Cooperative Business Law Basics:

A primer on organizational structure and capitalization options

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"Nought may endure but Mutability."—*Percy B. Shelley*

Change in the market, change in the world, can mean stress in the relationships within a cooperative as the organization adapts to the changing circumstances. Both having the right organizational structure and choosing the right vehicles to capitalize your co-op are important in making your cooperative responsive and resilient in the face of change. But their technical and legal aspects can make these issues difficult for cooperators to discuss.

We intended to provide an overview of these issues, including the basic vocabulary that you will encounter. Remember that the law of every state differs: this article is a guide to your local discussion. You will of course want to seek legal advice before introducing any structural changes to your cooperative or choosing a strategy for capitalization.

As Shelley poetically notes, change is the one thing that endures. This article is intended to provide basic information on organizational form and invested capital—two topics you are likely to encounter as a cooperative director or manager—and to help you navigate change.

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Organizational forms and multi-stakeholder co-ops

We begin with fundamental questions: How is your cooperative organized? Who are the owners? Who controls the capital?

There are many different forms of cooperative business ownership. Consumer cooperatives are owned by consumer owners. Producer cooperatives pool capital to help bring their goods and products to market. Worker cooperatives are owned by workers, who invest both capital and labor in the business enterprise.

Some co-ops have been formed as, or converted to, multi-stakeholder ownership. In most cases, this means both consumer members and employees and perhaps even suppliers participate in ownership economics and governance. There are several legal issues to consider with regard to multi-stakeholder co-ops:

Income tax: Precedents under Subchapter T of the U.S. Code (which governs treatment of cooperatives and their patrons) make clear that a co-op can allocate income to more than one member group. It should not create co-op tax problems if a co-op allocates part of the total income to the customer-owner class and part to the employee-owner class, as long as there is a reasonable justification for the amount of profit allocated to the two member groups. It is more difficult to maintain tax neutrality if income is split between customers and producer vendors. That is not consistent with Subchapter T co-op tax principles, because it involves two types of patronage for the same transaction. It may well work, however, to approximate the co-op single-level tax by treating the consumer-member as the patron and committing to a "rebate" program with the producers. There is a body of IRS precedent that could be used to permit the rebate amount to be excluded from the co-op's taxable income as long as there is a pre-existing commitment to give the rebate according to a specified formula.

Governance: For a hybrid consumer- and employee-owned cooperative, organizational documents should discuss the practical aspects of democratic control, including representation and election of board members. In addition, it is advisable to establish in the cooperative's bylaws the percentage of profit that is allocated to consumer-members on the one hand and employee-members on the other hand. The fixed percentage should not be subject to change unless there is a super-majority vote, perhaps with a majority of both member groups separately approving the change. This prevents the profit split between customers and employees from becoming a political and governance issue, and it also helps ensure the cooperative's Subchapter T tax status cannot be challenged on the grounds the obligation to allocate patronage is not subject to a pre-existing commitment.

Employee vs. member status: Being an employee member of the co-op does not mean the member is not an employee for purposes of the myriad state and federal employment laws, including minimum wage laws, overtime requirements, etc. The employment laws still apply to all member employees who are not designated as "exempt" from these laws.

Member capital campaigns

In addition to the primary sources of member-provided cooperative capital—member equity and retained patronage refunds—cooperative leaders also should understand two primary types of member investment vehicles: preferred shares and member loans. Some of the factors to consider in choosing the right vehicle are summarized in what follows.

Preferred shares: The category of preferred shares is usually permanent

equity, with no maturity date. Preferred shares have priority over member capital (retained patronage refunds and paid-in capital), but are subordinate to member loans and bank debt and trade creditors. Preferred shares are equity on the balance sheet. The liquidation value is fixed (it does not appreciate in value as the co-op's value increases). Because of this permanent nature, lenders and landlords usually view preferred shares as being better than member loans.

Sometimes member investors have a right to call shares for payment (redemption) after a specified number of years (e.g., 20) or when a change of control occurs. Having a member call right could cause preferred shares to be treated as debt for balance sheet (accounting) purposes as the call date nears, unless the board of directors has discretion to say no to share redemption if the board determines that the co-op's financial condition is or could be impaired. This is a decision the board would make at the time a redemption request is made, taking into account the current business circumstances and plans of the co-op. Some co-ops adopt policies for redeeming shares in hardship or other special circumstances.

Typically, an annual dividend is paid on preferred shares, but only if declared by the board. The dividend rate may be fixed, or it may be a range. Some bank loan agreements prohibit payment of the dividend if a default exists or would result from the dividend payment (including a financial ratio default).

If the board does not declare and pay the dividend, the unpaid dividend often "cumulates"—it creates a right of the member to receive payment of the dividend in the future, when the co-op can afford to do so or if the co-op liquidates. Noncumulative dividends are more beneficial to the co-op, but this may not be as attractive to the members.

There are usually no voting rights and few covenants or restrictions associated with preferred shares (although minimal rights could be established). Voting rights typically apply only if the preferred share is being subordinated, or if there are bylaw amendments that adversely affect the preferred share rights and preferences. Sometimes there is a "dividend stopper" associated with preferred shares—if the preferred dividend has not been declared and paid, no patronage payments can be paid to co-op members until the dividend has been paid (usually without interest for late payment).

