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Business Models and Producer-Owned Ventures: Choices, Challenges, and Changes

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Producer-owned business models are rapidly evolving. Producer-owned, value-added ventures face a number of organizational challenges, including capital acquisition, security exchange registration, antitrust exemption, borrowing eligibility, and operational flexibility. This paper examines the success of evolving producer-owned business models in addressing these challenges. The need for uniform criteria to distinguish producer-owned business from other business forms throughout the complex structure of policies and laws affecting value-added ventures is highlighted.

Key Words: cooperative, value-added organizational form

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Recent activity in the biofuel industry has attracted the interest of agricultural producers as a means of adding value to their crops. New biofuel ventures have been formed as both investor-owned and producer-owned firms. In 1990, three major players dominated fuel ethanol production, with ADM (Archer Daniels Midland) holding 60% of the market. The entire industry was then composed of about 20 firms. Today, that number has grown to 71, with the top three firms producing about 31% of the nation's ethanol. Of the remaining 68 firms, 44 are organized as farmer-owned cooperatives or locally owned limited liability companies (LLCs) (Crooks and Dunn). Farmer-owned plants currently account for 39% of the total U.S. ethanol capacity (Renewable Fuels Association).

Biofuel projects are just one example of a larger universe of producer-owned, value-added ventures with complex and intense processing activities. A recent study estimated that more than 80,000 producers have invested in processing facilities organized both as new generation cooperatives (NGCs) and limited liability partnerships (Merrett et al.). Although fewer than a dozen of these farmer-owned, value-added ventures existed in the early 1980s, today there are more than 165 that are operational, and at least another 100 are in some phase of development (National Corn Growers Association).

Despite this growth, the overall competitiveness of farmer-owned business forms for value-added ventures is less clear. Only 4 of the 33 ethanol plants currently under construction are farmer owned. These farmer-owned plants account for only 11% of new ethanol capacity. A number of value-added cooperatives, such as Diamond Walnut Growers, Ocean Spray Cooperative, U.S. Premium Beef, Dakota Growers, and Birds Eye, have converted to investor-owned business structures. This has led some experts to conclude that current cooperative structures cannot facilitate large-scale, complex, capital-intensive ventures (Hazen).

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This paper examines the challenges facing farmer-owned, value-added businesses and the evolution of farmer-owned business models to meet these challenges. The impact of legal issues, taxation, and information technology on producer-owned, value-added business models is also analyzed.

Background

The cooperative corporation is a common form of business in the agricultural sector (Adams et al.). Agricultural producers have used the cooperative business model to ensure themselves market outlets and sources of input supplies and to vertically integrate and gain economic power. The principles and properties of the cooperative business model have been defined in a variety of ways dating back to the Rochdale Pioneers in the mid-19th century (Zeuli and Cropp). Over time, the cooperative model has been refined through both practice and legislation. Today, the most basic cooperative business can be defined by three major principles: user-ownership, user-control, and user-benefit (U.S. Department of Agriculture 2002).

The two decades of the 1920s and 1930s are sometimes referred to as the golden age of cooperative development. The U.S. Department of Agriculture recorded over 12,000 agricultural cooperatives operating during the 1930s (Mather et al.). The activities of these firms centered on providing farm inputs and marketing bulk commodities (Kenkel).

These traditional cooperatives used an open membership system, allowing a producer to join at any time by making a small initial investment. The cooperatives built equity primarily through retained patronage (retaining profits) and per unit retains (volume-based assessments). This cooperative equity lacked a secondary market and was redeemed at book value (face value), regardless of the value of the cooperative. Thus, traditional cooperative equity has been described as nonappreciable, nontransferable, and nonredeemable (Chaddad and Cook 2004).

Neoinstitutional economists (Cook; Royer) have identified a number of challenges with the traditional cooperative structure. Resulting from vaguely defined property rights, these structural issues lead to various problems that are inherent in the traditional corporate model. Dealing with free riders and equity sourcing are just two examples of the issues that have hampered the growth of the traditional cooperative model as it strives to serve the demands of intense, value-added processing (Sykuta and Cook). These issues demonstrate that the traditional cooperative structure provides insufficient incentive for members to provide the start-up funds for capital intensive projects (Cook; Cook and Iliopoulos).

New Generation Cooperatives

Beginning in the 1990s, a new cooperative form, often referred to as NGCs, began to be used for value-added processing of agricultural products. The NGC model was viewed as correcting some of the property rights issues that plagued its traditional roots. The NGC is not a specific legal structure, but rather, it refers to a different structure of membership, equity, and delivery of benefits (Hackman). NGC members are required to make a relatively large up-front investment in order to obtain delivery rights, and supply is controlled through marketing agreements. The volume of crop inputs controlled through these marketing agreements is determined by the requirements of the processing facility. As a result, membership is closed to participating investors. However, cooperative stock (and associated delivery rights) can be traded among other producers eligible for membership. Most value-added NGCs distribute a high proportion of profits as they are earned in proportion to investment. This practice makes investment in an NGC more attractive and enhances the possibilities of appreciation (Goforth).

