Governance Implications of Higher Levels of Unallocated Equity

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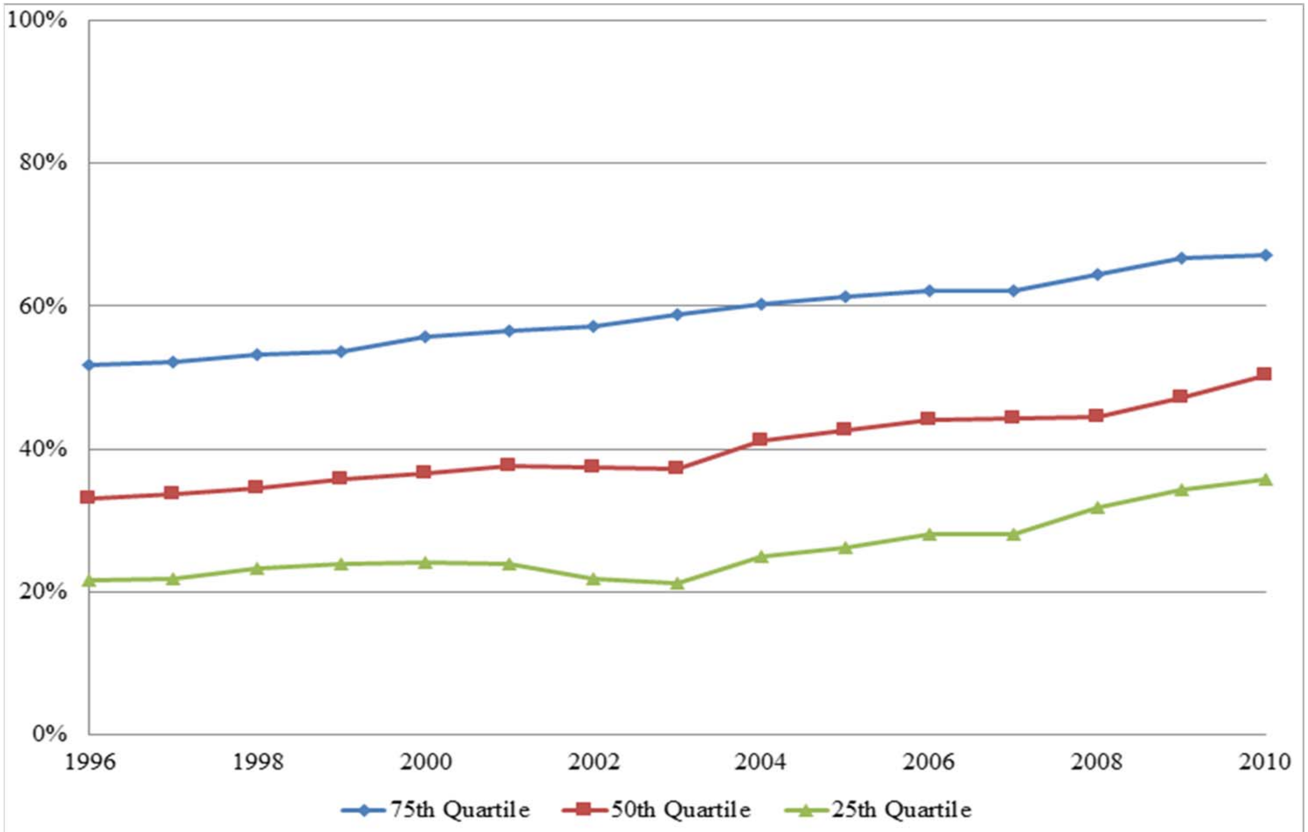
Background

- Cooperative equity structure is one of the most unique aspects of the business model
- Most U.S. agricultural cooperatives function under a structure of a small membership share and revolving equity distributed as patronage
- Consistent with "user owner" and "user benefit" principles

Origins of Unallocated Equity

- 1911: National Farmers Union suggested that it was permissible to retain a portion of profits as unallocated reserves
- 1922: IRS recognized that it was prudent to have a portion of equity as unallocated-typically interpreted as 10% total equity
- "User Benefit" principle relaxed and a new dimension of "User Owner" was created.

