Implications of Equity Structure on Governance

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Introduction

Cooperative finance principles are well known and factors that make a cooperative successful have been widely studied. A key financial principle, that members must provide the capital needed to finance the cooperative is commonly called the user-owner principle. Since the earliest days of cooperatives in the United States, this has been a challenge. Most U.S. agricultural cooperatives obtained equity by requiring members to purchase an equity certificate as a condition of membership and by distributing a portion of profits in the form of additional equity certificates. The distributed equity was eventually redeemed by the cooperative at book value, a structure referred to as revolving equity. This structure was consistent with a second key cooperative principle, the member-benefits principle, which indicated that profits should be distributed in proportion to use. Usage based profit distributions, in both cash and equity are referred to as patronage distributions.

In 1911, the National Farmers Union, which was instrumental in cooperative formation in certain geographies, indicated that it was permissible for cooperatives to retain a portion of profits in a general reserve fund commonly referred to as unallocated equity. The members had a collective rather than an individual ownership of the unallocated equity. The unallocated equity was permanent, non-revolving capital. This recommendation therefore relaxed the strictest interpretation of the "user-benefits" principle and added another dimension to the "user-owner" principle. In 1922, the Internal Revenue Service recognized that it was prudent for a co-op to have a reasonable portion of its equity in the form of unallocated equity to handle possible losses or major investments. This was typically interpreted to mean 10% of total equity and many original cooperative bylaws incorporated that philosophy.

In recent years, for a variety of reasons, some sectors of agricultural cooperatives, (primarily grain marketing and farm supply cooperatives) have significantly increased their use of unallocated equity relative to allocated equity.[1] While the ratio of unallocated equity to total equity among these firms has been gradually increasing for decades, the equity structures have changed relatively dramatically in the last five years. Other agricultural cooperatives operating on a pooling basis or engaged in other sectors have not seen this significant increase in unallocated equity.

The objective of this paper are to 1) quickly review cooperative finance principles, 2) discuss the factors associated with the increase in unallocated equity in grain marketing and farm supply cooperatives, 3) describe the implications for governance structure, and 4) provide recommendations for boards of directors to consider with regard to governance.

Overview of Cooperative Finance

Cooperative finance has been the subject of much research as noted by Boland and Barton (2013). Likewise, the user-owner principle of cooperatives is well-known. Barton, Boland, Chaddad, and Eversull (2011) note challenges in financing for cooperatives. In a report done specifically for farm input supply and grain / oilseed marketing cooperatives, Boland (2012) summarized the operations of this principle for these types of cooperatives and this is restated in the next three paragraphs

[1] The term "farm supply and oilseed / grain marketing cooperatives" is consistent with USDA's classifications. For simplicity, we use the term "grain market ing and farm supply" cooperatives in the subsequent sections of this paper. Grain marketing and farm supply cooperatives are typically "local" co-ops who are "members" of one or more regional cooperatives.

Figure 1 shows the board of director's basic choices with regard to distributing income. The first decision, which is necessitated by U.S. tax laws, is to separate member sourced (patronage) and non-member sourced (non-patronage) income. Most cooperatives distribute non-member income to unallocated equity. This implies that it is not paid out in cash, will not be redeemed in future years but instead serves as permanent equity. Unallocated equity which is also referred to as unallocated reserves or retained earnings, has an important function which can absorb unexpected losses without writing down the value of allocated equity.[2]

The next decision, after separating non-member income, is to decide what portion of patronage income should be retained as unallocated equity and what portion should be allocated to members. Retaining a portion of member-based profits as unallocated equity is one option for generating additional cash for infrastructure investment and/or equity redemption. Retaining member profits as unallocated equity creates permanent equity and thus avoids the discipline of managing equity redemption. Because the cooperative cannot exclude income distributed to unallocated equity from their earning calculations, the cooperative pays the corporate tax rate on these earnings. For this reason it is the after tax portion of profits channeled to unallocated equity that are actually retained. Retaining member-based profits as unallocated equity reduces the member's realized return because it is never redeemed for cash.

