

LAW OF COOPERATIVES
—A Question of Value Proposition and Capital Structure
in Search of a More Satisfying Approach—

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I. Overview

This chapter will examine and challenge the policy that open membership, nonfederated, nonexempt agricultural cooperatives must (or even can) allocate all or nearly all patronage earnings to patrons each year and then be expected to redeem all that allocated equity, again and again with each passing generation of producers. Under that policy, agricultural cooperatives typically allocate 75 to 90 percent of all their patronage earnings, pay 20 TO 30 percent in cash, distribute the balance with qualified written notices of allocation (QNAs), and obtain the Subchapter T tax deduction for these allocations of patronage earnings. Producers pay income and self-employment taxes on these distributions each year, and they understandably expect that the resulting allocated equity will be redeemed as soon as possible.

This policy has the advantage of maximizing the Subchapter T tax deduction obtained for patronage earnings that are allocated to patrons in proportion to their use of the cooperative. The policy also accords with the agency theory of cooperation. It holds that patronage earnings belong to the patrons and not the cooperative. Obviously patronage earnings that belong to patrons should be allocated to those patrons, or so the theory holds.¹

The tendency of this policy, however, is to create a burgeoning, unwieldy capital structure² for the cooperative and a miserable value proposition³ for patrons. When all patronage earnings must be and are allocated, no control can be exercised over either capital structure or value proposition. Often allocated equity is not redeemed until patrons reach age 70 or die. Even if the Board is certain that allocating more patronage earnings will only contribute to greater patron disappointment with the Cooperative, the earnings must be allocated anyway. Think of this existing policy as the “Pay Later” plan.

This chapter will propose that boards of directors must use value proposition and capital structure as objectives (rather than “accept” them as conclusions under the existing “Pay Later” policy) to assist the Board in determining how to allocate patronage earnings. It is illogical to allocate any patronage earnings without knowing under the “Pay Later” plan whether allocations will fulfill or destroy objectives established by the Board. In contrast, the proposed policy directs the Board of Directors to allocate only those patronage earnings that are consistent with the Board’s objectives for value proposition and capital structure. Think of this as the “Pay as You Go” plan.

Table 1 highlights four alternative scenarios through which the existing policy (“Pay Later”) will be compared and contrasted with the proposed policy (“Pay as You Go”) to show their effect, respectively, on value proposition and capital structure. Each alternative presents a situation where \$500 of patronage earnings must be distributed. The differences lie in (1) the percentage of patronage earnings that are allocated, (2) the percentage of allocated patronage earnings that are paid in cash, and (3) the number of years until the expected redemption of QNAs. This article will first evaluate these alternatives from the viewpoint of value proposition. Later in the article we will consider capital structure.

1 The principal failure is that this theory ignores the time value of money. With allocated co-op equity, nothing “belongs” to anyone until the equity is paid to the holder in cash.

2 As more equity is allocated, more earnings must be devoted to eventually redeeming equity. High allocated and low permanent equity = relatively weak structure. Low allocated and high permanent equity = relatively strong structure.

3 Sum of all pluses and minuses, either monetary (price, discounts, etc.) or nonmonetary (quality, people, knowledge, etc.), that result in the patron’s choice to choose one agricultural company over another one.

				Table 1
	“Pay As You Go”		“Pay Later”	
	Alt#1	Alt#2	Alt#3	Alt#4
Patronage Earnings	\$500	\$500	\$500	\$500
% Allocated	20%	30%	75%	90%
% Cash Patronage	100%	75%	40%	20%
# Yrs to Redemption	0	3	25	35

It should not be controversial that allocated equity affects the capital structure of agricultural cooperatives,⁴ that capital structure and value proposition are related, or that these are corporate objectives that require oversight and management. If members intended to dissolve the cooperative before the passing of a single generation of producers, no one would worry about capital structure or managing allocated equity because the redemption of equity would be financed from the dissolution of the cooperative. The co-op would operate until it dissolved, then its assets would be liquidated and debts paid off, and finally allocated equity would be paid to the extent possible from the remaining proceeds of the asset liquidation. Any excess proceeds would be allocated on the basis of historical patronage.

