

Minnesota Legislature Adopts New Cooperative Associations Act: Coops Should Carefully Review Options to Avoid Pitfalls

By Robert Hensley and David Swanson

The names may seem a bit confusing to some. The existing cooperative statute in Minnesota is found in Chapter 308A of the Minnesota Statutes and is designated as the “Minnesota Cooperative Law.” During the 2003 legislative session, the Minnesota Association of Cooperatives asked the state legislature to adopt a new cooperative statute, aimed at encouraging new value-added processing ventures to form as cooperatives rather than as limited liability companies, as has been the trend. As a result, the Minnesota state legislature adopted the new “Minnesota Cooperative Associations Act,” codified as the new Chapter 308B.

The New Chapter 308B

The theory behind the new Chapter 308B is that the existing Cooperative Law found in Chapter 308A does not allow for outside equity investment in a cooperative.¹ Thus, the purpose of the new Chapter 308B is to dramatically change the permissible equity structures of a cooperative. As a result, Chapter 308B theoretically allows for outside Investor-Members to hold as much as 99.99% of the equity of the cooperative and receive up to 85% of the profits from the cooperative.² Here are the highlights of the new statute:

- **Tax Treatment.** A cooperative formed under Chapter 308B can elect to be taxed as a partnership under Subchapter K of the Internal Revenue Code and receive pass-through tax treatment, or elect to be taxed as a cooperative under Subchapter T. 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). This language essentially means that the Investor-Member can control the outcome of certain “key” or “special matters” by including a provision in the Bylaws or Member Agreement that requires the consent of the Investor-Member and/or its Board member(s).
 - *Audit Committee.* Chapter 308B requires that the cooperative establish an Audit Committee, which for smaller cooperatives will add cost. In many start-up businesses, serving on the audit committee probably presents a greater risk than in most established businesses due to the increased financial risk associated with a start-up. Rather than establishing a sub-committee, many 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

¹ However, it should be noted that the existing statute does allow for the issuance of preferred stock to non-members and/or non-patrons.

² This is the case because presumably there must be at least one patron-member that is an equity holder. Although in this example the single patron-member would be entitled to at least 15% of the profits, the patron-member need not hold 15% of the equity and could actually hold a very small percentage of the equity.

voting rights. This part of the statute uses the phrase “matters of the cooperative” instead of the phrase “general matters of the cooperative” used elsewhere in Chapter 308B, presumably meaning that the 15% number cannot be altered by a Member Agreement or the Bylaws.

The basic purpose of the new statute is to allow an entity to be formed under Minnesota law that can elect to be taxed (and governed) as a limited liability company and still call itself a “cooperative.”³ The new statute is a flexible model that will fit some business enterprises, but as discussed below, businesses need to be very careful in the entity selection process.

The Wyoming Model

The starting point for the new Minnesota Chapter 308B was the Wyoming Processing Cooperative Law, adopted in 2001. The Wyoming statute allows for non-patron “members” (i.e., those who do not do business with the cooperative) to receive as much as 85% of the profits from the business. The adoption of the Wyoming Processing Cooperative Law has not been without criticism. For example, shortly after the passage of the Wyoming law, the Deputy Administrator of the USDA Rural Business-Cooperative Services, published an article stating, in part:

Cooperative leaders need to stop for a moment and ask themselves: “Is a law that permits this much deviation from the cooperative norms of user-ownership and user-control coupled with a provision that only 15 percent of earnings must be returned to users based on patronage really a law authorizing the formation of cooperatives?” If someone can answer this question “yes,” a second question needs to be addressed: “Just what, if anything, does the term cooperative mean?”

When an organization calls itself a “cooperative,” it has an obligation to meet expectations that it will act like one. Delaware could amend its laws to create another statute that lets General Motors or any other large investor owned firm call itself a “cooperative.” But if such entities disregard the key cooperative characteristics of user ownership and control and

benefits flowing to the users based on patronage, the integrity of all cooperatives is called into question.

Randall Torgerson, July 2002 issue, *Rural Cooperative Magazine*. In his article, Mr. Torgerson also questions whether an entity formed under the Wyoming statute would qualify for many of the benefits and exemptions offered to traditional cooperatives.