The third decision is whether to distribute allocated income as cash (immediately redeemed) or as retained patronage (redeemed at a later date). The member reports the cash patronage as income while the cooperative excludes the distributed income from their earnings calculations. Cash patronage distributions create immediate benefit to the member while

[2] In general, these cooperatives have not had a history of losses from local operations. Regional cooperatives write-downs of equity from bankruptcy or losses in the value of equity such as crop nutrients have been observed rarely. Many cooperatives in the Great Plains and eastern Corn Belt had equity write-downs from Farmland Industries in the 1980s and again in 2004 when it went into bankruptcy. CHS wrote down the value of crop nutrients and passed those equity write-downs to members in 2009. Many cooperatives took these losses out of unallocated equity rather than passing the losses onto members through a write-down of their equity.

reducing the cooperative's cash flow. The fourth decision is whether to structure the retained portion as qualified allocated equity or nonqualified allocated equity. The cooperative can deduct profits retained as qualified allocated equity from its taxable income in the current year while they can only deduct profits retained as nonqualified allocated equity when the equity is redeemed. The cooperative therefore retains the entire amount of profits structure as qualified allocated equity and the after tax portion of profits retained as nonqualified allocated equity. Historically, most grain marketing and farm supply cooperatives have retained allocated profits as qualified equity. In recent years, more than 30 grain marketing and farm supply cooperatives have transitioned to the nonqualified structure.

The diagram does not show every potential source of equity such as preferred stock or membership stock which is generated from direct investment. It does not explicitly differentiate between all possible sources of income such as income coming from joint ventures or similar structures, or income from direct investments such as "condo grain storage". In most cases those income sources would be classified as patronage income.

Local cooperatives also receive patronage in some ratio of cash patronage and retained equity patronage from the regional cooperatives that they patronize. Under the cooperative tax code, a local cooperative must pass on patronage from regional cooperatives to avoid being taxed on that income. The regional patronage therefore becomes part of the local cooperative's total patronage income which is retained or distributed in the portions selected by the board. In many cases the local's cooperatives profit distribution choices do not match the cash/retained patronage ratios of the regional cooperative. Regional patronage can therefore create cash flow issues which are not apparent in the diagram.

Allocating regional patronage can reduce the local cooperative's current year cash flow if the local cooperative's ratio of cash patronage to retained patronage ratio exceeds that of the regional cooperative. In can also reduce the local's cooperative's cash flow in the year that equity is redeemed if the local cooperative's redemption cycle is more rapid than that of the regional cooperative. In recent years many of the regional cooperatives serving grain marketing and farm supply cooperatives have transitioned toward base capital system where equity investment is matched to usage. Under these systems local cooperative would not expect equity redemptions since their annual business volume is stable or increasing. When those local cooperatives redeem the equity of local patrons, a portion of which originated as regional profits, they do so without corresponding redemption payments from the regional cooperatives. This mismatch between the equity revolving systems of local and regional cooperatives has led some local cooperatives to retain the entire noncash portion of regional income as unallocated equity.

It should also be noted that while qualified and nonqualified retained patronage is typically classified as revolving equity, there can be considerable variation in how that revolving process is managed. Some cooperatives systematically revolve equity based on the age of the patron or the age of the equity. A few cooperatives, usually those with low profitability, do not systematically revolve equity and by default, revolve at the death of the member. While the previously described base capital system is more common in regional cooperatives, some local cooperatives use a base capital equity management plan which matches equity holding with business volume and revolves equity only when a member's business volume decreases. A cooperative may also choose not to revolve the equity held by an entity with perpetual existence such as a corporation, LLC or Trust unless the entity is dissolved.

Two Trends in Grain Marketing and Farm Supply Cooperatives

Two trends have recently occurred in grain marketing and farm supply cooperatives. Investment in property plant and equipment has increased and the ratio of unallocated equity to total equity has also increased. Figure 2 shows net capital investment by U.S. grain marketing and farm supply cooperatives. These data from Boland (2012) represent 441 grain marketing and farm supply cooperatives. Net capital investment is defined as the amount by which capital expenditures exceed depreciation. It provides a measure of the increase in productive capacity of the firm. There has been a dramatic increase in net investment for many grain marketing and farm supply cooperatives. It is evident here that many cooperatives are responding to members' customer needs, replacing outdated assets and investing in new capacity and equipment. Figure 3 shows the increase in the ratio of unallocated equity to total equity during this same time period. The equity structure of grain marketing and farm supply cooperatives has also clearly changed. Both of these trends are worthy of further examination.