Most cooperatives, however, are formed to operate in perpetuity and Boards must create and manage capital structures and value proposition that are consistent with that intent. The more that a cooperative’s capital is tied up in long-lived assets, the more it must use permanent capital to finance those assets. If those assets are financed instead with allocated equity that patrons expect the cooperative will redeem before they die, it becomes increasingly more difficult for the cooperative to redeem that equity in a reasonable time. As allocated equity becomes tied up in long-lived assets and the redemption cycle lengthens, the value of allocated equity depreciates as its present value falls; hence, value proposition falls too. Obviously then value proposition and capital structure are interrelated, and both are tied to the distribution of patronage earnings. This article will compare the “Pay as You Go” with the “Pay Later” policies to demonstrate how the former provides a superior value proposition and a far more manageable capital structure than the latter policy.

The intent is not to discount the patronage deduction. Instead my point is that the deduction is too valuable and that using too much of the deduction causes the whole patronage proposition to implode on itself if the cooperative cannot keep up with equity redemptions on a reasonable cycle. Obviously nonfederated, nonexempt cooperatives will pay more income tax and use the patronage deduction less under the proposed policy. Frankly though, who will care if the policy creates a more attractive value proposition for patrons and stronger capital structure for the cooperative? In this context, the IRS’s view is irrelevant because the fiduciary obligations of the Board trump the IRS’s rather sterile concerns for how things look.

II. Value Proposition – A Comparison of the Two Plans

It should not be controversial that agricultural producers measure co-ops against each other and against private companies. We take it as given that the agricultural company (either private or co-op) with the most attractive value proposition wins in the marketplace against its competitors. Moreover, all companies in the marketplace continue to reexamine their value propositions for the purpose of increasing their odds of winning against competitors. Value proposition is always in play.

⁴ Take for example the NSAC’s integral role in expressing the co-op community’s concerns about FAS 150 and then working with FASB to develop a suitable approach.

Obviously value proposition includes more than monetary considerations, but there is no getting around the value of a dollar to any producer who works hard and pays income and self-employment taxes on distributions of the cooperative's patronage earnings. Producers are pretty jaded about the co-op issues of ownership and control so these notions only go so far in the value proposition mix. We take it as given that any producer's value proposition calculus includes (but is not limited to) the speed with which net cash (that is, after taxes) is allocated to patrons in the form of cash patronage refunds or equity redemptions.

Table 2 illustrates the four alternative scenarios for distributing patronage earnings and the value propositions each alternative provides to patrons.

				Table 2
Patron's Point of View – Value Proposition				
	Alt#1	Alt#2 – Best	Alt#3	Alt#4 – Worst
1099-PATR	\$100	\$150	\$375	\$450
Cash Patronage Refunds	\$100	\$112.50	\$150	\$90
Patron's Income and Self-Employment Taxes	\$30	\$45	\$112.50	\$135
Cash + / - After Payment of Taxes	\$70	\$67.50	\$37.50	(-\$45)
Allocated Equity	\$0	\$37.50	\$225	\$360
Present Value of Allocated Equity	\$0	\$27.79 ^{3 yrs}	\$18.54 ^{25 yrs}	\$10.93 ^{35 yrs}
Net Present Value of All Cash Received from Co-op	\$70	\$95.29	\$56.04	(-\$34.07)

Consider the four alternatives in Table 2 above from the points of view of the time value of money and a hungry agricultural producer. The best deal for patrons is Alternative #2. The co-op allocates 30 percent of its patronage earnings and pays at least 75 percent of that distribution in cash and up to 25 percent with QNAs, which the Board aims to redeem within three years of issuance. In 35 years that cash will have grown into a sum of approximately \$2,850 because we assume the producer will put that cash to work in his farming enterprise.

Now consider the worst deal illustrated by Alternative #4. This alternative actually *consumes* \$34 of the patron's financial resources. In fact, for the first 34 years after the patronage distribution, the patron is *under water to the tune of \$45*. It is not until the 35th year when the allocated equity is redeemed that nearly \$11 is recovered, reducing the patron's loss to \$34. Unlike Alternative #2 where the distribution grew into \$2,850 in 35 years, here the patron will only receive the face amount of the QNAs that were allocated to her 35 years ago - \$360.

The "Pay as You Go" plan illustrates that Alternatives #1 and #2 obviously provide a far more attractive value proposition for patrons than the "Pay Later" plan as illustrated in Alternatives #3 and #4. *We can even imagine producers investing their own money in an equity offering by a farm supply and grain cooperative under Alternatives #1 and #2 above.*

Alternative #3 is a more hopeful situation than Alternative #4 under the "Pay Later" plan, but the cooperative will have a difficult time maintaining that value proposition because as this chapter will discuss next, the

tendency of the “Pay Later” plan is to create overwhelming financial pressure on agricultural cooperatives that is difficult if not impossible to manage without undercutting or even destroying value proposition.

