficult as a cooperative's potential neighbors do not want the smell from a livestock operation, the dust from grain facilities, or the environmental concerns from fertilizer and chemical locations.[56]

2. Market feasibility: Quite simply, can the value added products or services to be produced or provided by the cooperative be sold? What is the target market and the plan of attack? What competition exists? Who will guide the efforts of the cooperative?[57]

3. Technical feasibility: Depending on the purpose of the cooperative, this portion of the study may be the most expensive and time consuming. Engineers, architects, environmental consultants or other professionals may be needed to address all of the potential aspects of the design, construction suitability of any proposed facility.[58]

4. Financial feasibility: This will be an "independent" analysis from an accountant hired by the cooperative. It should address cash flow, income and expense sources, and uses of funds. In addition, the analysis should provide pro forma

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50. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm.

51. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm; *see also* Matson, *supra* note 27, *available at* http://www.rurdev.usda.gov/rbs/pub/sr58.pdf.

52. *See* Rapp & Ely, *supra* note 28, *available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm.

53. *See* Matson, *supra* note 27, *available at* http://www.rurdev.usda.gov/rbs/pub/sr58.pdf.

54. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/sr58.pdf.

55. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/sr58.pdf.

56. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/sr58.pdf.

57. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/sr58.pdf.

58. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/sr58.pdf.

financial calculations as well as any other areas required by the proposed lender and/or guarantor.[59]

5. Management feasibility: This section is commonly overlooked but can be critical to an accurate feasibility study and the ultimate success of the venture. The identification of proposed management, by name or by job description and experience requirements, will be needed.[60]

Universities and industry associations can be of great assistance in recommending or locating experts or industry consultants for these tasks.[61] State or federal grants may be available to offset all or a portion of these costs, but it is likely that cooperatives will need to think of methods to raise funds to finance the project from this point forward and until the cooperative is open for business and generating income. State and federal political representatives or agencies can also be a valuable source of information as to the availability of funds and assistance.[62]

Once completed, the study and plan should be formally presented to the potential membership and fully discussed.[63] Again, question and answer sessions are invaluable to provide for an informed base of interested and potential members.[64] Those in attendance should vote one final time on whether to adopt the study and plan and whether to proceed.[65]

VI. Formal Incorporation and Creation of the Cooperative as a Legal Entity

With pre-organization and feasibility issues completed, it is time to formally establish the cooperative entity. Surprisingly, the legal process of creating an agricultural cooperative is simple. Most states have a well-developed statutory scheme that outlines the method of organizing an agricultural cooperative and the rules which are to be used in operating them.[66] Certain issues are more easily dealt with, such as the number of directors or the name of the cooperative. Other issues appear to be more mundane (where will meetings be held, who can nominate directors, etc.), and court opinions are brimming with disputes that have arisen because improper planning failed to address them. Care and attention to every detail should be the rule of thumb.

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59. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/sr58.pdf.

60. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/sr58.pdf.

61. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/sr58.pdf.

62. *See* Rapp & Ely, *supra* note 28, *available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm.

63. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm.

64. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm.

65. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm.

66. *See* Baarda, *supra* note 45, at § 11.01, T. 11.01.

A. *The Articles of Incorporation: A Cooperative's "Constitution"*

Once the business purpose of the cooperative is determined, the cooperative can be "created" by filing the articles of incorporation with the appropriate agency of the state in which the business of the cooperative will be located or transacted.[67] The articles of incorporation, along with the cooperative's bylaws, will generally govern and control the relationship between the cooperative directors, officers, and members, as well as direct the activities of the cooperative.[68]

The articles of incorporation will provide the general framework from which the cooperative will be governed and operated. The requirements of state statutes may vary,[69] but the articles of incorporation will normally establish: (1) the cooperative's name; (2) purpose; (3) principal place of business; (4) term for which it is to exist; (5) the number and qualifications of directors; (6) whether the cooperative is organized for stock, and; (7) the property, voting, membership, and participation rights of cooperative members.[70] This is not an exclusive list, but it is representative of the types of issues that need to be considered during the organization and document drafting phases. The articles of incorporation will become the "Constitution" of the cooperative from which all authority to act flows.