Recent Growth of Unallocated Equity



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

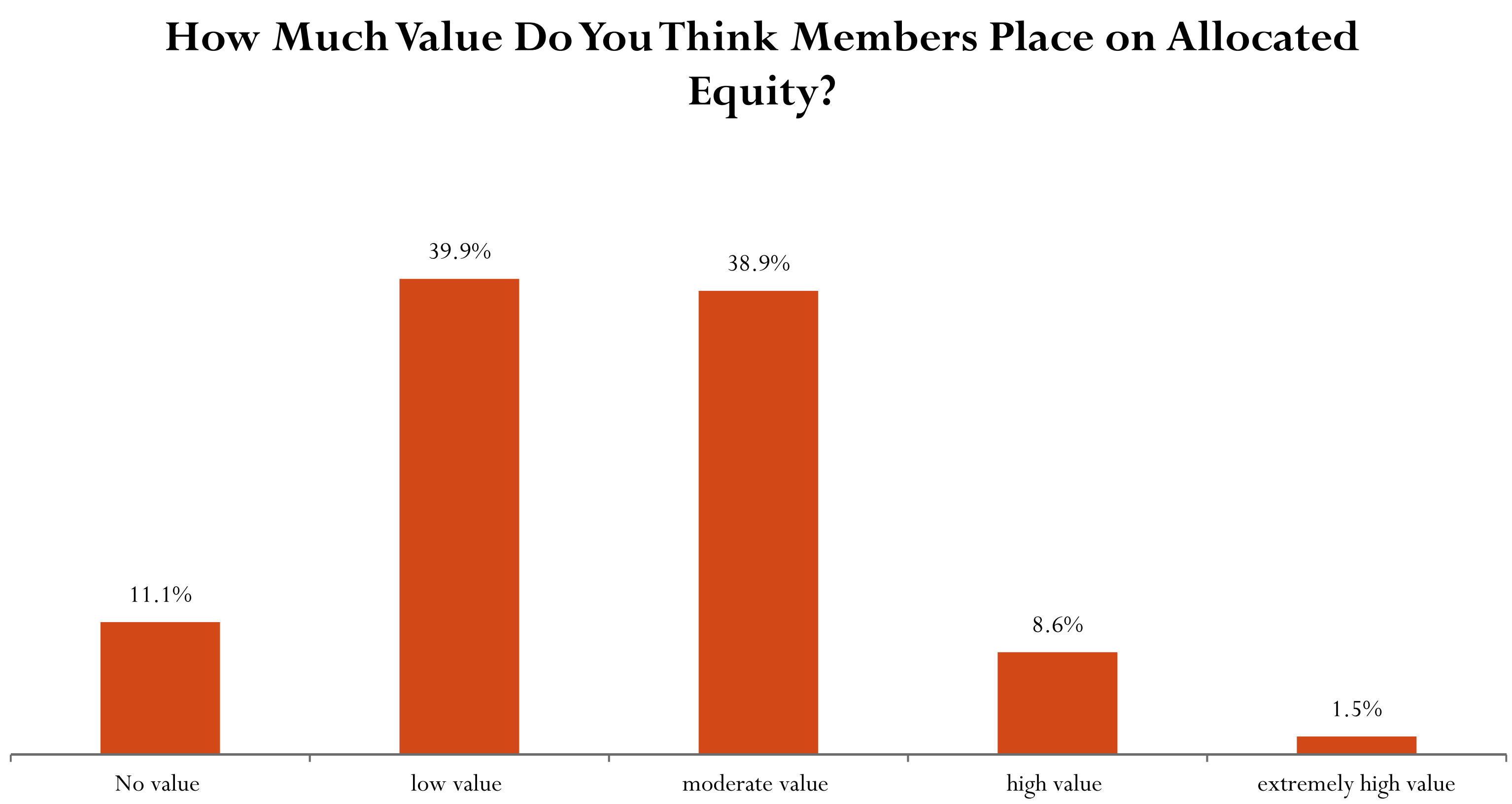
Driving Forces

- Need to invest in new assets
  - Increase in crop yields
  - Changing cropping patterns
  - Parallel increase in crop inputs
- Section 199 Tax Credit
- Changing attitudes of the board of directors
  - Retaining regional patronage as unallocated
  - Retaining a higher portion of member-based profits as unallocated equity