There has been a need to construct new assets and replace existing assets for handling grain and oilseeds, crop nutrients, chemicals, energy, and agronomic services. Risch, Boland, Crespi, and Leinweber (2014) describe the two primary reasons which are summarized here. First, there has been a dramatic increase in crop yields for corn and soybeans due to advances in genetics and higher-yielding varieties as noted by Pardey and Wright (2003). Second, cropping patterns have changed in certain geographic regions in the United States (Beddow and Pardey 2015). For example, eastern South Dakota, eastern North Dakota, northwest Kansas, and similar regions in the Great Plains have more corn and soybeans today than ten years ago, while storage and handling facilities were designed for lower yielding grain crops such as hard red winter wheat or barley. This increase in supply means greater volumes of grain and oilseeds being handled by marketing cooperatives. Kowaslski (2014) documents such capital expenditures for rail shuttle unloaders and shows the rapid investments in the 2000s as grain and oilseed yields increased.

This has resulted in grain marketing and farm supply cooperatives observing large increases in business volume. These increases have placed stress on facilities which were not designed for the current throughput. Bechdol, Gray, and Gloy (2010) note that the average planting and harvesting times have almost halved in the last decade meaning that this increased grain volume and parallel increased volume of crop nutrients must be handled in shorter time periods.

Grain marketing and farm supply cooperatives have responded to their customer needs with significant increases in capital expenditures. These investments have totaled billions of dollars in grain and oilseed storage, crop nutrient and chemical storage, application equipment, and similar assets. Many boards have been reluctant to increase leverage levels due to the inherent volatility in throughput and margins. The increased net investment has therefore led to a parallel increase in the need for equity capital which has traditionally been provided by members through retention of patronage.

A cooperative board of directors desiring to increase equity has two basic choices. They can increasing the percentage of patronage income retained as allocated equity and reduce cash patronage. Alternatively they can take some portion of patronage income, pay the corporate tax, and retain the after tax portion as unallocated equity. As the unallocated choice illustrates, the profit allocation decision is also intertwined with taxation and cash flow considerations. Retaining profits as qualified allocated equity creates the highest current year cash flow since the cooperative can deduct the retained patronage from its taxable income. Retaining profits as either qualified or nonqualified allocated equity implies a future year cash flow obligation of equity redemption. The future cash outflow of redeeming nonqualified equity is partially offset by the tax deduction received at the time of redemption. Profits retained as unallocated equity are not deductible so it the after-tax portion which is retained. There is no future year cash flow obligation from retentions as unallocated equity since it is never redeemed.

In recent years, grain marketing and farm supply cooperatives have employed multiple strategies to generate the equity and cash flow required for infrastructure investment. The overall tendency has been toward retaining a greater portion of both local profits and regional profits as unallocated equity.

Impact of the Domestic Production Activities Deduction

As discussed, cooperatives are typically able to retain only the after tax portion of profits which are channeled to unallocated equity or nonqualified allocated equity since the cooperative is not able to deduct profits channeled to those choices. However, since 2004 marketing cooperatives have been able to use a deduction against patronage income (analogous to a tax credit) called the Domestic Production Activities Deduction (DPAD). This allowed them to retain profits as unallocated equity without the associated increase in tax liability. The DPAD also increased the attractiveness of retaining profits as allocated nonqualified equity but some cooperatives were reluctant to engage in the communication campaign to explain the new class of equity to their members.

It is not possible to determine the changes in profit distribution and retention strategies of grain marketing and farm supply cooperatives from available public data sources. Balance sheet data is available and the change in equity structures suggests that there were major changes in those strategies. Anecdotal evidence from directors at our education meetings suggests that grain and marketing cooperatives take full advantage of the DPAD which significantly reduces their effective tax rate on patronage income. Many of those cooperatives have shifted profit retention from allocated revolving equity to non-revolving unallocated equity. In addition, many of these cooperatives have chosen to retain some or all of regional patronage income as unallocated equity rather than allocate it to members as cash and allocated equity.