Although the NGC structure increases the attractiveness of cooperative equity, it has not eliminated cooperatives' problems in acquiring equity. Because NGCs are limited to acquiring capital from agricultural producers who are able to deliver the required commodity, many project organizers find that they are

unable to attract sufficient equity funds. Members reaching retirement can be forced to sell their equity in an NGC because they are no longer producers. The limited nature of the market for NGC stock (agricultural producers who are eligible for membership and able to deliver the required commodity) can also make it difficult for members to sell their stock. Although the structure of the NGC permits a more liquid equity investment, there is no formal market for exchange.

Several cooperatives with delivery right/obligation systems have created a marketing pool that can buy the specified commodity in the name of members who cannot meet delivery requirements. Although originally designed to cover emergency situations such as drought or disease, this mechanism has allowed producer members to become pure investors and forgo delivery (Nelson). This practice pushes the boundaries of the cooperative definition by moving squarely away from the principle of use. The legal limits of these delivery systems have not been tested. They bring into question the legal status of the business as a cooperative organization as outlined in legal statutes across the country. These systems also highlight the broader question of what distinguishes or should distinguish a cooperative from other business forms (Nelson).

Successful NGCs may find they are unable to finance expansion projects because they have exhausted available producer investment (Hazen). Because of constraints on additional equity and stock liquidity problems, several high-profile NGCs (e.g., Dakota Growers Pasta, Minnesota Corn Processors, U.S. Premium Beef) have converted to stock corporations or LLCs. These structures allow investors other than farmers to buy stock in the ventures and provide more liquidity to shareholders who want to sell their stock.

Investor/Cooperative Hybrids

Although the NGC solves some of the problems associated with the traditional cooperative model, the problem of raising the initial capital from the members can still be problematic. In addition, should the business flourish, it could be in need of additional equity for expansion. Outside investors could be appealing. This brings us to another evolution of the cooperative business model, namely cooperatives with nonmember equity. Known as hybrid cooperatives, LLC cooperatives, limited cooperatives, and more, this structure provides two classes of ownership: outside equity investors and patron stockholders. The entity returns are split between the two classes, with the outside investors receiving investment-based returns and the patron stockholders receiving patronage-based distributions. This structure is part of a broader classification termed investor-share cooperatives, which access outside equity through preferred stock, nonvoting common stock, and participation certificates (Chaddad and Cook 2003).

This evolution of the traditional cooperative is currently attracting attention nationwide. A number of states, including Wyoming, Minnesota, Wisconsin, and Tennessee, have enacted legislation enabling cooperative/LLC hybrids, and others are currently evaluating its potential. Efforts to develop a uniform federal law for this structure are under way by the National Council of Farmer Cooperatives. Although there are differences in individual state statutes, this structure, in general, mandates control by farmer members but can allow the investor class to receive up to 85% of the profits (Hensley and Swanson).

Investor-Focused Models

As mentioned, spurred by needs for growth, a number of cooperatives have converted to LLCs and other investor-owned business models. Producer groups seeking to establish value-added businesses are increasingly selecting the LLC form (National Corn Growers Association). This structure allows producers to invest without making delivery commitments and provides a vehicle for nonproducer equity capital.

However, although investor-focused business models eliminate restrictions on ownership, they also eliminate guarantees that profits will flow to producers and/or local

communities. As value-added efforts shift to investor-oriented business forms, there are concerns about whether the projects will continue to fulfill their original objectives. In this regard, we often think of profitability and improved member income. One study of the economic impact of farmer-owned ethanol plants concluded that the contribution of a farmer-owned plant to the local economy is over 50% larger than an absentee-owned corporate plant (Urbanchuk). However, it should also be noted that cooperative members may be concerned about counterbalancing some form of market power or providing economic stability for a local economy.

Producer groups attempting to attract nonproducer capital often struggle to understand and evaluate proposed structures and terms. Venture capitalists and other outside investors are often interested in designing an exit strategy for the venture capital participants within a 3- to 7-year time period—a concept that is contrary to the way of thinking proscribed by the traditional cooperative model. Such exit strategies often involve preferred classes of equity with provisions for cumulative dividends and conversion to common equity. Exit provisions allow the developers to repurchase the venture capital equity at predetermined price formulas, often a multiple of the firm's profits. Outside investors typically demand representation on the governing board and/or participation in management.

Producer groups eliciting interest from multiple venture capitalists can find themselves (or their consultants) analyzing a confusing array of structures, contractual obligations, and governance provisions. The resulting business structure is often quite different from the developers' initial concept and motive for incorporation. Value-added projects run into problems when the developers attempt to "pull a business plan through a new business structure" (Hanson 2002).