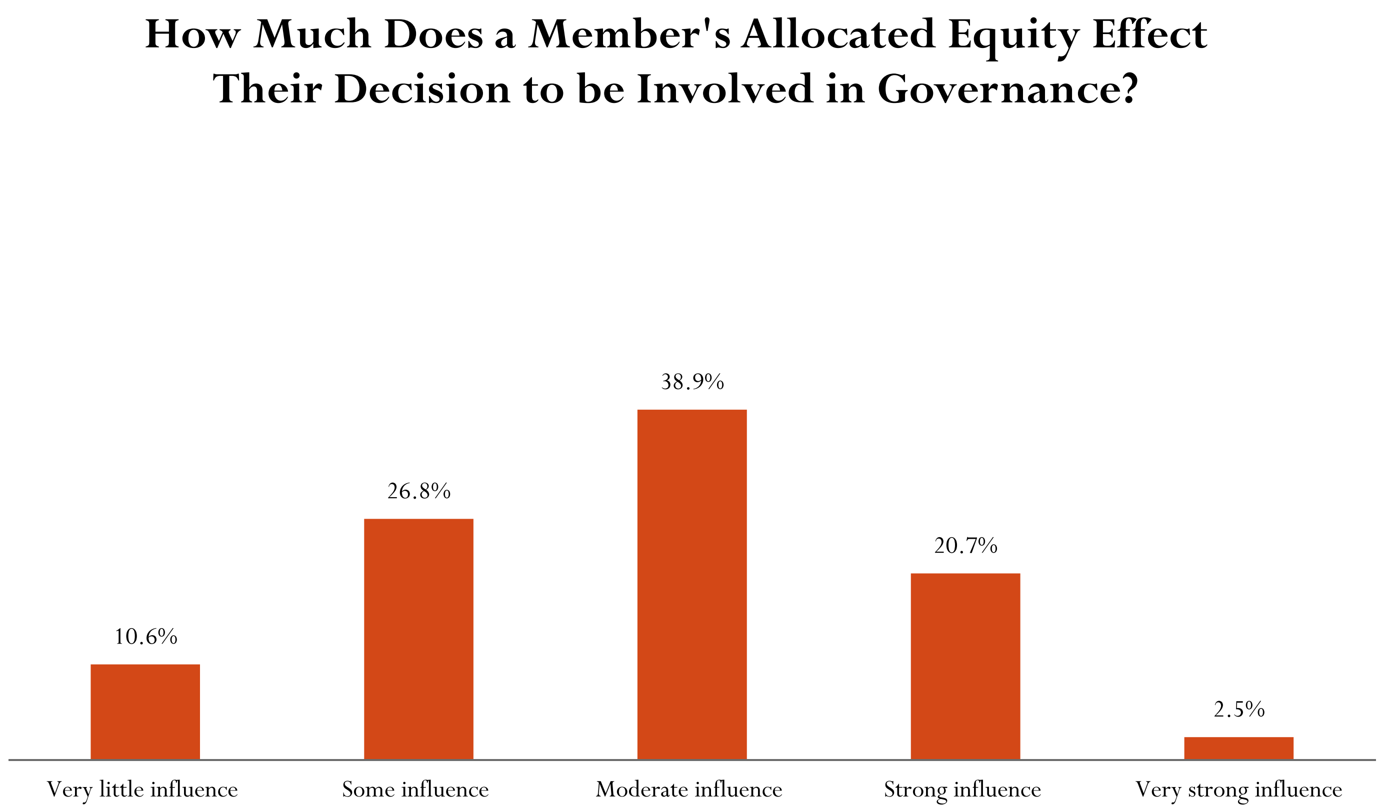
Implications

- Balance sheet structure doesn't matter if members are satisfied with services and opportunity for future patronage
- One member-one vote system could enable inactive members to liquidate the cooperative to gain access to the unallocated equity
- Results of national survey suggest at least a moderate threat

