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The Transition to New Cooperative Organizational Forms: Public Policy Issues

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Recent organizational innovations in cooperative business structures have created renewed concerns over public policy treatment of agricultural cooperatives. These innovations have also presented new questions about the ability of the legal system to treat organizations as dynamic entities that evolve in response to internal and external forces. The transition to new types of equity structures, the use of outside board members, and the creation of defined membership cooperatives can all be seen as specific responses to internal and external forces affecting organizational performance. They are only three of a number of recent innovations used in cooperative business structures. Examining this transition process will require a new type of legal framework—one that understands these internal and external forces and can identify the potential legal issues arising during this transition process.

As cooperatives evolved in the United States, they became successful in correcting, or at least ameliorating, the negative economic impacts of market failure. Consequently, the strategic behaviors of non-cooperatives began to modify. Prices differed little between cooperatives and their non-cooperative competitors. Cooperative members began to scrutinize the costs of transacting with their cooperatives. These coordination and motivation transaction costs are generated by a vaguely defined "user versus investor" set of property rights. These property rights are not clear to members or management and the multiple interpretations of

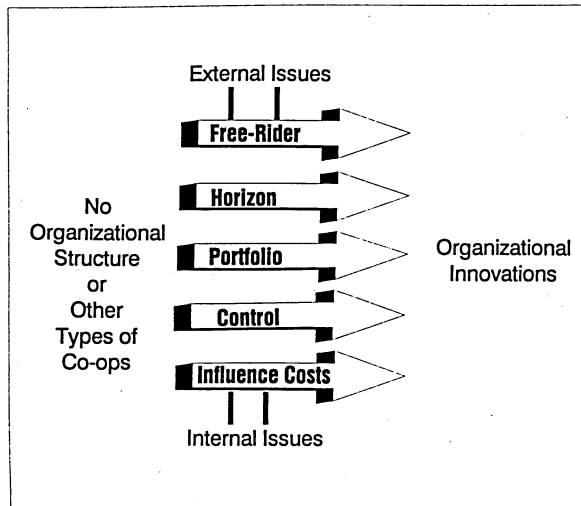
these vaguely defined rights lead to conflicts over residual claims and decision control, especially as cooperatives become increasingly complex in organizational structure. Conflicts over residual claims and decision control caused by the unique user-driven characteristics of cooperatives can be categorized as the: 1) free rider problem, 2) horizon problem, 3) portfolio problem, 4) control problem, and 5) influence cost problem (for details see Cook). ✓

The vast majority of producers encourage cooperative leaders to examine the negative consequences of these problems, especially those that act as disincentives to investing risk capital. Consequently, cooperatives adopt more proportional operating policies such as base capital plans, proportional voting, narrowing product scopes, pooling as a business unit basis, and capital acquisitions on a business unit basis. As the multipurpose and marketing co-operatives adopted these more "proportional" characteristics, producers started developing a new cooperative organizational form that attempts to reduce the costs of these vaguely defined cooperatives. This new cooperative organizational form is known as the new generation cooperative.

However, this transition to new organizational forms or other organizational innovations, is not boundless. There are both internal and external issues that affect this transition process and limit the array of available choices.

Figure 1 is a simplistic depiction of this transition process in which the attempt to over-

Figure 1. Internal/External Issues and Conflicts Affecting Transition to New Organizational Forms



come the vaguely defined property rights presents both internal and external issues. Internal issues are those that arise within the boundaries of the organization, such as organizational failure, bureaucratic costs, speed of decision-making, trust, coordination mechanisms, and costs of monitoring. External issues are those that exist external to the organization itself, such as the legal and financial systems and culture—all of which may affect the performance of an organization or the transition to new organizational forms. These categories are not mutually exclusive since solutions to internal issues may create additional external ones. For example, some defined membership cooperatives have created delivery rights clearinghouses to facilitate the exchange of tradeable shares among members and prospective members of the cooperative. A clearinghouse or secondary market is often established to circumvent the registration and ongoing reporting requirements under the securities laws. However, the costs of setting up an internal system to coordinate and monitor trading activity may also include the threat of insider trading liability.