III. “Pay Later” Tendency to Create Debilitating Financial Pressure

The dynamic of the “Pay Later” plan—our present approach—is that the cooperative constantly allocates more patronage earnings than it redeems in allocated equity. The result is that net allocated equity grows unrelentingly, along with patrons’ expectations about redemption of all that equity some day. The rate of expenditure for redemption of allocated equity must also grow constantly as the Board tries to maintain a constant revolvment cycle (*i.e.*, value proposition). Unfortunately, the cooperative will not keep pace with its growing mound of allocated equity, in which case the Board of Directors must either lengthen the revolvment cycle or borrow long-term debt to shore up and maintain the cooperative’s liquidity position, both of which weaken value proposition for patrons.

The financial stress of this dynamic will be illustrated in the following example of a farm supply and grain cooperative. Consider the plight of a very successful farm supply and grain cooperative that is committed to a 15-year revolvment of allocated equity. This cooperative has \$130 million in sales, \$3.25 million of total earnings and \$2.75 million of local earnings. The cooperative has no long-term debt. Net working capital requirements are 10 percent of sales. It has a working capital surplus of \$2.0 million.⁵ The cooperative allocates 90 percent of its patronage earnings and allocates 30 percent in cash with the balance in QNAs. This cooperative has some over \$8.0 million of allocated equity and last year the cooperative redeemed \$535,000 of equity. At that pace, the cooperative has achieved a 15-year revolvment. The Board is committed to maintaining that 15-year cycle.

Graph #1 (see graph at end of chapter) shows how the allocation of patronage earnings creates the pressure that eventually requires annual expenditures for equity redemptions to be ratcheted up so excessively. The cooperative always allocates more patronage earnings than it redeems of previously allocated equity, so net allocated equity grows each year. At zero growth in sales and earnings, allocated equity *still grows* from \$8.0 million to \$20.0 million in 10 years. At a growth rate of 5 percent in sales and earnings, allocated equity *will triple* in size to a total of \$25.5 million in 10 years. And at a 10 percent growth rate, the cooperative’s total allocated equity will increase by *a factor of four to a total of \$33.0 million* in 10 years. Imagine trying to maintain a 15-year revolvment as allocated equity grows each year.

Next Graph #2 (see graph at end of chapter) illustrates the pressure created by maintaining a 15-year revolvment cycle. Even if total earnings or sales do not grow but remain at \$3.25 million per year, this cooperative *must more than double* its annual rate of expenditure for equity redemptions from \$535,000 to \$1.3 million annually by 2015. If earnings and sales grow at a 5 percent annual rate, the cooperative *must triple* its annual rate of expenditure for equity redemptions from \$535,000 to \$1.6 million annually by 2015. And if the growth rate in sales and earnings is 10 percent, the annual rate of expenditure for equity redemptions *must quadruple* to \$2.0 million annually by 2015.

Notice that the cooperative does not have any wiggle room if it faces a weakening economy. In fact, it must count on a growing economy and/or the cooperative growing its sales and market penetration at the expense of

⁵ When the cooperative is at its low point in receivables, inventories, and prepaid expenses, its seasonal financing is completely paid off and it is current with all supplier payables. In addition, the cooperative has a working capital surplus of \$2.0 million which is represented by \$2.0 million in savings that is spread out among several banks. For a cooperative of this size, \$2.0 million is an adequate surplus but it does not represent too aggressive of a position. Otherwise one could argue the cooperative should redeem some of its equity.

a competitor *just to keep up* with equity redemptions. Notice also that if earnings do not grow fast enough, which is almost a certainty, this cooperative will not maintain a 15-year revolvment. It would not be unrealistic for the revolvment cycle to lengthen to 258 or 30 years, or even more.

Finally, Graph #3 (see graph at end of chapter) shows how the increasing rate of expenditure for redemptions creates pressure on liquidity. If sales and earnings do not grow, the cooperative improves liquidity and its surplus grows over the next seven years but at a decreasing rate of growth. By the eighth year the cooperative is starting a slow burn of its working capital surplus, and from there its liquidity position will continue to deteriorate in the months and years ahead. At a 5 percent annual rate of growth, by 2015 the cooperative will burn up over two-thirds of its working capital surplus. And at a 10 percent rate of annual growth in sales and earnings, by 2015 the cooperative will borrow \$10.0 million of long-term debt to shore up a working capital shortage plus maintain a \$2.0 million surplus.