Difficult decisions will arise when the managerial aspects for the future operation of the yet-to-be-formed cooperative are being determined.[71] At this point, the organizers must attempt to address the current concerns and forecast the future needs of its anticipated members so as to provide for the future stability and operation of the cooperative before it comes into existence. Past cooperative experience and good legal representation are again critical to the decision.[72] Using a "form" set of articles of incorporation or those from another similar cooperative may not be the best method to follow, especially if those being reviewed are not from a value added cooperative or are old and potentially outdated. Special care should be taken to review the potential consequences of the various provisions that are most important. These may include voting issues, methods for amendment, provisions for the use of outside directors (where allowed) or advisory boards, membership limitations, notice provisions, business purposes, and corporate governance matters. In most states the

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67. *See* Rapp & Ely, *supra* note 28, *available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm.

68. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm.

69. *See* Baarda, *supra* note 45, at § 11.01, T. 11.01 (analyzing various state statutes); *see also* Rapp & Elyl, *supra* note 28, *available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm (explaining that each state has special enabling laws under which cooperatives may incorporate).

70. *See* Bob Cropp & R. H. Vilstrupp, *So You've Been Elected to the Co-op's Board of Directors, at* http://www.wisc.edu/uwcc/info/win_00.html#elect (last visited Feb. 2, 2002); *see also* Rapp & Ely, *supra* note 28, *available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm.

71. *See* Rapp & Ely, *supra* note 28, *available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm.

72. *See id. available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm.

vote of at least a majority of the members will be required to amend the articles of incorporation, so it is especially important to fully discuss and explore these issues in the beginning.

B. *A Cooperative's "Statutes": Its Bylaws*

Just as the articles of incorporation are a cooperative's Constitution, the statutes of the cooperative are its bylaws. The bylaws are, by necessity, a lengthy more detailed document that establishes the more specific operating aspects and internal governance of the cooperative.[73] Again, forms and bylaws from other cooperatives should be avoided except for clearly acceptable boilerplate language.[74] Many older cooperatives have not updated their bylaws for a number of years, and the provisions of such bylaws may not be appropriate in light of today's agribusiness economy, technology, and the value added, closed cooperative concept. However, a review of as many bylaws as possible will provide insight and ideas regarding issues to be addressed and the alternative methods used to do so. A cooperative's bylaws generally establish: the qualifications for members, directors and officers; the requirements as to annual, monthly or special meetings; the methods and rights of members, directors, and officers as to notice and voting procedures; amendment requirements; or any number of other topics aimed at providing an outline of how the cooperative will be governed.[75]

It is at this time that many issues, which were, heretofore, unaddressed will need to be determined. Some of these issues are essential to the success of the cooperative. These issues may include how dividends or patronage will be determined and paid, what issues require the approval of the members (and by what vote, i.e., majority, two-thirds, etc.), what the terms and functions of the directors and officers will be, and how, if at all, a member can be added, removed or the member's interest transferred. The bylaws should also establish certain committees of the board and provide authority for the board to create additional committees it deems as necessary.

There is no magic formula to determine the correct answer to any of the issues that arise. Reference should always be made, at a minimum, to the state cooperative statutes, the Internal Revenue Code, and USDA regulations to determine what requirements are mandatory, what options are available or precluded, and what statutory provisions will be advantageous.[76]

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73. *See* Rapp & Ely, *supra* note 28, http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm; *see also* John Moye, THE LAW OF BUSINESS ORGANIZATIONS 136 (2d ed. West Pub. Co. 1974).

74. *See* Moye, *supra* note 73, at 118.

75. *See* Rapp & Ely, *supra* note 28, *available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm; *see also* Moye, *supra* note 73, at 137.