Managing the Equity Structure

The cooperative's equity structure is under the control of the board of directors. The board can influence the structure by retaining all future member sourced profits as allocated equity. Over time, a cooperative that was uncomfortable with its portion of unallocated equity could adjust its equity structure. Another potential strategy available to the board of directors is to distribute the profits from non-patronage-based business as dividends to equity owners rather than retain those profits as unallocated equity. The repeal of the dividend allocation rule in 2004 (Section 312 of the American Job Creation Act of 2004) made dividend payments more attractive. Prior to 2004 a cooperative that wished to distribute dividends had to allocate on a pro rata basis the amounts paid from income between patronage and non-patronage sources (Frederick 2005). The dividend allocation rule reduced the net income available for patronage distribution by the amount of the dividend allocated to patronage income. Dividends can now be paid on shares of allocated equity entirely from non-patronage sourced income that would otherwise be added to unallocated reserves. In order to comply with this tax ruling, cooperatives must authorize payment of stock dividends in either their articles of incorporation or by-laws (Frederick 2005).

At least one Mid-Western cooperative experimented with paying dividends on equity once the member reached a trigger age. This presumable increased member satisfaction and decreased member pressure to reduce the revolving period. Avoiding additional increases in unallocated equity coupled and not accelerating the redemption of allocated equity helped achieve the desired equity structure.

A question that periodically arises is whether a cooperative could directly "reallocate" unallocated equity. This practice is not common but the obvious issues can be highlighted. Qualified allocations (which are deductible in the year issued) and nonqualified allocations (which are deductible in the year they are redeemed) must be made within 8 ½ months of the cooperative's year end. In the case of earnings retained as unallocated equity, the payment period is closed and a deductible allocation cannot be created. Additionally, the portion of unallocated equity generated from nonmember profits could not be distributed as a patronage dividend, regardless of the timing. A few cooperatives have allocated previously unallocated equity by issuing shares of a new class of equity. This would clear up the property rights in the event of a merger or liquidation.

The tax consequences of allocating previously unallocated equity can be complicated because there is always uncertainty as to how the provisions of Subchapter C of the tax code (which govern the tax treatment of equity exchanges in investor-owned corporations) applies to Subchapter T cooperatives.. The goal would be structure the exchange as a nontaxable event. Re-characterization of cooperative equity has been addressed in several private letter rulings including Ltr. 85040070, Ltr. 8617040 and Ltr 8638054, Cash distribution of this new equity class would have to be structured as a dividend and would be taxable to the member. Because of the complexities of reallocating equity and time lag in increasing allocated equity levels, cooperatives with high portions of unallocated equity need to understand the governance issues that become more prominent with their equity structure.

Implications of Balance Sheet Changes with regard to Governance

Unallocated equity represents a collective ownership by the members but a member has no individual property right. At higher proportions of unallocated equity there is a theoretical incentive for the members to liquidate the cooperative or convert it to an investor owned corporation. This phenomenon is termed demutualization. Unallocated equity balances are generally considered a contributing factor, but not the major cause of demutualization.

Demutualization in the United States has occurred mostly in mutual insurance companies (Chaddad and Cook 2004b). However, there are agricultural examples such as Birds Eye Foods (Amanor –Boadu et al. 2003), CALAVO, Cal-West Seeds (Gigstad, Boland, and Brester 2009), and Diamond Growers (Hardesty 2009) who demutualized.

While most agricultural cooperative boards do not perceive a risk of demutualization there is a growing concern of the implications of higher levels of unallocated equity on governance. As some board members point out, the balance sheet really does not matter as long as the majority of the voting members are satisfied with the cooperative's services and opportunity for future patronage. In those conditions the membership will elect a board of directors that is dedicated to protecting the long term viability of the cooperative. However, grain marketing and farm supply cooperatives have generally had an open membership policy whereby members can join for a nominal fee..[3] Being a member entitles them to voting privileges and patronage.[4]

This structure of open membership and one member-one vote raises the possibility that a group of inactive members could vote to demutualize the cooperative in an attempt to access the value of the unallocated equity. A governance structure that helps to mitigate this risk is the establishment of a patronage thresholds o $5,000 to $10,000 in order to maintain voting privileges. These amounts are not unreasonable for an agricultural producer. Cooperatives that do not establish usage thresholds to maintain voting privileges, or are lax in enforcing those policies are at risk of losing control to inactive members. The one-member one vote system which is common in most cooperatives makes this issue practically problematic.

Indivisible Reserves

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[3] Sexton (1986) shows why open membership is a critical part of why cooperative have unique treatment with regard to antitrust.
[4] The number of patrons is often larger than the number of members in these cooperatives since patronage can be paid to corporations and other organizational forms.