IV. A Manageable Capital Structure (“Pay as You Go”)

Our existing “Pay Later” plan obviously puts significant pressure on management and the Board of Directors to manage working capital requirements, expenditures, and earnings to keep pace with redemptions. The financial pressure consistently grows as the cooperative becomes more and more financially successful.

A few cooperatives prevail against these pressures with superior management and by obtaining near perfect efficiencies and still maintain a 10-year revolvment. The best explanation for these rarities might be that these cooperatives operate in a parallel universe. When one considers the issues outlined in this chapter, those few cooperatives that stand up or even flourish under this pressure are marvels to behold and appreciate.

Most cooperatives, however, cannot prevail against the persistent “Pay Later” pressures particularly when boards of directors and management attempt to balance all the needs of all their patrons, which understandably may include subsidizing businesses that are not as profitable as they should be. Some businesses may even lose money.

In addition to providing the most attractive value proposition, Alternatives #1 and #2 also illustrate how the proposed “Pay as You Go” plan creates a more manageable capital structure for the cooperative. This plan creates a far more manageable capital structure because it substantially reduces the cooperative’s total financial obligations (payment of income taxes plus cash patronage refunds plus equity redemptions). An attraction of the “Pay as You Go” plan is that the Board never gets too far ahead of itself, and redemption of equity occurs close in time to when the earnings are generated by the cooperative.

For example, Table 3 below illustrates how the cooperative’s total financial obligations under Alternative #1 are only 57 percent of the financial obligations of Alternative #4. The cooperative pays more income tax in Alternative #1 over Alternative #4 (\$168 versus \$21) but its obligation to redeem allocated equity is reduced by \$360. A similar conclusion occurs between Alternatives #2 and #3. The cooperative’s total financial obligations under Alternative #2 are 30 percent less than the obligations of the cooperative in Alternative #3.

Table 3

Cooperative’s Point of View – Capital Structure				
	Alt#1 – Best	Alt#2	Alt#3	Alt#4 – Worst
Total Allocated Earnings and Equity	\$100	\$150	\$375	\$450
Cash Patronage	\$100	\$112.50	\$150	\$90

Refunds				
Allocated Equity	\$0	\$37.50	\$225	\$360
Taxable Earnings	\$400	\$350	\$125	\$50
Corporate Tax	\$168	\$147	\$52.50	\$21
Co-op's Total Financial Obligation	\$268	\$297	\$427.50	\$471

Parenthetically, the “Pay as You Go” plan does not shortchange patrons even though the plan increases the payment of taxes and reduces the total of all earnings that are allocated or redeemed in the ordinary course of business before the cooperative’s dissolution occurs, if ever. Recall that Table 2 above showed that the present value of cash distributions for either Alternative #1 or #2 are superior to Alternative #3 or #4. Consequently, Alternatives #1 and #2 provide both the best value proposition and capital structures over Alternatives #3 and #4. Value proposition and capital structure might seem like inconsistent concepts but here they work together.

V. Are Unallocated “Reserves” Illegal Under Subchapter T?

The policy argument recognizing the Board’s fiduciary obligation to create value propositions and capital structures favoring the cooperative and its patrons is an overwhelmingly powerful legal position opposing the IRS’s view that all earnings must be allocated. As near as I can tell, this position has never been asserted against the IRS. Moreover, nothing in the statute or legislative history cuts against or even fights with this policy argument.

Subchapter T does not require the allocation of all patronage earnings. Start with the statute first, and consider the definition of patronage refund. The relevant portions of this Treasury Regulation define patronage refund as *an amount* paid to a patron under a written obligation to pay the amount, which is determined *by reference* to patronage earnings.⁶ The determination could have been expressed in the regulation as “*all patronage earnings except reasonable and necessary reserves . . .*,” but the language of the statute is far broader and appears to allow broad discretion to determine *an amount*. The amount of the patronage refund is determined simply and only *by reference* to patronage earnings, which implies the amount paid could be less than all patronage earnings.

Moreover, Congress knew how to require cooperatives to allocate *all* patronage earnings when it required the same of exempt cooperatives. Cooperatives exempt from taxation under Section 521 are permitted to establish reasonable reserves, but the clear inference for exempt cooperatives is that all other patronage earnings must be allocated. The absence of similar language in Subchapter T is significant.