76. *See* Rapp & Ely, *supra* note 30, *available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm.

C. *The Election of a Board of Directors: The Crucial Decision on Leadership*

Perhaps no decision the members will make is more significant than the election of members to serve on the board of directors. These individuals will be the leaders of the effort during the critical early stages of the project. Again, knowledge of the education, desires, and experience of the candidates is a must. Potential directors should possess certain characteristics and intangibles that will have a positive influence on the board and the project, such as:

1. The ability to listen, process, and then make decisions.[77]
2. Leadership skills to lead the cooperative in a manner which is in the best interest of the membership as a whole by representing all the members of the cooperative without showing favoritism to an individual or a special interest group.[78]
3. Have sufficient time available to consistently participate in and attend all board meetings and cooperative functions.[79]
4. The ability to be interested, tactful, broad-minded, and aware of his or her influence on the attitude of other members and staff.[80]
5. Be a loyal supporter of the cooperative.[81]

Potential board members should also be informed of the expectations of the members electing them and their respective duties and obligations under the articles of incorporation and bylaws.[82]

An interesting issue that has recently developed involves the right to elect outside (non-cooperative member) directors. For example, in 1998 Ohio revised its cooperative laws to allow for outside directors with voting privileges.[83] Where state law permits, consideration should be given to whether outside directors meeting the qualifications established by the cooperative could provide skill sets and experience that the membership may not possess.

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77. *See* Bob Cropp & R. H. Vilstrupp, *So You've Been Elected to the Co-op's Board of Directors*, *at* http://www.wisc.edu/uwcc/info/win_00.html#elect.

78. *See* Bob Cropp & R. H. Vilstrup, *So You've Been Elected to the Co-op's Board of Directors*, *at* http://www.wisc.edu/uwcc/info/win_00.html#elect.

79. *See* Bob Cropp & R. H. Vilstrup, *So You've Been Elected to the Co-op's Board of Directors*, *at* http://www.wisc.edu/uwcc/info/win_00.html#elect.

80. *See* Bob Cropp & R. H. Vilstrup, *So You've Been Elected to the Co-op's Board of Directors*, *at* http://www.wisc.edu/uwcc/info/win_00.html#elect.

81. *See* Bob Cropp & R. H. Vilstrup, *So You've Been Elected to the Co-op's Board of Directors*, *at* http://www.wisc.edu/uwcc/info/win_00.html#elect.

82. *See* Rapp & Ely, *supra* note 28, *available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm.

83. *See* Ohio Rev. Code Ann. §1729.22(c) (West 2001).

D. *Board Committee—Spread the Wealth of Things to Be Done*

The use of committees can dramatically reduce the workload of the board members. An effective committee system should provide for the distribution of various duties to committees, which in turn analyze and investigate the issues given to it and report back to the full board with a recommendation for action.[84] This system provides an effective method to simultaneously deal with numerous matters.

Certain committees should be considered, obviously based upon the type of project being considered by the cooperative. The steering committee may be disbanded at this time or may become the executive committee because of their overall knowledge of the process from the start.[85] Also proper at this time may be the creation of other committees considered for the upcoming tasks that will be undertaken. Most important among the early committees will be the membership committee, who will put together a plan or grass roots effort to develop interest in the cooperative from producers who are candidates for membership.[86] A financing committee may be established and given the task of locating lenders and raising equity. Where site selection is a factor, a committee should be established to draft citing criteria and develop a list of potential locations.[87] A governmental relations committee is also useful to work with local governments on site location issues as well as working to establish a good relationship with state, federal, and agency officials. A community relations committee may be established once the potential locations are narrowed to provide information with the general public and the news media. Clearly, the options are limitless.

These board committees will usually be chaired by a member of the board of directors and committee members will be composed of other board members or potential members of the cooperative. This provides a mechanism to bring others into the process without the need for them to commit the time and resources necessary to be a board member. Note that it is important to be acquainted with the knowledge, education, and interests of all potential committee members so they can be assigned to a committee that will make the best use of their talents for the good of the cooperative.