The focus of this paper is the legal system, which is just one of the external forces affecting

the creation of, and transition to, new organizational forms. To date, much of the focus has been on smaller parts of a larger picture. This focus on our legal structure as a collection of discrete parts, however, may obscure the need to understand the evolutionary process of organizations. It also may delay revisiting the purposes of public policy treatment of agricultural cooperatives and other types of producer collaboration.

The explosion of cooperative action in the Upper Midwest in the early 1990s has brought renewed institutional interest in collective action in the agricultural sector. The success of these new cooperatives has been followed by a number of attempts nationwide to replicate this success. Entities attempting to stimulate cooperative action often focus on the positive externalities of producer collaboration, with much attention given to the economic value these new organizational entities can bring to producers and surrounding regions. Some have also recognized there may be additional dimensions of value to rural areas, although further research needs to be done to determine the actual effects upon the human capital and social capital dimensions within communities linked to defined membership cooperatives and other types of new cooperative organizational structures.

As producer groups find new ways to put into operation the user-owned, user-benefited, user-controlled characteristics of cooperatives, there is continued uncertainty about the extent to which state and federal courts and legislative bodies will value these new forms. This rapid evolution of, and experimentation with, cooperative organizational structures has created a new and urgent need to reexamine these issues since there is growing concern whether the statutes first promulgated in the United States in the 1920s are suitable for the organizational structures of tomorrow.

Additionally, there are concerns that the legal system's current treatment of producer collaboration will substantially hinder new types of organizational innovation that may have positive externalities.

A common argument is that our existing legal framework is sufficiently flexible to accommodate new ways of operating as a cooperative while still providing adequate safeguards for other concerns, such as consumer protection, prevention of market power abuses, and distributional issues. Others point to specific examples of how current statutory frameworks hinder organizational innovation. For example, a number of commentators highlight specific legal concerns of existing cooperatives and the tradeoffs cooperatives are forced to make given the current legal framework (for example, see National Council of Farmer Cooperatives). Additionally, there are a number of broad legal issues at the state and federal levels that need to be examined. These issues include the uncertainty in the direction of public policy and its effect on organizations, consistency between state and federal approaches to cooperatives, consistency between the cooperative statutes and public policies of states, and the fundamental purposes of cooperative statutes. The discussion of legal issues presented below is not comprehensive, nor are most of these issues mutually exclusive. The discussion may, however, provide a framework through which we can identify the legal barriers producer groups encounter in developing new types of organizational structures. An expansive discussion of specific legal issues is beyond the scope of this paper; however, in-depth analyses of these issues are forthcoming.

At the federal level, public policy treatment of cooperatives has not changed dramatically throughout the 1900s, with continued recognition for the need to allow producer collaboration. Most of the articulated public policy to date has focused on the defensive nature of producer collaboration and it is not clear whether offensive strategies, such as entry into value-added processing, will be given the same treatment. At the state level, there has been more activity, with a dramatic transition over the last decade in a limited number of states toward

more flexible statutes that provide a wide array of choices for producers desiring to collaborate economically.¹ It is at this level that statutory provisions primarily affect the permissible equity, membership and management structures of cooperatives, as well as their ongoing operations. There are concerns, however, that new innovations in organizational structure will test the boundaries of public policy protection. The increased use of defined membership cooperatives in the Upper Midwest, along with increased institutional interest in facilitating the growth of these new entities, however, has prompted many states to question whether these boundaries may need to be modified.

Many of the new organizational innovations are related to cooperative equity structures. At both the state and federal levels, legal concerns relating to these new equity capital structures present some of the most challenging legal issues. In an attempt to correct for the portfolio and horizon problems, many new organizational forms involve the creation and sale of delivery rights. These new types of organizations are different from earlier cooperative structures in that they have developed a system of contracts tied to the processing capacity of the cooperatives. These tradeable rights, which can fluctuate in value, essentially solve the portfolio and horizon property rights issues in that they allow members to align their current use with current benefits. The tradability and appreciability characteristics of these assets, however, do raise fundamental legal issues.