Subordinated notes, such as member loans: Subordinated debt is debt on the balance sheet, and it has a set maturity date. For some co-ops the maturity date is quite distant; for others the maturity date is much closer (e.g., five years); or the member may be given a choice of maturities.

Member loans are almost always specifically subordinated to all trade debt, lease payments, and secured debt. But member loans have priority over preferred shares and other member capital.

Member loans usually have no voting rights or financial covenants.

Many natural foods co-ops have used member loans to raise capital for store development and expansion. These notes are similar to preferred shares, except they have a maturity date, and they are classified as debt rather than equity on the balance sheet. The existence of the maturity dates means the co-op needs to manage cash flow to allow for payment of maturing loans.

Securities law and exemptions

It is important to understand the securities law implications of offering member loans and preferred shares. There are federal securities laws (Securities and Exchange Commission: SEC), plus each state has its own securities laws. These securities laws generally make it illegal to sell loans or shares to members in a broad offering, even to a community or members of a co-op, unless state or federal securities registration is filed (which is usually much too expensive and detailed to be practical) or there is an exemption from this registration requirement.

Consequently, exemption from securities registration for co-op member loans and preferred shares is key. Most of the co-op member investment programs use a combination of the SEC "intrastate exemption" and a state-specific exemption for securities sold to cooperative members. The intrastate exemption precludes SEC jurisdiction if the program is limited to residents of a single state (there cannot be even one non-resident member investor) and the co-op is doing business in the state. The SEC rules say that: (i) the co-op must have derived 80 percent of its gross revenues from within the state in the past six months; (ii) 80 percent of the co-op's assets must be located in the state; (iii) 80 percent of the proceeds of the offering must be used within the state; and (iv) the principal office of the co-op must be located in the state.

State securities laws vary widely on exemptions, so it is important to consult legal advice on your particular state's "blue sky" laws, which protect investors from securities fraud by requiring specified disclosures. But many states have specific exemptions for co-op sales of shares or loans to members.

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As examples: The Colorado cooperative law applicable to most Colorado co-ops says, "Any security…issued or sold by a cooperative association as an investment in its shares or capital to the members…is exempt from securities laws" of Colorado. The Wisconsin "blue sky" law exempts "[a]ny securities of a cooperative corporation organized under chapter 185."

An alternative in cases where a co-op has many members in two or more states is to use the SEC's so-called Rule 504 exemption. This exemption limits the amount of the offering to $1 million, and it requires a relatively simple SEC notice filing. But only existing members are eligible, and no broad advertising can be done. Additionally, a separate state exemption must be available for each of the states.

Many states have recently adopted "crowdfunding" exemptions that could be used by co-ops. Again, the state laws vary widely. However, many of the state crowdfunding laws apply only if the SEC intra-state exemption

is used, and most of them limit the total dollar amount that can be raised. In some cases, a registered portal must be used, and some states have "suitability" rules that limit the amount a member can invest based on their income and/or net worth. These requirements limit flexibility and increase transaction costs, but the crowdfunding exemption allows advertising and likely broadens the investors who are eligible.

Finally, it is important to make sure exemptions are available from laws that are designed to prevent individuals from selling securities unless they have appropriate broker-dealer licenses. Most states have exemptions that allow directors and officers of a co-op to be involved in member capital programs even without a license, as long as there is no commission paid. But some states do not. For example, New York exempts directors and employees of housing co-ops but not directors and employees of other types of cooperatives.

Documentation

Here is a summary of the legal documentation needed for cooperative capital:

Articles and bylaws: For issuing preferred shares, there needs to be authorization in the articles and/or bylaws (and in the state incorporation law). For subordinated notes, the board can authorize these without amendment of the articles or bylaws. Even a non-stock co-op may be able to issue "preferred equity"; CHS, a large agricultural cooperative representing over 600,000 farmers, is a non-stock cooperative that has issued over $2 billion of preferred equity listed on NASDAQ and called "preferred shares".

Board resolution: The board would need to authorize preferred shares and subordinated notes. For preferred shares, the resolution would establish the terms (liquidation preference, dividend rate, etc.). For subordinated notes, there would likely be a signed note given to each member who invests.

Offering materials: The most complex document is the offering materials, and this document will take the most time and thought. It protects the board and the co-op from securities fraud claims. The form of this document is not specified in the securities laws—hence, the co-op will have some judgments to make. But there are "standard" practices. The offering documents used by other food co-ops—such as the example in Food Co-op Initiative's "Capital Campaign Workbook" (at fci.coop)—would be good models. These documents vary in length and complexity. They include a form of agreement that investing members must sign.

Concluding thoughts

We warned you that this article would be a bit technical! Cooperation requires a good many skills and competencies, and excellent managers and directors are at least familiar with the language and basic concepts of each of those skills. As this article demonstrates, it is critical to have expert advisors to help cooperators understand the issues and options around ownership and capital structures.

We hope this article helps cooperative leaders identify key issues and seek appropriate advice for the difficult, interesting, and potentially world-changing decisions and discussions that arise around their cooperative's organizational and capital structures.

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