Is the New Chapter 308B the Right Alternative for Your Business?

If the Wyoming statute is any predictor of the future of Chapter 308B, then over the next couple of years, a handful of Minnesota businesses will probably form under Chapter 308B.⁴ Many businesses will like the flexibility of Chapter 308B, especially those that do not need to rely upon the securities or antitrust protections offered to traditional agricultural cooperatives. Some examples of those that may form under Chapter 308B include:

- **Joint Ventures.** Chapter 308B will offer a new mechanism for the formation of joint ventures. Many cooperatives that currently form joint ventures do so by forming a limited liability company (LLC). With the passage of Chapter 308B, two cooperatives, or even a cooperative and a third party investor, can form a Chapter 308B cooperative as the joint venture vehicle and call the new joint venture a “cooperative.” In this situation, the new entity would likely elect tax treatment as an LLC, and could still potentially qualify for antitrust protection under the Capper-Volstead Act.⁵
- **Investor-Owned Agribusinesses.** Chapter 308B provides an opportunity for large agribusinesses (non-farmer owned) to join together with cooperatives or individual farmers in order to form a Chapter 308B cooperative. The new cooperative could market itself as a “cooperative,” but still be almost entirely investor-owned. The new statute provides a significant investment opportunity for large investor-owned agribusinesses, which for the first time in Minnesota history will be able to invest in enterprises that historically have

³ What exactly is a “cooperative” is a matter of subjective interpretation. However, even though an entity is a “cooperative” under Minnesota law, a Chapter 308B cooperative with outside equity investors should not be surprised to later discover that for the purpose of many state and federal statutes and programs, the Chapter 308B cooperative does not qualify because of the make-up of its membership.

⁴ According to the Wyoming Secretary of State’s office, in the nearly two years since the Wyoming Processing Cooperative Law was adopted, four domestic entities have been formed under its provisions. Thus, the type of entity created by the Wyoming statute has a fairly narrow application in the entity selection process.

⁵ The joint venture entity could also form as an LLC, which may be the preferred entity if the other party to the joint venture is not a Minnesota cooperative.

been farmer-owned. These new enterprises will be able to capitalize on the goodwill associated with calling themselves cooperatives.

- **Value-Added Processing Plants.** Farmers who would like to start a value-added processing plant and who are, for example, only able to raise 75% of the needed equity may be able to find an outside investor to cover the 25% shortfall. Thus, the new entity would be able to form as a Chapter 308B cooperative and elect tax treatment as an LLC.⁶
- **Electric, Housing, and Purchasing Cooperatives.** Chapter 308B provides a wide range of opportunities for non-agricultural businesses to form as “cooperatives.” For example, the statute could offer opportunities for housing cooperatives, electric cooperatives, purchasing cooperatives, health care cooperatives, and other types of businesses to form as “cooperatives” and have most of the equity held by non-patrons.

On the other hand, those Minnesota cooperatives formed under Chapter 308A should not spend much time worrying about being passed in the night by the trends of “modern” cooperation. By almost any standard, Minnesota’s existing cooperative law found in Chapter 308A is an example of a modern cooperative statute. Although the new Chapter 308B would allow an existing cooperative to convert to a Chapter 308B cooperative, in nearly all situations, there is no reason to do so. Here’s why:

- **Antitrust Issues.** Without the benefit of the protection provided by the federal Capper-Volstead Act,⁷ many of the activities performed today by agricultural cooperatives, including collectively processing and marketing products, would be contrary to state and federal antitrust laws. The Capper-Volstead Act provides an antitrust exemption for certain activities by “persons engaged in the production of agricultural products as farmers, planters, ranchmen, dairymen, nut or fruit growers” and authorizes such producers to collectively process, handle, and market their

products. To qualify for the Capper-Volstead exemption, an association must be “operated for the mutual benefit of the members thereof, as such producers” and meet the following requirements: (1) no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own or the association cannot pay dividends on stock or membership capital in excess of 8% per year; and (2) the association shall not deal in the products of nonmembers to an amount greater in value than such as are handled by it for members.