Legal Issues Influencing Value-Added Projects

The legal issues involved in the organization and establishment of value-added businesses are quite complex (Goforth; Hanson 2000; O'Brian). Cooperatives are not created or defined under federal law. Over 90 separate state statutes deal with the incorporation or regulation of cooperatives, with many states having separate provisions for agricultural and nonagricultural cooperatives (O'Brian). At the federal level, policies define that if a business organization meets certain restrictions, it will receive different treatment with respect to tax, antitrust, security registration, and more.

Most notable of federal cooperative legislation, The Capper Volstead Act provides cooperative members limited exemption from restrictions on collectively setting prices. Subchapter T of the Internal Revenue code allows "any corporation operating on a cooperative basis" with the option of being taxed at either the corporate or member level. Cooperatives meeting a more restrictive set of restrictions in Section 521 of the code are entitled to additional deductions. These firms, which are often referred to as 521 cooperatives or exempt cooperatives, also have advantages with respect to security registration.

Federal security regulations protect investors by requiring firms that sell or trade securities (including initial stock offerings) to undergo rigorous registration and reporting requirements. The cost of security registration has been estimated at between $200,000 and $500,000 (Bradford). The registration process can be avoided by offering the equity in a private placement where only sophisticated investors participate. This generally requires the investors to have a net worth above $1 million (excluding house and automobile) or $200,000 of annual income, along with knowledge and skill to evaluate such investments. These requirements prevent many producers from investing in private-placement ventures.

Federal policy also defines what types of firms are eligible to borrow from the federal credit system. Cooperative firms meeting a set of eligibility restrictions can borrow from CoBank, an arm of the Federal Credit System. Because of its status as a government-sponsored entity, CoBank can generally offer more

favorable interest rates than commercial banks. To borrow from CoBank, a cooperative must be an association of agricultural producers (or a federation of this type of cooperatives), have either a "one member–one vote" or a dividend restriction provision, do at least 50% business with members, and have at least 80% voting control by producer or eligible farmer associations.

Legal and Tax Issues Versus Evolving Business Forms

NGCs are typically organized as 521 cooperatives in order to receive security exchange registration exemption. Among the requirements of Section 521 of the tax code are stipulations that the common stock must be owned by agricultural producers and that at least 50% of the business volume must come from members. A 521 cooperative must also treat nonmember and members equally with respect to patronage (profit) distribution. This effectively prohibits nonmember business, because members would be unwilling to share profits with producers who had not funded the value-added business.

However, avoiding nonmember business can be problematic for growing value-added businesses. A case in point is Value Added Products (VAP) in Alva, OK. VAP was organized by area wheat farmers as a section 521 closed cooperative processing wheat into frozen pizza dough. After establishing operations, the firm discovered that a plant expansion to add pizza toppings would be a logical business move. Unfortunately, because the area farmers did not produce the topping ingredients, the toppings operation could not be considered a member business and could not be added under the existing business structure, prompting conversion to an investor-oriented model.

Hybrid cooperative structures also raise legal considerations. New investor/cooperative hybrids do not appear to qualify under the narrow definitions of a cooperative under The Capper Volstead Act and would, therefore, not have exemption from antitrust regulations (O'Brian). Hybrid entities would also likely not qualify for exemption of registration under the Securities and Exchange Commission and could face an expensive and time-consuming registration process (Hanson 2004).

A hybrid cooperative structure with less than 80% farmer control or less than 50% farmer ownership is currently ineligible to borrow from CoBank. Proposals have been made to modernize these restrictions to address evolving producer-owned business models (Jaeger). Hanson (2004) suggests that lenders and policy makers would be better served by defining a cooperative business in terms of producer benefit rather than "bright-line" limits on business structure. However, even supporters of expanded eligibility (including Under Secretary of Agriculture for Rural Development, Thomas C. Dorr) have questioned at what point hybrid organizations cease being cooperatives (Jaeger).

Summary and Conclusions

We currently are on the verge of a new era in cooperative business. The needs and demands of many modern cooperative efforts have outpaced the abilities of the traditional cooperative model. Producer-owned businesses in the United States were once organized with fairly similar structures within the cooperative business model. The advent of producer-owned, value-added businesses highlighted the limitations of traditional cooperative models. Most of these limitations are related to the limited supply of equity capital and the restrictions on ownership and supply sources.

In response to these changes, a wide variety of business models for producer-owned businesses have evolved. Despite the evolution of business models, producer-owned, value-added projects often struggle to raise equity capital for establishment and expansion. These businesses also face a wide array of organizational challenges, including security exchange registration, antitrust exemption, borrowing eligibility, and operational flexibility.

While increasing flexibility, the shift toward investor-oriented models creates the risk of reducing farmer control and benefits. These

issues have highlighted a need to reexamine the criteria for distinguishing producer-owned business and to consider how modernized criteria could be integrated into the complex structure of policies and laws affecting value-added ventures.

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