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84. *See* Bob Cropp & R. H. Vilstrup, *So You've Been Elected to the Co-op's Board of Directors, at* http://www.wisc.edu/uwcc/info/win_00.html#elect.

85. *See* Bob Cropp & R. H. Vilstrup, *So You've Been Elected to the Co-op's Board of Directors, at* http://www.wisc.edu/uwcc/info/win_00.html#elect.

86. *See* Bob Cropp & R. H. Vilstrup, *So You've Been Elected to the Co-op's Board of Directors, at* http://www.wisc.edu/uwcc/info/win_00.html#elect.

87. *See* Bob Cropp & R. H. Vilstrup, *So You've Been Elected to the Co-op's Board of Directors, at* http://www.wisc.edu/uwcc/info/win_00.html#elect.

VII. OTHER RELATED CONSIDERATIONS SPECIFIC TO THE COOPERATIVE

The activities of the cooperative will most likely raise additional issues which may be directly or indirectly related to the purpose for which the cooperative exists.[88] For example, a cooperative handling grain may need to obtain certain licenses or permits. The name under which the cooperative will do business or offer services and products must not violate any trademarks or service marks that are in use or are registered. In addition, environmental concerns, not to mention licensing and regulation, may affect the ability of a cooperative to sell or apply chemicals.

Value added cooperatives that have delivery requirements, such as pork processing facilities or ethanol plants also pose a unique problem. The drafting of a uniform contract equitable to all cooperative members is a time consuming and sometimes laborious process.[89] The marketing contract will present a host of issues that is beyond the scope of this article.[90]

Finally, some common themes have been identified that should be understood, addressed and avoided. These include:

1. Purchase of delivery rights outside the grower's production territory.[91]
2. Use of purchases "off the market" rather than a member's delivery as a predominant means of fulfilling delivery right obligations.[92]
3. Leasing of delivery rights as a way to hold on to appreciated value rather than having ownership in the hands of active producers.[93]
4. Making of fixed-term market obligations for final products when the market for raw commodity is short, causing wide price disparity for producers and losses for the business.[94]
5. Hiring of management from outside of the industry that does not know intricacies of the market . . . . [95]
6. Sourcing equity outside of membership, thereby resulting in conflicting goals and fiduciary responsibilities.[96]
7. Attempts by board members to micro-manage the business.[97]
8. Engaging in large amounts of non-member business.[98]

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88. *See* Matson, *supra* note 27, *available at* http://www.rurdev.usda.gov/rbs/pub/sr58.pdf.
89. *See* Rapp & Ely, *supra* note 28, *available at* http://www.rurdev.usda.gov/rbs/pub/cir7/cir7rpt.htm.
90. *See e.g.*, Jeffrey A. Mollet, *Agricultural Production And Marketing Contracts*, ILLINOIS LAW & AGRIBUSINESS, Illinois Institute for Continuing Legal Education, 2001 (providing further information and a bibliography of resources).
91. *See* Torgerson, *supra* note 6, at 15, 17.
92. *See id.*
93. *See id.*
94. *See id.*
95. *See id.*
96. *See id.*
97. *See id.*
98. *See id.*

9. Efforts by the board chairman to also serve as chief executive officer, creating lack of trust within the membership.[99]

VIII. NOW HOW DO WE GET THE MONEY TO FUND THE DEVELOPMENT OF THE COOPERATIVE'S PROJECT?

Finally, we can discuss the big question, at least in part: How does the cooperative get the money to fund the development of its project? As with many start-up businesses, there are limited resources available to most cooperatives. Cooperatives in the organizational phase generally get their funds from state or federal grants, loans, membership fees, donations, or directly from members in the form of loans or as the result of a securities offering.[100] Most commonly, value added cooperatives use a combination of these sources.[101]

