

Best Buy, Josten's and Born Form Technology Cooperative

Robert Hensley and Dave Swanson



On February 26, 2004, a new breed of company was formed in Minnesota. On that date, Best Buy Co., Inc., Josten's, Inc., and Born Information Services, Inc. became the founding members of "Avalanche Corporate Technology Cooperative." Integral Business Solutions has since joined the cooperative. Approximately a year in the making, Avalanche is a technology sharing cooperative operated for the benefit of its members.

Working with Dorsey attorneys, Avalanche was formed as a result of a merger of Avalanche Software LLC, a Delaware limited liability company, into Avalanche Corporate Technology Cooperative, a new entity formed under Minnesota Statute Chapter 308B.

The Business Model of Avalanche Corporate Technology Cooperative

For years companies have been paying huge dollars to develop their own software and technology systems. The founders of Avalanche saw an opportunity to share the technology developed by their companies with other companies. According to Jay Hansen, the President of Avalanche, "There is a huge opportunity for our members to reduce costs and increase control of mission critical software through collaboration and shared risk. We will work closely with our members to help them identify, develop, and manage software that is specific to their business at a much lower cost than historic levels." The current initiatives that Avalanche is undertaking on behalf of its members include:

- Application Integration Tools and Methodologies
- IT Management and Operation Tools
- Performance Projects for Application Servers
- Oracle Repository
- JDEdwards Repository

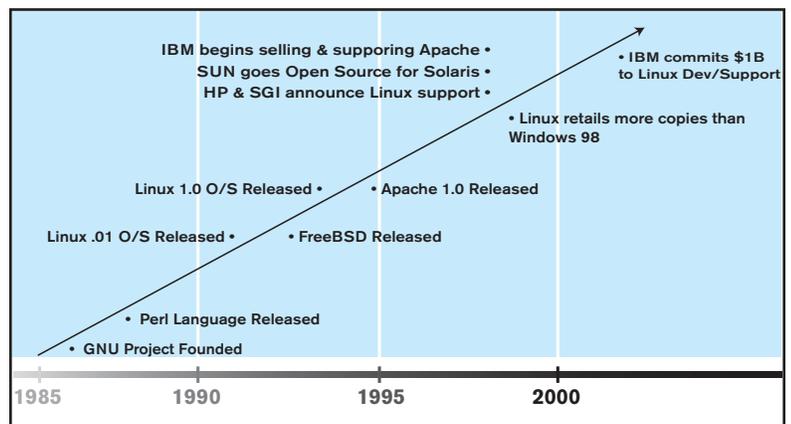
The basic business model followed by Avalanche is that members of the cooperative are encouraged to collaborate in the development of software and other technology that is utilized internally within the member companies. When a member contributes software to the cooperative, other members will have access to the contributed software. All of the members will have access to the shared technology and the ability to modify the technology to fit their own particular business needs.

What is Open Source?

Open Source and Collaborative Source are models that have been used by developers for years. They have served as the foundation for many of technology's greatest achievements, including the Internet, World Wide Web, Linux Operating System and the Apache HTTP Web server. Although there are variations in licensing, the principle behind each one is to promote collaboration among developers and corporations in order to create the most viable and cost effective solution for a specific community or organization. The collaborative model allows organizations to reuse, extend, enhance, and leverage community skills, which ultimately ensures the preservation of information systems and protects existing investments in business applications.

History of Open Source

The Open Source model has been actively used by various organizations since the mid-1980's. It is estimated that \$55 Billion of hardware was shipped with Open Source software last year and that \$68 Billion will be shipped in 2005.



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Given the growth of Open Source software and the benefits of collaboration, Avalanche serves a niche for its members by serving as a central location for the sharing of ideas, concepts, and technology.

Avalanche Is Member Controlled

Another unique feature of Avalanche, is that as a Chapter 308B cooperative, the cooperative is member-owned and can have multiple membership categories. As Hansen puts it: "I work for the members of Avalanche. My number one goal is to deliver results for the members, which translates into saving them money and delivering business opportunities over the long haul."

Avalanche anticipates having members in several categories, including corporate users, vendors, and service providers. Members who utilize the services of the cooperative are classified as Patron Members. Patron Members are required to execute a Subscriber Agreement with Avalanche and have the right to elect the Board of Directors of Avalanche. According to Hansen: "This business is truly a cooperative. It is member-owned and member-controlled. It is our members who establish the goals for this business, and my job is to achieve those goals."

Although Avalanche is member-controlled, as a 308B cooperative, the new statute does allow Avalanche the opportunity to bring in outside equity, if necessary. In addition, the statute allows Avalanche considerable flexibility in designing incentive compensation programs for management, a flexibility not generally available under most state cooperative statutes. As Hansen puts it: "We have tremendous flexibility going forward and strongly believe that this platform provides us with the opportunity to significantly grow the company."