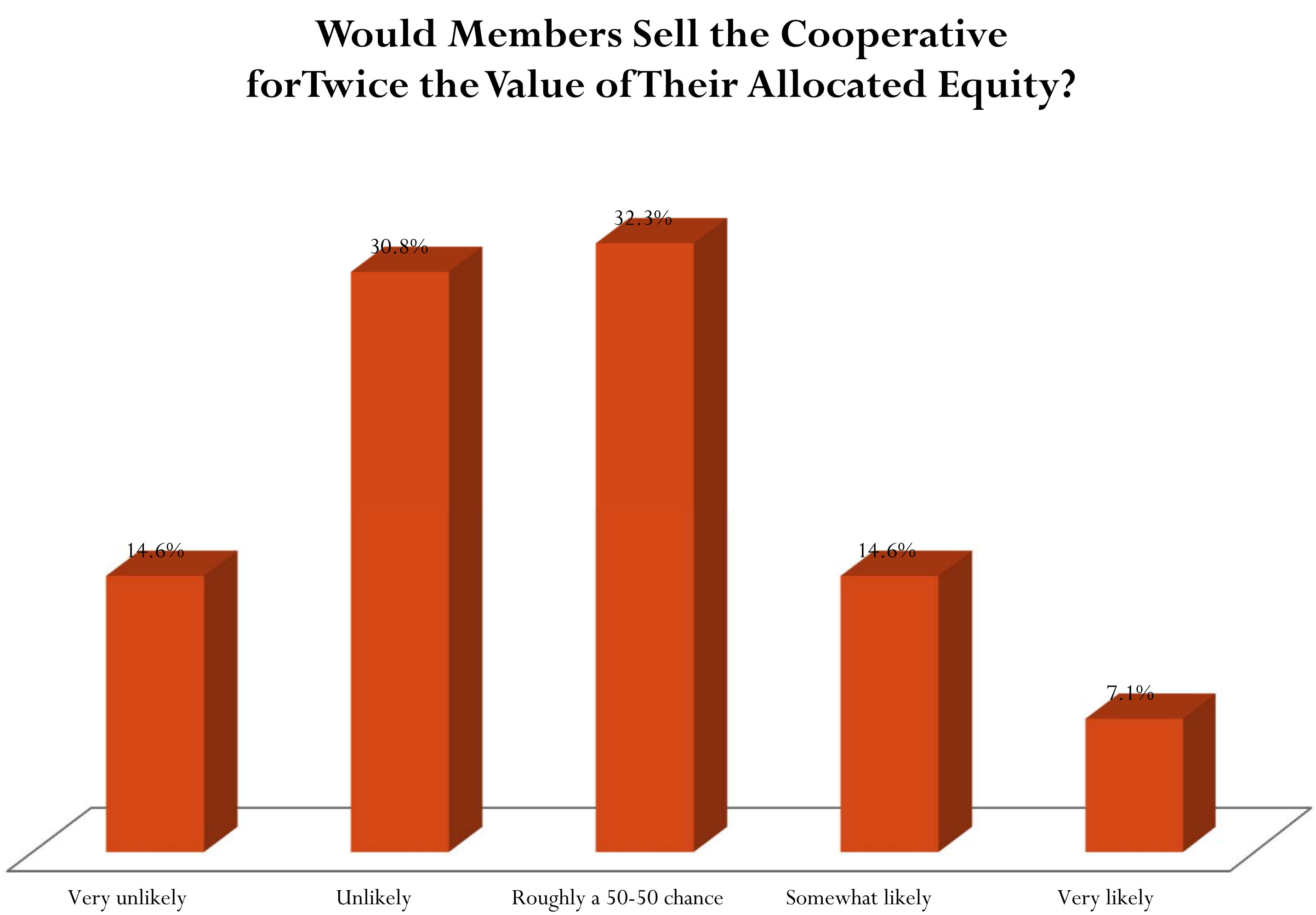
Around 50% Think Members Place Moderate to High Value on Allocated Equity



62% Think Allocated Equity Influences Involvement



54% Thought That Members Would Sell at 200% Allocated



Change in Business Philosophy

- Argument that members place little value on revolving equity
- Argument that members are most interested infrastructure and are willing to fund the next generation
- Other cooperative forms such as credit union operate without revolving equity
- Some family owned companies are controlled by members with small portion of total ownership capital

Other Possible Adjustments

- Retain future profits as allocated equity-possibly as nonqualified equity
- Pay dividends on allocated equity which are funded from non-member profits which would otherwise be retained as unallocated equity
- "Reallocate" a portion of the unallocated equity
- Create "indivisible reserves"- class of unallocated equity that cannot be distributed in liquidation but is instead used for new cooperative development or for cooperative organizations

Is "Reallocating" Possible?

- Have to be in the form of nonqualified since the 8 ½ month time period for a qualified distribution has expired
- Would have to demonstrate that the equity being reallocated came from member-based profits
- Would require the records to essentially recalculate patronage which might make it impractical to go back past the most recent few fiscal years
- No precedent that we know of

Indivisible Reserves

- ICA specifies IR as a component of its 3rd cooperative principle: "member economic participation."
- Common in European cooperatives where retained indivisible reserves are tax deductible. Often mentioned in context of workers cooperatives
- Would require changes to Bylaws and possible Articles of Incorporation
- If members truly buy in to a permanent capital model then the indivisible reserve structure is logical.
- Are members really indifferent to property rights to equity capital?

Higher Unallocated Equity and Communication Efforts

- Make sure members "buy in" to the change
- Communicate the need for infrastructure re-investment
- Emphasize the value for future generations
- Explain the value of future patronage and use

Governance Changes: Voting

- Purge voter roles of inactive members
- Establish a threshold of annual business to maintain voting privileges- Example: $5,000
- Increase the majority threshold for a special meeting and/or a motion to dissolve the cooperative
- Require two different membership votes with "cooling off period" for major actions
- Clarify when the board of directors has an obligation to take an outside offer to the membership

Governance Changes (continued)

- Define and communicate the procedures for distributing the residual value in liquidation
  - Active members during a specified look back period
  - Define requirements for active membership
  - Define a specific look back period. (some auditors suggest that 6 years is a minimum)
  - Those defined procedures reduce the incentive of inactive members to pursue liquidation

Board Succession

- Firms controlled by a smaller sub-set of active owners tend to yield more power to the CEO
- Places more emphasis on having the right talent in the board room
- Active process of director recruitment and nomination helps to prevent nominations from the floor
- Good time to address gender diversity and nomination and voting processes

Changing Board Election and Annual Meeting Format

- Call for director nominations months before the annual meeting
- Ballots, nominee statements and biography are mailed
- Director election results announced at annual meeting