Chief among these issues is whether delivery rights are securities—a concern at both federal and state levels. The issue of whether membership stock is a security was the subject of judicial action in the 1920s, at which time it was recognized that the cooperative structure was fundamentally different than other types of organizations. These decisions were based upon what we might now consider standard cooperative organizational structures, and courts were

swayed by the fundamental purposes of these organizations.

The registration and reporting of financial instruments under state and federal securities laws is often a costly and time-consuming process. If delivery rights are securities, the Securities Acts of 1933 and 1934 have exemptions that may alleviate registration and reporting requirements. Two of these exemptions have been used extensively by defined membership cooperatives: 1) Internal Revenue Code Section 521 exemption² and 2) the intrastate exemption.³ The former is the most widely-used among the new defined membership cooperatives in the Upper Midwest; however, it has, in recent decades, become more strict in its operation. The intrastate exemption is also very strict, with potential loss of this exemption with just one out-of-state sale of stock. The cooperative exemption under the Securities Act of 1934 provides a broader exemption for cooperatives and does not pose the same level of concern as the Securities Act of 1933.⁴

Courts have used various tests over the years to determine when a financial instrument is a security and thus subject to registration and reporting requirements. To date, there have been no definitive answers regarding the status of delivery rights as securities; however, all commentators agree this is a complex issue.

Past judicial decisions may frame this issue and provide guidance. For example, using the "investment contract test," the United States Supreme Court in *S.E.C. v. W.J. Howey*⁵ stated that a financial instrument is subject to the securities registration requirements when a person: 1) invests money; 2) in a common enterprise; 3) is led to expect profits; 4) solely from the efforts of a promoter or third party. The 9th Circuit expanded upon this last requirement in *S.E.C. v. Glenn W. Turner Enterprises, Inc.*⁶, stating that the issue is "whether the efforts made by those other than the investor are the undeniable significant ones, those essential managerial efforts that affect the failure or

success of the enterprise." It is this fourth factor that is most relevant in the discussion regarding delivery rights as securities in that the user-controlled characteristic of cooperatives requires member involvement in the ongoing operation of the organization.

In *Landreth Timber Co. v. Landreth*⁷, the U.S. Supreme Court used a different test. In finding financial instruments to be stock, the court stated it would look for: 1) right to receive dividends; 2) negotiability; 3) ability to be pledged; 4) voting rights in proportion to amount of stock owned; and 5) appreciability in value. The court also stated that public perception is relevant. While delivery rights in defined membership cooperatives potentially exhibit a number of these characteristics, the use of one-member one-vote as an operating principle will at least preclude a finding of the fourth factor in this test.

In *Reves v. Ernst & Young*⁸, the court stated that a number of factors would be examined, such as 1) motivations of buyer and seller; 2) plan of distribution; 3) reasonable expectations of the investing public; and 4) presence of other risk-reducing factors. Although this test has not been used to find a cooperative interest as a security, this may provide a number of issues for cooperatives to consider in their ongoing educational and public relations programs.

In a series of housing cooperative cases, court treatment of various types of equity arrangements may be illustrative. In *United Housing Foundation v. Forman*⁹, for example, the court found a number of factors relevant in determining that the cooperative stock was not a security. The factors listed by the court may not be those found in new cooperative organizations in the agricultural sector (for a discussion on the relationship between housing cooperative and agricultural cooperative court cases, see Noakes). Organizationally and operationally, the housing cooperative in *Grenader v. Spitz*¹⁰ differed from the one in the *Forman* case; however, the 2nd Circuit did not find these

differences substantial enough to vary the end result. In this case, members had the right to sell membership stock to prospective tenants at current market value with board approval; however, the court found that cooperative members were not led to purchase membership stock with the expectation of profits. Among these factors was the presence of equal voting rights, regardless of shares owned, and the presence of transfer restrictions in which members only had the right to transfer shares with permission from the cooperative.

The court also stated that even though the shares could potentially appreciate in value, the investment was not for profit-making, and members only had the right to sell shares to prospective tenants at the initial purchase price.