The New 308B Cooperative Model

In 2003, the Minnesota Legislature adopted the Minnesota Cooperative Association Act, codified as Minnesota Statutes Chapter 308B. The theory behind the new Chapter 308B is that the existing Cooperative Law found in Chapter 308A does not allow for sufficient flexibility in obtaining outside equity investment in a cooperative. Thus, the purpose of the new Chapter 308B is to dramatically change the permissible equity structures of a cooperative. Here are a few additional highlights of the new statute:

- **Tax Treatment.** A cooperative formed under Chapter 308B can elect to be taxed as: (1) a partnership under Subchapter K of the Internal Revenue Code and receive pass-through tax treatment, (2) a cooperative under Subchapter T, or (3) a corporation under Subchapter C. A potential benefit of electing tax treatment under Subchapter K is that the profits from non-member business would receive pass-through tax

treatment and avoid the "double tax" on non-member business under Subchapter T.

- **Outside Investor-Members Permitted.** A cooperative formed under Chapter 308B can have outside Investor-Members who own equity in the cooperative and who do not patronize the cooperative. Investor-Members may receive up to 85% of the profits from the cooperative. Thus, as a practical matter, the cooperative may be 85% owned by an Investor-Member who does not patronize the cooperative (although the Investor-Member could in theory own 99.99% of the equity).
- **Governance.** The statute allows for flexibility in governance and financial rights.
 - **Bloc Voting.** Chapter 308B provides that the members may agree to "bloc" voting, meaning that the Patron-Member(s) vote as a group and the Investor-Member(s) vote as a group. This bloc voting can apply to votes by the Board of Directors and/or votes by the Members.
 - **Board of Directors.** Chapter 308B provides that the Patron-Member directors shall hold at least 50% of the voting power "on general matters of the cooperative" (emphasis added).
 - **Audit Committee.** Chapter 308B requires that the cooperative establish an Audit Committee. Rather than establishing a sub-committee, Chapter 308B cooperatives may instead elect to have the Board as a whole serve as the Audit Committee.
 - **Members.** The Bylaws may not reduce the collective Patron-Member vote to less than 15%. Thus, the Investor-Member may hold up to 85% of the member voting rights.

The basic purpose of the new statute is to allow an entity to be formed under Minnesota law that has significant flexibility with regard to its equity structure, tax treatment, and governance structure.

The Future of Avalanche

So what will be the future of Avalanche? The cooperative expects its membership base to continue to grow. Already, a number of other "blue chip" companies have expressed interest in membership in the cooperative. According to Jay Hansen: "Companies see the value in the concept of Avalanche. Because of our existing membership and new members that have committed to join, we believe that not only will Avalanche be a benefit to our members, the cooperative will eventually become an indispensable part of the operations of our members." Only time will tell, but with the support of members like Best Buy, Josten's, Born and Integral Business Solutions, the new cooperative seems destined for success.

Robert G. Hensley is a Partner with the law firm of Dorsey & Whitney LLP and represents clients on a variety of business issues, including business formation, contracts, joint ventures, risk management and governance issues. He is active in the Agribusiness, Cooperative and Rural Electric Law practice group and represents agribusinesses, cooperatives and companies throughout the United States. He is also a member of the firm's Closely Held Businesses practice group and advises clients on general business issues, including formation, shareholder agreements, shareholder disputes, mergers and acquisitions, succession planning and tax planning. Mr. Hensley is an Adjunct Professor of Law at the University of St. Thomas Law School, where he teaches Business Planning. He can be reached at (612) 340-2655 or at hensley.robert@dorsey.com.

Dave Swanson is the Chairman of the Agribusiness, Rural Electric and Cooperatives Practice Group and Partner with the law firm of Dorsey & Whitney LLP. Mr. Swanson has devoted his legal career almost exclusively to working with cooperatives and related organizations. His work has been primarily split between rural electric and agricultural cooperatives, and has also included work with several cooperative finance organizations and cooperatives in various other industries. He specializes in cooperative consolidations/mergers, cooperative equity issues, financing transactions and organization of new cooperatives and

cooperative joint ventures. Mr. Swanson is a frequent speaker and author. He can be reached at (612) 343-8275 or at swanson.dave@dorsey.com.

Jay Hansen is the President of Avalanche Corporate Technology Cooperative. He can be reached at jayhansen@projectavalanche.org. Learn more about Avalanche by visiting its website at www.projectavalanche.org.

For more information on Avalanche, please also read the following press releases:

Star Tribune (4/14/04)

Wall Street Journal (4/12/04)

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Can Business Conduct Be Legislated by a Code of Ethics?

By Robert G. Hensley

Editor's Note: This is the second in a series of articles by the author on policies and procedures dealing with accounting and regulatory issues.

The Sarbanes-Oxley Act ("SOX Act") requires public companies, including cooperatives that register their stock with the Securities and Exchange Commission ("SEC"), to disclose whether or not they have adopted a code of ethics for senior financial officers. While the SOX Act does not mandate that a public company have a code of ethics, the SOX Act does state that if a public company does not have a code of ethics, the company must disclose that it does not, and "the reason therefore." The message to public companies is fairly clear - you should have a code of ethics.

