Explore the New Legal Flexibility

Revised co-op statutes provide more options for co-op capital

BY JOEL DAHLGREN

Variations of new co-op statutes have been adopted in Wyoming, Minnesota, Tennessee, Iowa, Wisconsin, Nebraska and Utah. Cooperatives formed under the new co-op statutes provide advantages that should make those statutes the presumptive favorites for any group of cooperators who form cooperatives in those states. Those statutes may even provide a superior alternative for cooperators wanting to form a cooperative outside of those states—but only if those cooperatives are unlikely to rely on the intrastate federal exemption from registration of securities.

For this article, I assume that Subchapter T is the federal statute that cooperators will want applied to their new cooperative because most, but not all, cooperatives in the United States are taxed under Subchapter T. Large segments of cooperatives in the United States are not taxed under Subchapter T—for example, most telephone, rural electric, and ditch associations, and a few agricultural cooperatives are tax exempt and hence not taxed under Subchapter T. Cooperatives taxed under Subchapter T are called non-exempt cooperatives to contrast them with tax-exempt cooperatives. Most of your cooperatives are taxed under Subchapter T.

Not only do the new statutes provide greater flexibility than older statutes, I believe the new statutes have more in common with the society statutes that were in place at the time of the formation of the Rochdale Cooperative. Consequently, these statutes are philosophically consistent with the cooperative movement and cooperative principles.

Flexibility is the key benefit

If the choice of entity decision boils down to a business that is a cooperative—i.e., a corporation where (1) members (users or patrons) exist with unique needs that will and can be collectively satisfied; (2) the members will govern themselves democratically; and (3) the members agree to distribute the resulting earnings on the basis of use or patronage rather than ownership—and the cooperators specifically want to use the word "cooperative" (or co-op, or co-operative, or association) in its corporate name, then the presumptive choice of entity

ILLUSTRATION BY KEN DAVIS

under state law should be a co-op formed under one of the new co-op statutes.

Note that a Subchapter T cooperative could be formed under state law as a corporation (for-profit or not-for-profit), a limited liability company, or as a cooperative (under either an old or new statute), but only the latter choice will require the word "cooperative" to be included in the cooperative's legal name.

It is very unlikely in my own practice that I will ever form a co-op under one of the older statutes if I determine that the intrastate exemption from registration of securities is unnecessary, and the cooperators have no objection to forming the cooperative under one of the new statutes. Everything else being equal, I believe it is inadvisable to ignore the flexibility offered by the new co-op statutes over the old co-op statutes. The added flexibility arises from there being no limitation on the amount of preferred dividends paid to providers of equity capital and from greater flexibility in seating nonmembers to serve as voting directors on the board of directors.

(The new co-op statutes are also more flexible because they allow but do not require cooperatives to obtain capital from nontraditional parties and even to allow those parties noncontrolling voting rights. The new co-op statutes also permit cooperatives to be taxed under Subchapter K, which is sometimes more advantageous than Subchapter T. Most of your cooperatives will not care about these added measures of flexibility, and these advantages are not the subject of this article.) ■>

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The new statutes do not limit the amount of preferred dividends that the cooperative may pay to attract capital for carrying on its business activities. Many if not most of the old co-op statutes limit preferred dividends to 8 percent per annum. Although that limitation attempts to honor the principle of limited returns on capital, it is an arbitrary ceiling that undermines the discretion of the cooperatives' members to determine for themselves the appropriate limitation on returns to capital. If the cooperative must obtain equity capital, but after negotiating with likely providers it becomes obvious that a dividend of 15 percent must be paid to attract that capital for use by the cooperative, shouldn't the cooperative's members be allowed to make that decision for themselves rather than having to live with an arbitrary ceiling that makes no sense for their cooperative?

The new co-op statutes also provide more flexibility in seating "outside" directors in comparison to the older co-op statutes. It is true that all co-op directors are "outside" directors because they are not selected from or controlled by management. This is a strength to be applauded, particularly in the current business climate, when it appears that corporate governance is out of control.