The change in equity structure can also be viewed as a change in business philosophy. The system of allocated revolving equity allows members to gradually build ownership in the cooperative through retained profits and then eventually reduce their ownership after their use of the cooperative decreases. The implicit assumption of this structure is that members are more supportive of profit retention when it is linked with their individual equity balances. Anecdotal evidence from our board director education programs suggests that members rank highest the customer transaction for which the capital investments have been made followed by patronage, control, and equity creation and redemption. Some directors argue that members are indifferent over allocated retained patronage that is to be redeemed at a future date.

If cooperative members are chiefly concerned with future generations a cooperative could consider an equity component called indivisible reserves (IR) which has been discussed by Reynolds (2013, 2015). While not common in the U.S. the structure of IR eliminating the demutualization threat associated with high portions of unallocated equity. Cooperatives in several Western European countries designate a portion of permanent capital as IR. This creates a class of unallocated equity that cannot be distributed to members upon the dissolution of the cooperative. Instead, if the cooperative is liquidated, the IR are used for new cooperative development or transferred to organizations serving cooperative development and education. In the countries where they are used, indivisible reserves are subject to very low levels of taxation. There are no provisions for indivisible reserves in the U.S. tax code so the tax advantages of indivisible reserves are not available to U.S. cooperatives. A U.S. cooperative could modify its articles of incorporations and bylaws to specify that the value represented by unallocated equity would not be distributed to members. As Reynolds points out, that could be a viable strategy for a cooperative with a strategy of retaining funds as permanent capital and with membership goals to benefit future generations.

Specific Recommendations for Boards of Directors

The greater use of unallocated equity in grain marketing and farm supply cooperatives happened gradually. It is important that boards of directors consider whether their existing governance structure matches the intent of their balance sheet decisions. Here are some questions that should be asked.

Do the members fully buy in to the goal of preserving the cooperative for future generations?

In listening to directors articulate rationales for the high unallocated mode they often comment that their objective is to make sure they are a surviving cooperative and that a future generation has a choice of doing business with a cooperative. The cooperative's education programs for members should take this into consideration. Communication efforts should emphasize the value of preserving the cooperative as a part of the members' value package. In addition, the cooperative's assets should be maintained in good condition and the cooperative should have a strategy of being competitive today and in the future.

Is the membership roster updated on a regular basis?

The cooperative bylaws should have provisions for suspending voting privileges of members who have not met a patronage threshold for some specified period of time. This can assure that vote outcomes reflect the views of active stakeholders and also help ensure that quorum and super majority requirements are based on the appropriate voting member group. Many cooperative members have organized their farm businesses as closed corporations or limited liability companies. Boards should review how these structures are treated for both patronage and voting privileges. In most cases it is advantageous for the cooperative to use a "look through" procedure to represent the voting privileges of the participants in such legal structures. The board should also consider how ownership and participation in the farm business relates to voting privileges in the cooperative. For example, are the husband and wife both voting members and eligible to run for the board of directors?

What are the quorum and majority requirements for special votes of the membership?

Quorum and majority requirements differ across states but the minimum number of members required to constitute a majority or quorum should be known by a board and communicated to the membership. The board of directors should consult with an attorney to fully understand the bylaws and determine the minimum number of member votes that could determine the liquidation of the cooperative. It may be prudent to establish a supermajority requirement for decisions involving major structural changes. Some cooperatives have established procedures under which major decisions require two separate votes of the membership with a specified "cooling off" period between them. That structure makes it more difficult for a group representing a sub-set of the membership to push through a major action. It also provides time for cooperative leaders to provide full information to the membership.

What are the procedures for distributing the residual value of the cooperative upon liquidation?

Cooperative bylaws typically state that the claims of all debtors are satisfied first followed by the claims of allocated equity holders. The procedure by which the residual value is distributed is not always explicitly specified in the bylaws. As the proportion of unallocated equity increases the importance of that residual value is also magnified. Some cooperatives have provisions to divide the remaining value on a pro-rata (even share) basis across the membership. That is obviously an undesirable structure since a group of members with very low business volume and levels of allocated equity could reap a windfall by dissolving the cooperative. While cooperative liquidations are fairly rare, the accepted procedure is to use some sort of a look back period with six years commonly considered as being a minimum. If the bylaws are silent on the number of years, the look back period it is left up to the discretion of the board of directors. Cooperative boards should examine their bylaws to ensure that any for language concerning the distribution of residual value is appropriate. If the board decides not to specify the procedures in the bylaws they should develop a clear policy statement concerning the distribution of residual value that could be communicated to members if need be.