The SOX Act defines a code of ethics as standards that are "reasonably necessary" to promote:

- honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships,
- full, fair, accurate, timely and understandable disclosure in periodic reports required to be filed by the issuer, and
- compliance with applicable governmental rules and regulations.

Most public companies have altered, developed or reviewed their code of ethics in order to adopt standards that are reasonably necessary to comply with the conduct legislated by the SOX Act.

The Role of the Board of Directors

In determining whether to adopt a code of ethics, the Board should address just exactly who the company is trying to protect in adopting a code of ethics. A public company has stockholders, often thousands or millions of stockholders, and the basic premise of the code of ethics is to protect the stockholders from the unethical business practices of employees. With respect to a private cooperative, there may be similar reasons to adopt a code of ethics.

Many private cooperatives have hundreds or even thousands of members. For example, REI, the successful retail cooperative that supplies outdoor gear, is a private cooperative with nearly two million members. In many private cooperatives, the members expect the directors, officers and employees to deal honestly and fairly with the customers, suppliers and competitors of the cooperative. Should the Board of a private cooperative be any more lenient than the Board of a public cooperative in prohibiting kickbacks from suppliers? Probably not. A written policy will manage the expectations of employees by defining what is acceptable and what is not acceptable in the operation of the business.

Content of the Code of Ethics

Cooperatives come in a variety of forms, and a code of ethics may need to be tailored to fit your particular business. Some public companies have one code of ethics for financial officers and another for employees. However, the approach that is more common is to have a single code of ethics that covers all directors, officers, employees, including consultants. Some topics frequently covered in a code of ethics:

Fair Dealing

- Prohibiting bribes, kickbacks or any other form of improper payment to any representative of a government, a labor union, a customer or a supplier.
- Prohibiting directors, officers and employees from accepting any bribe, kickback or improper payment.
- Prohibiting gifts or favors of more than nominal value to or from customers or suppliers.
- Limiting marketing and client entertainment expenditures to those that are necessary, prudent, job-related and consistent with company policies.
- Reflecting accurately the sale price and terms of sales for products sold or services rendered.

Conflicts of Interest

- Prohibiting officers or directors from being hired by or involved in the management of an outside business that competes with the cooperative or does business with the cooperative.
- Prohibiting officers or directors from seeking or accepting any loans or services from the cooperative and any entity with which the cooperative does business.
- Prohibiting officers or directors from conducting business on behalf of the cooperative with immediate family members.

Full, Fair, Timely and Understandable Disclosure

- Not making false or misleading entries in books and records.
- Not condoning any undisclosed or unrecorded bank accounts or assets.
- Maintaining an adequate system of internal accounting controls.
- Presenting information to members in a clear and orderly manner.

Compliance with Laws, Rules and Regulations

- Promoting a workplace that is free from discrimination or harassment.
- Supporting fair competition and laws prohibiting restraints of trade and other unfair trade practices.
- Conducting activities in compliance with environmental laws.

- Keeping the political activities of directors, officers and employees separate from company business.

Monitoring Compliance with the Code of Ethics

It does little good to adopt a code of ethics if there is no process in place to monitor compliance. Many larger companies have an "ethics officer" in order to ensure compliance. The position is usually assigned to an employee who has a number of job duties. If a cooperative does not have an ethics officer, potential violations can be reported to the audit committee chair, the human resources director or legal counsel.

Training is also an important aspect of compliance with a code of ethics. Employees, directors and officers should receive training on the code of ethics as part of new employee orientation and possibly as part of on-going training programs. To ensure familiarity, directors, officers and employees are frequently asked to read the code of ethics and sign a compliance certificate. The compliance certificate frequently states the consequences of violating the policy, including potential demotion or discharge.

But Can You Legislate Business Ethics?

Probably not. However, a written code of ethics can ensure that employees, directors and officers are aware of the "rules of the game" that have been adopted by your cooperative. Personnel who violate the code of ethics probably will not have a defense that "I wasn't aware of the policy."

If your cooperative does not have a written code of ethics and an employee, officer, or director engages in inappropriate conduct, the other officers or directors may be subject to criticism that the behavior could have been prevented if the cooperative had appropriate policies in place. Thus, while ethics cannot be legislated, a cooperative can establish expectations on how it will conduct its business and reduce its potential liability by enacting appropriate policies and safeguards.

Robert G. Hensley is a Partner with the law firm of Dorsey & Whitney LLP and represents clients on a variety of business issues, including business formation, contracts, joint ventures, risk management and governance issues. He is active in the Agribusiness, Cooperative and Rural Electric Law practice group and represents agribusinesses, cooperatives and companies throughout the United States. He is also a member of the firm's Closely Held Businesses practice group and advises clients on general business issues, including formation, shareholder agreements, shareholder disputes, mergers and acquisitions, succession planning and tax planning. Mr. Hensley is an Adjunct Professor of Law at the University of St. Thomas Law School, where he teaches Business Planning. He can be reached at (612) 340-2655 or at hensley.robert@dorsey.com.