The bulk of the funds needed to get the project off the ground will likely come from the cooperative's members who will agree to purchase shares of stock in the cooperative.[102] This may subject the cooperative to state and federal securities laws, an issue that should be thoroughly reviewed and understood at the outset.[103]

The specific issues relative to possible exemptions from the securities registration requirements and the provisions of the Securities Acts of 1933 and 1934 is beyond the scope of this paper. If the particular offering falls within the definition of a security, and no available exemption exists, the security must be registered with the Securities and Exchange Commission before it can be registered for sale.[104] The issue of whether attempts to raise equity by a cooperative constitutes the offer of "securities" as defined by state and federal law is an unsettled issue that has been the subject of much debate.[105] The determination of this issue is of particular importance in light of the

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99. *See id.*

100. *See* David S. Chesnick, *Continued Expansion of Assets Shows Greater Reliance on Debt By Farmer Co-ops*, RURAL COOPERATIVES., Sept./Oct. 1997, at 25, 28-30 (comparing current cooperative assets with short and long-term liabilities from various funding sources).

101. *See* Torgerson, *supra* note 6, at 18-19 (detailing the various financial source combinations implemented by many valued-added cooperatives).

102. *See* 14 NEIL E. HARL, AGRICULTURAL LAW, §§ 136-4-136-6 (2001).

103. *See* Taylor & Reinken, *supra* note 10, at 177 n.33 (indicating that "the number of state jurisdictions and the breadth of the variance among them precludes a definitive discussion of the state securities 'blue sky' laws and their possible impact on cooperative financing instruments. Nevertheless, those bodies of law frequently impose their own requirements on issuers of securities, parallel to federal requirements discussed below. Thus, while focus here is on federal Laws and cooperatives, legal practitioners must also consider the implications of any governing securities law arising from individual states."). This article also notes the problems in defining "securities." *See id.* at 178-87.

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

105. *See* Taylor & Reinken, *supra* note 10, at 177 n.33; *see also* Goforth, *supra* note 13, at 46; Carol R. Goforth, *Appropriate Securities Law Treatment of Equity Interest in Value-Added Cooperatives*, Presentation at the American Agricultural Law Association Conference (Oct. 15, 1999) at pp. B-3-1 - B-3-21 (unpublished manuscript, on file with author).

registration and exemption language found in the Securities Act of 1933[106] and the Securities Exchange Act of 1934.[107]

These Acts only exempt a cooperative from the requirement of registration and they do not exempt a cooperative from the anti-fraud and disclosure requirements of the act.[108] One possible exemption is found in the 1933 Securities Act which provides that any security issued by a "section 521" agricultural cooperative is exempt from the provisions of the 1933 Securities Act, except as otherwise provided.[109] Section 521 of the 1933 Securities Act is referred to section 521 of the Internal Revenue Code. Therefore, in order to qualify for the exemption the cooperative must meet the following requirements set forth in section 521:

> (1) The farmers' cooperatives [must 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 supplies and equipment to them at actual cost, plus necessary expenses.
>
> (2) [If the cooperative issues capital stock, the interest rate may not succeed 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 [of the cooperative] (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.
>
> (4) Exemption shall not be denied any such association which markets the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, or which purchases supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases.[110]

As you can see these requirements are quite specific. "At one time most agricultural cooperatives were organized so as to comply with the requirements of Section 521 of the Code."[111] Now, less than one-third of the current agricultural

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106. *See* 15 U.S.C. § 77a-aa.
107. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78a-mm (1994).
108. *See* 15 U.S.C. § 77*l*(a)(2).
109. *See* 15 U.S.C. § 77c(a)(5).
110. 26 U.S.C., § 521(b) (1994).
111. U.S.D.A., *Income Tax Treatment of Cooperatives*, RURAL BUS./COOP. SERV., *in* IRC § 521, at I-III (1996).

cooperatives operating in the United States claim 521 status, and many authors believe that some of those cooperatives may, in fact, be ineligible to do so.[112]