In *Case-Swayne Co. v. Sunkist Growers, Inc.*,⁸ the Supreme Court of the United States addressed the issue of whether a cooperative that has non-producer members qualifies for Capper-Volstead protection. In the *Sunkist* case, Sunkist was 80% owned by producers, but also had some members who were private corporations and partnerships that did not grow agricultural products, but instead owned and operated packing houses. As the Supreme Court stated: “The issue is whether Sunkist is an association of “[p]ersons engaged in the production of agricultural products as . . . fruit growers” within the meaning of the Capper-Volstead Act, notwithstanding that certain of its members are not actually growers. We hold that it is not” (emphasis added). In addition, the Court not only held that the non-producer members of the cooperative were outside the Capper-Volstead Act immunity, but that the presence of the non-members in the cooperative resulted in a complete loss of antitrust immunity for the cooperative and all its members, whether producer or processor.⁹

In many cases, conversion to a Chapter 308B cooperative may jeopardize the antitrust status of an existing cooperative, possibly even leading to civil and criminal penalties against officers, directors, and members. Although some cooperatives may not need the protection afforded by the Capper-Volstead Act, for many agricultural cooperatives the protection is essential, and the existence of a single member that is not a “producer” may put all of the members at risk for civil and criminal penalties.

⁶ It should be noted that this entity could also form as an LLC, and if the outside investor is from outside of Minnesota, the outside investor may feel much more comfortable forming the entity as a Delaware LLC due to the general nation-wide acceptance and use of the Delaware statute.

⁷ 7 U.S.C. 291.

⁸ *Case-Swayne Co., Inc. v. Sunkist Growers, Inc.*, 389 U.S. 384 (1967).

⁹ It should be noted that an association does not have to be formed under a state “cooperative” statute in order to qualify for Capper-Volstead protection. For example, an association of producers formed as a corporation or a limited liability company under Delaware law could qualify for Capper-Volstead exemption. The focus is whether the association is owned by “producers,” not on the type of legal entity that is formed under state law.

- **Conversion Issues.** An existing cooperative formed under Chapter 308A that is taxed under Subchapter T would likely experience a significant taxable event if the cooperative converts to a Chapter 308B cooperative and elects tax treatment under Subchapter K. It is likely that the IRS would view such a conversion as a liquidation of the Chapter 308A cooperative.
- **Tax and Securities Issues.** With respect to agricultural cooperatives, a Chapter 308B entity with Investor-Members probably would not qualify for Section 521 tax status, thereby subjecting the entity to certain registration requirements imposed by the federal securities laws.
- **Legal and Tax Consulting Costs.** The new Chapter 308B is a long and complicated statute. Most lenders and third party investors are not very familiar with traditional cooperatives, let alone the type of cooperative permitted by Chapter 308B. As a result, a business desiring to form under Chapter 308B will most likely have to do a fair amount of “educating” its lenders and third party investors, who will be much more familiar with LLC statutes and may encourage the business to form as an LLC rather than a Chapter 308B cooperative. If the outside investor is investing a significant amount of cash in the business, their lawyers will have a significant impact on the type of entity ultimately selected.
- **Other Potential Issues.** Other potential issues include: (1) a loss of protection against handler coercion and discrimination in the Agricultural Fair Practices Act; (2) a loss of the exemption from registration requirements of the Securities Act of 1934; (3) a loss of exemption from the trust provisions of the Perishable Agricultural Commodities Act; and (4) a loss of exemption from trucking regulation under the Interstate Transportation Act.

Conclusion

There is no question that the number of businesses formed in the United States as cooperatives is shrinking. This fact reduces the number of businesses that can borrow from cooperative banks, reduces the number of businesses eligible for certain government programs, and reduces the number of businesses that can join the various trade groups dedicated to cooperatives. What makes a cooperative a cooperative? Many would say that an entity which is 85% owned by an outside investor that is not a patron of the business is not a cooperative. Minnesota law now expressly provides that such a business is a cooperative. In the end, whatever form of entity that has the highest reward for the patrons of the business, be that reward access to markets, increased profits, or the opportunity to own a home, will be the most successful model — both socially and economically.

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