It is unclear which test a court might use and which factors are likely to be emphasized if the question of whether delivery rights of defined membership cooperatives are securities is ever before a court. Depending upon the specific test used, courts could reach very different results. Relying on the "expectation of profits" criteria used in the housing cooperative cases, for example, may result in finding delivery rights as securities. Alternatively, an emphasis on the user-owned, user-controlled, and user-benefited characteristics of agricultural cooperatives may lead a court in the other direction.

Because of the variance in securities law treatment of agricultural cooperatives across state lines and the availability of the intrastate exemption as an option under federal securities laws, start-up cooperatives may seek to avoid crossing state lines in the expansion of their membership base. Eleven states presently do not have a cooperative exemption in their state securities laws, thus there may be situations in which new cooperatives seeking members and equity may be required to register in one state and not in another (for an overview of recent changes in state cooperative securities treatment, see Reilly, 1996b). If one state has a cooperative exemption and another does not, it

is unlikely that the cooperative will expend the additional monies necessary for registration and reporting unless there is some level of certainty about the number of potential members living in the state without the cooperative securities exemption. For small, geographically concentrated cooperatives this may not be an issue; however, the large total equity required for viable value-added enterprises may necessitate a larger membership base than can be obtained in a small geographic region. Additionally, cooperatives dealing with very specific commodities may require wider geographic boundaries from which to solicit members and start-up equity.

A number of arguments have been provided over the years supporting the exclusion of cooperative equity instruments from the registration and reporting requirements of the securities laws. First, it has been argued that agricultural cooperatives' narrowly defined membership base makes these entities much different than investment opportunities open to the general public. Because the good faith provisions still apply and the audience is narrowly defined to agricultural producers, it has been argued that purchasers are adequately protected from fraud on the part of issuers (Taylor). Second, members' involvement in cooperative decision-making through the election of directors and delivery of commodities may alleviate the need to have additional protection through the securities laws. It has also been argued that the Section 521 exemption is not an appropriate standard by which to give securities exemptions since the Internal Revenue Code has purposes much different than those articulated in the securities laws. Thus, tying the securities exemption to the tax status of the cooperative is not an effective regulatory strategy.¹¹ Finally, it has been argued that the costs of registration and reporting could place cooperatives at a competitive disadvantage, which could affect the use of cooperatives as a means of producer collaboration. This final point could have

significant impacts on industry structure and rural development efforts.

In addition to the securities question, there is the issue of whether state and federal statutes will allow for the transition to new equity structures. Limitations on possible equity structures may affect the array of options cooperatives have available and may be an important force in the evolution of cooperative structures (Cook).

An additional concern is whether there will be legislative attempts, as there already have been, to establish state-imposed rules for equity revolvment. State-imposed time limits on revolvment of equity is currently not a big force in the operations of defined membership cooperatives because current use and current capital requirements are aligned with current benefits; however, changes in equity revolvment requirements may provide incentives for the transition to new equity structures in existing cooperatives.

Both antitrust and intellectual property rights laws also present relevant issues for new cooperative organizational forms. As cooperatives become more offensive in nature, they may be required to become more innovative in the processing and marketing of their products. These new concerns may require increased attention to intellectual property rights such as patents, trademarks and certification marks.

Additionally, a new array of antitrust issues may arise with the advent of new organizational forms. The Capper-Volstead Act will most likely continue to provide protection for marketing and bargaining cooperatives and for those that engage in value-added processing; however, the level of future protection is not certain. As with other types of entities, antitrust law will not protect these new organizational structures from predatory practices. However, the threshold for predatory practices and anticompetitive behavior is unclear. A variety of specific antitrust issues are relevant during this transition to

new organizational forms. First, is exclusion of members a predatory practice? Second, will a system of marketing contracts and delivery rights ever rise to become a predatory practice? Third, will the use of strategic alliances and joint ventures be limited? Fourth, what types of production controls may rise to the level of anticompetitive behavior? Finally, how will antitrust laws treat the continuum of possible farm-level ownership structures in defining "producer"?