The often-cited 1979 General Counsel Memorandum 38099 is not an obstacle to the “Pay as You Go” plan because unallocated retained savings are not “reserves.” The word “reserves” does not accurately describe permanent capital that by definition cannot be redeemed until the dissolution of the cooperative, which is why “retained savings” is a stronger description for this unallocated equity than “reserve.” Even if this permanent capital is a “reserve,” then it is *reasonable and necessary under the circumstances* because the capital management policy will require all available cash to be allocated to current patrons in the existing or near future, before the equity has lost more than one-third of its value. Nothing remains of cash flow to redeem anything else, unless and until the cooperative dissolves.

⁶ 26 C.F.R. §1.1388-1 Definitions and special rules.

The IRS's argument that all earnings must be allocated to operate at cost cannot stand in the face of the cooperative's argument that the Board is a fiduciary given the power to allocate patronage earnings. Obviously the Board cannot allocate those earnings as a dividend on stock or equity and hope to claim the patronage deduction. Similarly, the Board cannot build up excessive cash balances or other working capital with unallocated retained savings but without explanation and hope to claim a deduction. However, if the Board is stripping out and distributing all available cash on a patronage basis, and if the cooperative does not have the capacity to redeem the balance of equity until the dissolution of the cooperative, surely the Board is not required to allocate those earnings in opposition to the collective wisdom of the Board of Directors.

It is true that using Non-qualified written notices of allocation avoids confrontation with the IRS's mandate that all patronage earnings must be allocated, but there are good business reasons for nonfederated cooperatives to account for patronage earnings as unallocated retained savings. If the equity resulting from these earnings cannot realistically be redeemed until the dissolution of the cooperative, which might be 100 years from now, why allocate those earnings and either create expectations for redemption that cannot be met or invest ownership of equities in parties that must be transferred over and over to succeeding generations of families?

V. Concluding Comments

This chapter is buttressed by the fact that three of the most successful cooperatives I know have determined that the "Pay Later" plan is untenable. These Boards of Directors have drawn their conclusions independently of each other, and each is addressing these issues with a variety of approaches.

Cooperative #1. In 2004, this cooperative had redeemed all of the patronage earnings that it allocated prior to 1992. The cooperative appeared to be in an enviable position at first glance. From where the cooperative was situated, it was only twelve years back on its redemptions. Things, however, were not as they seemed.

Year	Cumulative Allocated	Allocated by Year
1992	\$1,082,794	\$1,082,794
1993	\$1,720,350	\$637,556
1994	\$2,453,636	\$733,286
1995	\$3,002,938	\$549,301
1996	\$3,155,440	\$152,502
1997	\$3,783,877	\$628,437
1998	\$4,463,211	\$679,334
1999	\$5,098,879	\$635,668
2000	\$5,634,855	\$535,976
2001	\$6,385,159	\$750,304
2002	\$7,591,191	\$1,206,032
2003	\$8,746,321	\$1,155,130

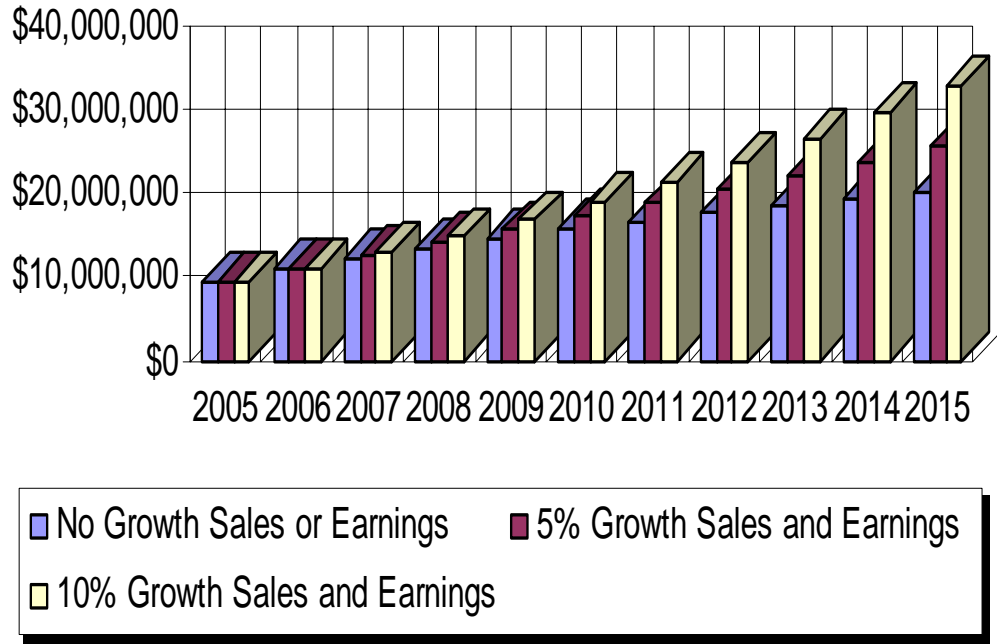
It was obvious the cooperative could not maintain a 12-year revolvment. The cooperative was redeeming an average of \$300,000 of allocated equity annually, and the Board and management saw nothing that encouraged them to believe the annual expenditure could be significantly increased. At \$300,000 of redemptions annually for the foreseeable future, the reality this Board and management faced was that the cooperative was really 30 years back rather than only 12 years. And it appeared the cooperative would continue to fall behind even further. The