Does the cooperative have the right talent on the board of directors?

As cooperatives transitions to permanent equity members tend to become less involved in governance since their benefits stem from customer transactions. This makes it important that the board has the best talent with expertise in areas such as finance, governance, strategy, and succession planning. Boards should re-examine their criteria for board candidate eligibility and recruitment to ensure that members can select from a diverse set of candidates with the needed expertise. In a "traditional" family farm structure, the cooperative's membership was held in the husband's name which made him the legal member of the cooperative. Consequently, communications from the cooperative such as announcement of the annual meeting, director nominations, ballot for directors, patronage checks, and similar communications were often put in the husband's name. It also meant that only men could be legal nominees for the board of directors. It is not complicated to create multiple legal members of a cooperative that reflect all members of a multi-generational farming family. This gives the cooperative access to a broader and more diverse set of directors that reflect the modern membership in the cooperative.

Is member control balanced with the need for deliberate decision making?

Most cooperative annual meetings follow a traditional structure covering the areas required by the governing documents, reports from the auditor, chairman of the board and manager, followed by the election of directors. Some cooperatives have implemented a call for director nominations months before the annual meeting. The director biographies, personal statements from the candidates are then mailed out, along with the director ballots. The results are announced at the annual meeting. The rationale for this change in board election procedure is that it is a better structure for recruiting the best director candidates and informing members of their qualifications. It also limits the ability of a minority of members to force a change in governance by nominating directors from the floor at the annual meeting. The member's right to control is maintained, and likely enhanced, through the mail in nomination and voting process. Members also maintain the right to petition for a special meeting of the membership.

Conclusions

The equity structure in some sectors of agricultural cooperatives has shifted rather dramatically away from allocated and toward unallocated equity. This has been driven by both practical reasons such as the availability of tax credits as well as fundamental changes in business philosophy. These new equity structures create a higher potential threat of demutualization. Cooperative boards can adjust equity structure but the adjustment process occurs over a period of time. Cooperatives with high portions of unallocated equity should examine their governance structures to ensure that the voting rights are held by active members, that quorum and liquidation thresholds are appropriate. They should also implement communication efforts to ensure that the membership is on-board with the business philosophy and understands the rationale for permanent capital.

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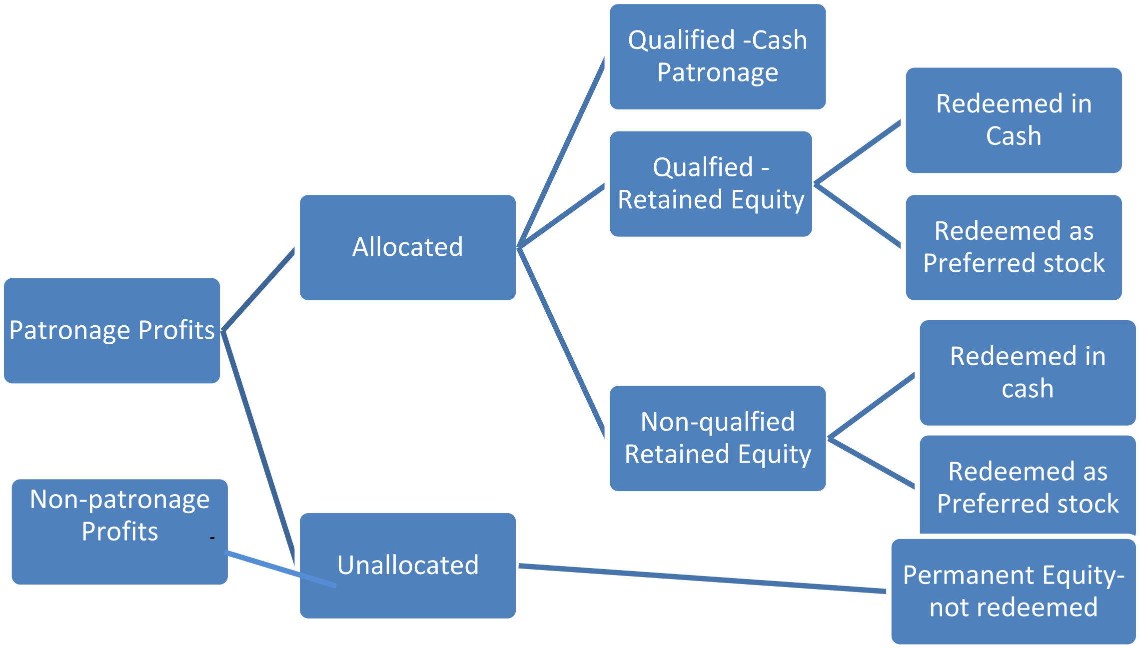