In lieu of qualifying for a section 521 exemption, there are other possible alternatives to avoid the members' interest from being classified as securities. Note however, that this is a subjective determination and every issue will present questions of fact with no black or white answers. These tactics are clearly set forth in Professor Carol R. Goforth's article, entitled "Appropriate Securities Law Treatment of Equity Interest in Value-Added Agricultural Cooperatives", as follows:

> A. Emphasize the Benefits of Membership in Marketing Efforts
>
> --NGCs should encourage farmers to buy into the business in order to obtain the usual benefits of cooperative membership.
>
> --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 which will flow from acting with other farmers.
>
> B. Un-link a Member's Return from the Investment.
>
> --Take steps to un-link a member's return from the investment.
>
> --One option is to require members to buy "membership stock" (as distinguished from "delivery rights stock") for more than a nominal price.
>
> --This would result in total investment which is not necessarily proportionate to either patronage or eventual return on investment. (It is possible, however, that the delivery rights stock would be treated as a security even in this case.)
>
> --The primary potential disadvantage to this alternative is that un-linking investment from return may make it significantly harder for the enterprise to attract capital for long-term projects.
>
> C. Limit Transferability of the Interests.
>
> --Limit the transferability of whatever interests are being sold.
>
> --The problem is that allowing free trading in such interests is likely to make them look a lot like securities.
>
> --Steps to limit the resales might include limiting the class of potential purchasers (especially to those who are actually in the agricultural business as producers of the particular commodity or commodities in which the co-op deals); insuring that the co-op's board retains full power to approve or disapprove transfers.
>
> --The potentially negative economic consequences associated with this approach are that they will diminish the potential for appreciation, which may be the very thing making investment in the co-op attractive to farmers.
>
> D. Encourage Members to Participate in Management.
>
> --It is probably always a good idea to encourage members of a co-op to participate actively in the management of the business, at least up to the level of their abilities.
>
> --If the business is structured so that members make the significant operational decisions, it will be hard to argue that they are relying on others for any profits.
>
> --The drawbacks here are practical: most farmers are already busy people; their expertise may not extend to value-added processing and distribution; and the larger the co-op, the less efficient direct owner-management business.[113]

112. *See* Goforth, *supra* note 13, at 36.

In any event, the issues to be examined are difficult and important. Registration can cost tens of thousands of dollars, but failure to register when required to do so can be equally costly and submit a cooperative to the wrath of the SEC and Internal Revenue Service.

IX. Where to Get Preliminary Information and Assistance

The USDA Rural Development offices in some states have a cooperative development specialist on staff who can help you avoid the pitfalls experienced by many businesses during incorporation and their early years of operation. An additional resource for assistance is the USDA Rural Business-Cooperative Service located in Washington, D.C. Cooperative Services have a staff of professionals who may help you organize a cooperative and provide technical assistance to existing cooperatives.[114]

X. Did I Say It Was Simple To Form a Cooperative?

Despite all of the issues surrounding the organization of a cooperative, and the matters raised herein, patience, proper planning, good representation, and a dose of good-old fashioned logic are the keys to success. Thankfully, the generally conservative, rationally thinking, and ethical farmers of our great country are a perfect fit for these requirements.

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113. Carol R. Goforth, *Appropriate Securities Law Treatment of Equity Interest in Value-Added Cooperatives,* Presentation at the American Agricultural Law Association Conference (Oct. 15, 1999) at pp. B-3-1 - B-3-21 (unpublished manuscript, on file with author).

114. For more information, *see* USDA, *Rural Business Cooperative Service*, *available at* http://www.rurdev.usda.gov (last visited April 7, 2002). Or contact: Rural Business-Cooperative Service Cooperative Services, Stop 3250, Washington, DC 20250-3250; (202) 720-6483 (general information), (202) 720-7558 (project requests); FAX (202) 720-4641 Attention CDD.