The strength of the new co-op statutes, however, lies in their openness to allowing nonmembers to serve on the board of directors with the same voting power as any member of the co-op who is elected to serve as a director on the board. Nonmember directors should not control the board or serve in greater numbers than directors elected from the membership, but nonmember directors can provide an important source of expertise and insight if they are carefully selected for service on the board.

The older co-op statutes do not typically prohibit nonmembers from serving on the board of directors, but those statutes are often difficult to read as clearly permitting nonmembers to be seated as directors. When those older statutes are read in their totality, they seem to imply that only members may serve on the board of directors. The state of Oregon, in fact, recently amended its co-op statute to expressly allow nonmembers to serve on the board of directors. Without that kind of clarification, practitioners may have a difficult time opining that nonmembers can serve as voting directors on the board. Just one issue created by that ambiguity is whether nonmember directors are covered by director and officer liability insurance if it is ruled that those directors were ineligible to serve on the board.

By the way, the expertise and insight that nonmember directors bring to the board can be supplied by advisory directors as well, without giving those directors voting power. Still, it may be difficult to secure financing or win the confidence of agencies or institutions that expect that a board of directors will consist of directors with diverse, relevant experience. If those expectations exist but are challenged by a co-op's lack of nonmember directors, the institution's reaction

may be to hesitate in contracting with or supporting the cooperative.

Obviously, each group of cooperators must decide for themselves, when they are forming a cooperative, whether nonmember voting directors are advisable or even necessary. That decision should be informed by their evaluation of the parties with whom the cooperative will be doing business or from whom the cooperative will need licenses or governmental permits.

Historical precedents

Some will argue that the new co-op statutes provide for the formation of "bastard children," but the Rochdale Pioneers would more easily recognize and be more at home with the new co-op statutes as compared to the older co-op statutes. The statutes providing for the formation of societies in the United Kingdom did not (then or now) limit the payment of dividends or even imply that nonmembers were unable to serve as directors on societies formed in the United Kingdom.

In fact, the new co-op statutes have more in common with the United Kingdom society statutes and hence are more uniquely "cooperative" in their form and spirit than our older co-op statutes. One can argue that the United Kingdom has always provided for the formation of cooperatives that were, in the first order, created by statute with fewer limitations and hence were vigorous economically and financially. This philosophy is consistent with the view of early co-op leaders like George Holyoake, who suggested cooperatives were businesses with the power to redistribute wealth bloodlessly, without resorting to warfare.

Check the box

If a new co-op statute is chosen for the formation of a cooperative that will be taxed under Subchapter T of the Tax Code, the cooperators must file Form 8832 with the Internal Revenue Service to elect to be taxed as a corporation. Subchapter T applies generally to corporations operated on a cooperative basis (democratic control; subordination of capital without identifying a specific ceiling on the amount of allowable preferred dividend; and allocation of patronage earnings on basis of patronage), rather than specifically to businesses formed under cooperative statutes.

The older co-op statutes provide for the formation of a "corporate" co-op, and an 8832 choice-of-entity election is unnecessary because the new entity will default to treatment as a corporation, which is the necessary perquisite for taxation under Subchapter T. The new co-op statutes, however, provide for the formation of an unincorporated association, which defaults to a partnership unless the election is made. If an 8832 election to be taxed as a corporation is not filed, the service will treat the new co-op as a partnership that will be taxed under Subchapter K. Form 8832 should be filed at the same time that a Federal Employee Identification Number is obtained for the new co-op.

Conclusion

At the end of the day, lawyers are called upon to work on behalf of their clients and to do their client's bidding. In other words, if the cooperators want to form a cooperative under an older co-op statute, then the co-op should be formed under an older co-op statute. Lawyers, however, should be aware of the advantages of the new co-op statutes and be prepared to discuss them with the cooperators at the time of formation. Clients deserve the ability to make an informed choice that best reflects the business outcome the incorporators desire for their members. ■

Joel Dahlgren is an attorney and partner at the Stoel Rives law firm with offices in Minneapolis, Minn. He has worked nearly 30 years with cooperatives, for the past 16 years as a lawyer in private practice. Dahlgren's practice consists almost entirely of cooperatives of all sizes, both agricultural and nonagricultural in nature.

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