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Figure 1. Different types of equity classes available for a board of directors to consider in the income distribution decision

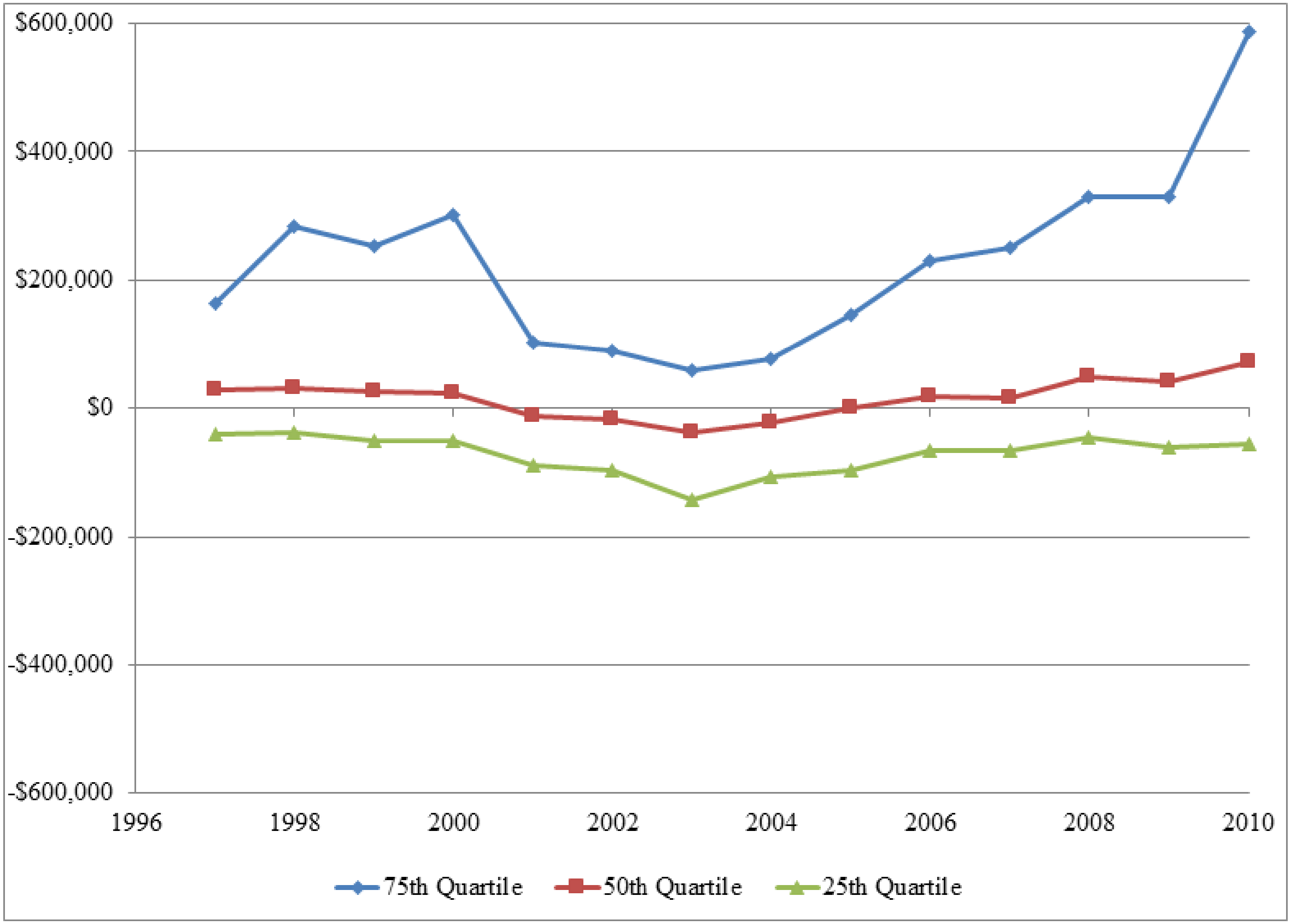

Figure 2. The net difference between capital expenditures and depreciation for local grain marketing and farm supply cooperatives, 1996 to 2010 (Boland 2012)