cooperative's value proposition was already weakening, and it would weaken further if the Board and management continued on the same path.

This cooperative has now abandoned its equity redemption policies. Instead, the cooperative will periodically convert allocated equity to preferred equity at a discount. Rather than redeem equity, the Board and management will seek to pay a strong enough dividend on the preferred stock that patrons who own preferred stock will trade it between them. You may argue this cooperative is still on the "Pay Later" plan, but if so, the plan has been dramatically reconfigured.

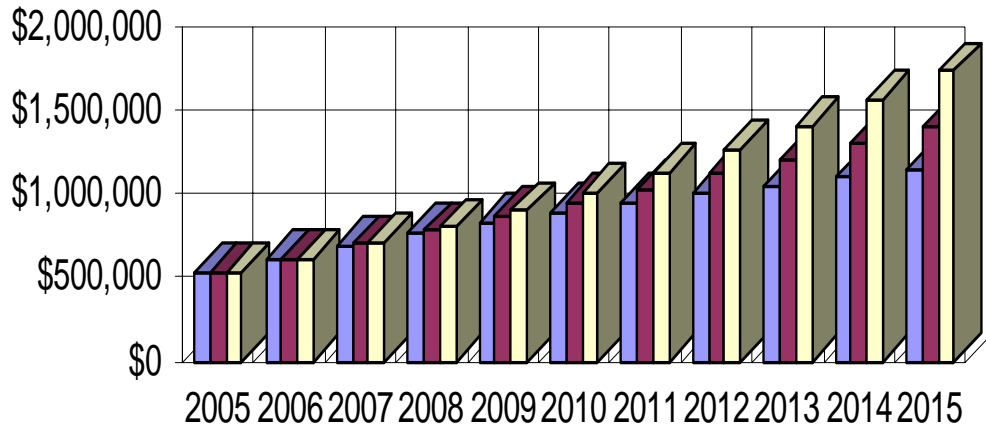
Total Allocated Equity

Graph #1



Annual Redemptions to Maintain 15 Year Cycle

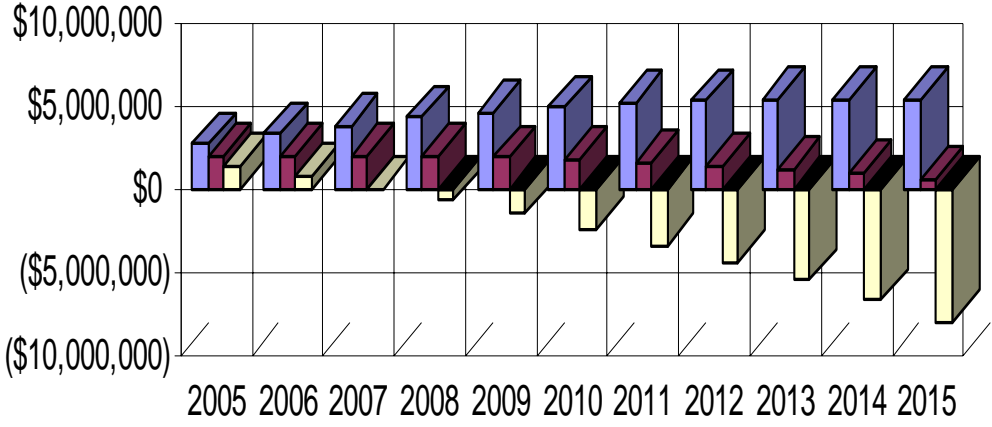
Graph #2



■ No Growth Sales or Earnings ■ 5% Growth Sales and Earnings
■ 10% Growth Sales and Earnings

Evaluation of Liquidity - W.C. Surplus or Shortage

Graph #3



■ No Growth Sales or Earnings ■ 5% Growth Sales and Earnings
■ 10% Growth Sales and Earnings