In terms of operations, the marketing agreements and delivery rights used by new generation cooperatives are primarily governed at the state level. Cooperatives engaged in value-added processing tie marketing agreements and delivery rights to the processing capacity of the organization's facilities. These contracts must be dependable and reliable if the cooperative is to operate most efficiently, thus one concern is the monitoring and enforcement rights provided through the state statutes. One additional trend is an expansion of authorized activities allowing cooperatives to engage in a much broader array of activities than previously allowed. Some states are still fairly restrictive; however, many recent amendments to cooperative statutes now allow a cooperative to engage in most any type of activity (for an overview of specific statutory changes, see Reilly, 1996a).

Changing membership structures also present new legal issues, particularly at the state level. State statutes amended in recent years have expanded permissible membership structures of cooperatives through expanded definitions of "person," and transitional cooperatives may see increased heterogeneity of membership as they begin to expand the scope of activities pursued. Again, the issue of what constitutes "producer" on the continuum of risk becomes relevant. Additionally, a cooperative may have tremendous heterogeneity of interest given the expansive nature of allowable activities, which may raise influence costs and control issues. Additional issues are the effect of limits on

stock ownership, limits on transfers of membership stock, as well as allowances for proportional voting.

Concerning the management of cooperatives, board of director liability may become a greater concern as cooperatives enter into new arenas of action and experiment with new ways of operating as a cooperative. A primary risk is liability under the securities laws, especially for interim boards and the management team in securing upfront equity. Additionally, the dependence upon delivery rights and marketing agreements may present new dimensions of conflict between the role of members and the role of boards of directors and management.

A number of broad issues are also relevant in the discussion regarding the evolution of cooperative business structures. One primary issue is the uncertainty regarding the direction of policy. Experimentation with new organizational structures or new ways of operating as a cooperative—while still keeping the user-owned, user-benefited, and user-controlled characteristics central to the organization—may affect the array of feasible choices as seen by groups of producers. As new organizational forms that continue to exhibit these three characteristics are created, there is much uncertainty about how courts and legislatures will treat these new entities. These are the characteristics that have, in tandem, set cooperative structures apart from investor-owned firms, but how far can organizational structures move along this continuum? Organizational innovations can be seen as organic responses to both internal and external forces. Thus, an important issue for our present legal system is whether we allow these organizational changes to occur or whether the legal system should limit the choice set available, managing, to some extent, the evolution of these structures.

Second, the interaction between the various cooperative-related laws at the federal and state levels may be critical in the transition to new organizational forms. This issue is relevant at

three levels—at the federal level between various cooperative-related federal laws, at the state level between various states' cooperative-related laws, and between state and federal laws. The efficiency and sustainability of a legal framework that provides incompatible incentives and barriers to organizational innovation is questioned, as well as the impact this type of system has upon decision-making of social and economic actors.

Finally, the purposes of public policy regarding cooperative action are becoming more relevant as organizational forms change. Cooperative development is increasingly seen as a tool for community economic development. Many of the arguments used in the promotion of cooperatives focus on both the need to increase producer wealth and on the importance of using a grassroots, capacity-based approach to community development. Reconciling the need for a legal system that protects consumers and investors, while at the same time providing the incentives needed for sustainable economic growth, will present a major challenge for those institutions either regulating or facilitating cooperative action. More research needs to be done to determine the appropriate institutional arrangements at the federal and sub-federal levels to support, monitor and/or direct these entities.

Notes

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1. With the exception of ten states, there has not been a series of broad, sweeping statutory changes. Rather, the majority of states amending their cooperative statutes over the past decade

have chosen to make modest changes to their cooperative statutes (for an overview of these changes, see Reilly, 1996a).

2. 15 U.S.C. 77c(a)(5)(B)(i)
3. 15 U.S.C. 77c(a)(11)
4. 15 U.S.C. 78(1)(g)(2)(E)
5. 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946)
6. 474 F.2d 476 (9th Cir.), *cert. denied* 414 U.S. 821 (1973)
7. 471 U.S. 681 (1985)
8. 507 U.S. 170 (1993)
9. 421 U.S. 837, 95 S.Ct. 2051, 44 L.Ed. 621 (1975)
10. 537 F.2d 612 (2d. Cir. 1976)
11. 1995 Resolution (reaffirmed in 1996), Legal, Tax and Accounting Committee, National Council of Farmer Cooperatives.

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