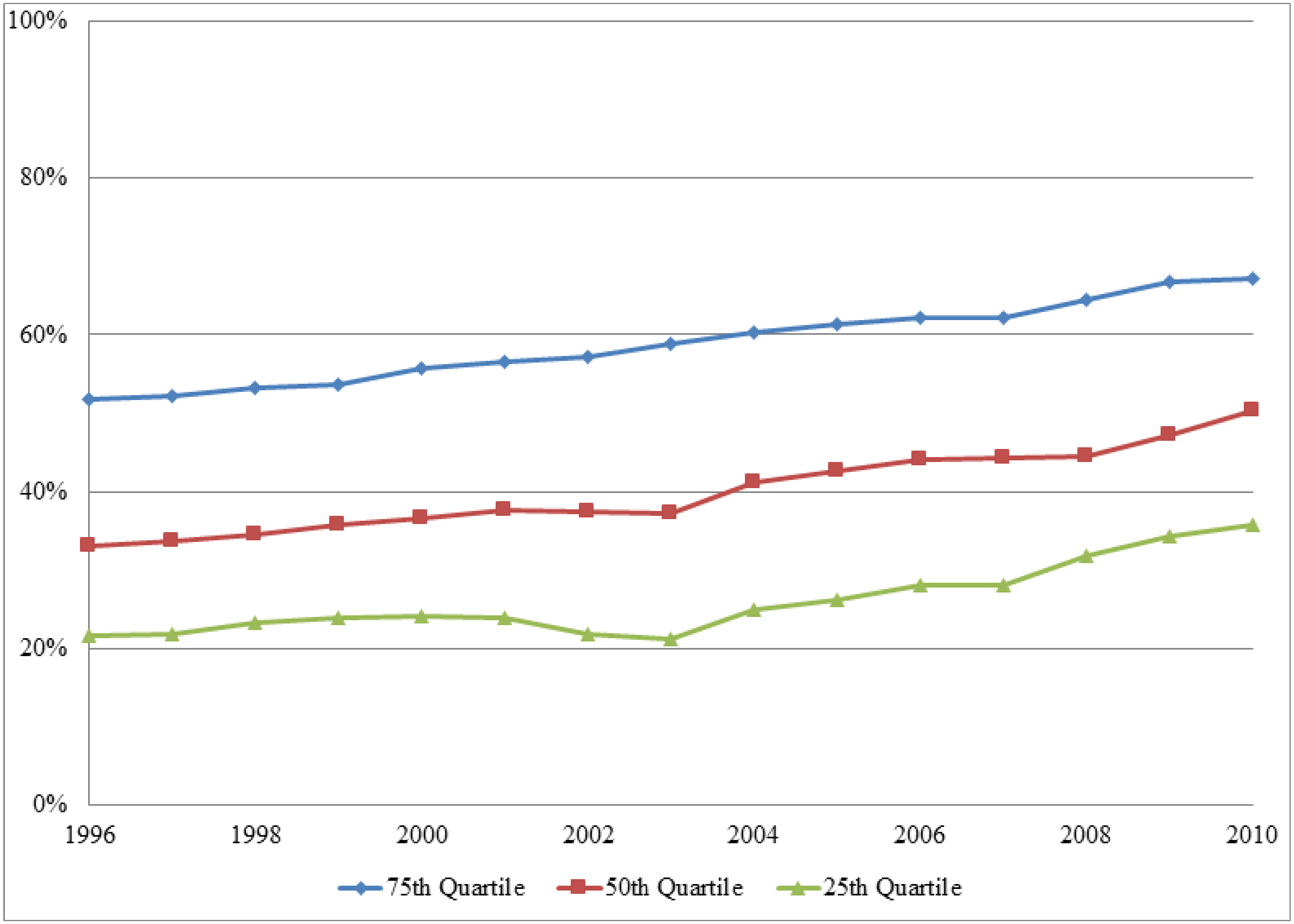

Figure 3. Unallocated income as a percentage of total equity for local grain marketing and farm supply cooperatives, 1996 to 2010 (Boland 2012).