

LAW OF COOPERATIVES
—Conversions and Restructurings of Cooperatives —

Joel J. Dahlgren
Stoel Rives LLP
33 South Sixth Street, Suite 4200
Minneapolis, MN 55402
612-373-8806
jjdahlgren@stoel.com

Ronald D. McFall
Stoel Rives LLP
33 South Sixth Street, Suite 4200
Minneapolis, MN 55402
612-373-8807
rdmcfall@stoel.com

Introduction

In the past few years, a number of cooperatives, including some rural electric cooperatives and credit unions, have restructured to adopt other business structures. In addition to rural electric coops and credit unions, some “value-added” or “closed” cooperatives have engaged in such restructurings, as have a small number of open membership cooperatives. Some of the cooperatives who have pursued such restructurings (often referred to as “conversions”) have converted into a corporate form of organization. Others have elected to become limited liability companies. This article is intended to briefly discuss the reasons for such conversions, to consider some of the conceptual obstacles inherent in the cooperative structure that may lead a cooperative to consider a conversion, and to provide an overview of the legal and procedural requirements involved in a cooperative conversion.

I. Why Convert a Co-op into an LLC or a Corporation?

Members of the co-op community have been upset by conversions of rural electric cooperatives and credit unions into LLCs in transactions in which the only beneficiaries appear to be management. If it appears that a cooperative’s senior management or the board of directors did not properly discharge the fiduciary obligations that are owed to the cooperative and its members, objecting cooperative members and other parties have considered and in some cases pursued responses through efforts to persuade cooperative members to vote against the proposed conversion, through litigation or through moral suasion. (An example of the latter occurred in the Washington, D.C. area when the National Cooperative Business Association exerted itself to stop the conversion of a federal credit union.[□]) While some members of the cooperative community will object on philosophic grounds to any conversion of a cooperative, circumstances may arise in which the conversion of a cooperative into some other form of business organization is necessary and beneficial to the cooperative’s members and the business operated by that cooperative.

The most commonly cited reason for a cooperative to consider conversion into an LLC or a corporation is the need for additional equity investment. This situation occurs when the cooperative is starved for equity capital and cannot raise sufficient equity from its patron members or the sale of preferred shares or similar equity interests to non-members. Preferred interests typically pay a dividend of no more than 8 percent or 10 percent per annum[□] and do not provide governance or voting rights. Non-patron equity investors typically want to invest in an instrument that pays dividends in excess of the 8 percent or 10 percent limitation, that appreciates in value and that permits participation in governance through voting rights that are proportionate to the equity investment. (Even if demand existed to purchase preferred equity in the co-op, co-ops, like any business organization, can tolerate only so much dividend-bearing preferred equity and will be forced to consider other approaches.) Non-member private equity investors are often not familiar with the cooperative structure and, consequently, may be uncomfortable investing in a business that is not

[□] See [□] HYPERLINK "<http://www.ncba.coop>" [□] www.ncba.coop[□] for news reports about this credit union.

[□] Dividends are usually limited by state law and are limited by Subchapter T, under which many co-ops are taxed.

organized as a corporation or LLC. As a result, if a cooperative's business requires equity investment beyond that which can be provided by the patron-members of the cooperative or through the sale of preferred stock, the cooperative's board may be compelled to consider conversion to another form of business organization to pursue the necessary equity investment.³

Another reason cited for converting a cooperative into an LLC or a corporation is to align the goodwill and going concern value of the cooperative (residual rights and claims) that might be obtained upon a future sale of the business with the investment provided by the member patrons. (This consideration seems to be most prevalent in the case of "value-added" or "closed" cooperatives in which the members are both patrons of the cooperative and have made a significant initial investment to participate in the cooperative.) If a producer owns \$1,000 of allocated equity in a cooperative that is expected to be worth \$10,000 in the event of the hypothetical sale of the cooperative, a conversion to an LLC or corporation is likely to be strongly supported by co-op members seeking that capital for their own operations.

A final reason often cited for considering the conversion of a cooperative arises from an understandable desire for liquidity. With the exception of certain classes of preferred stock, equity interests in cooperatives may typically be held only by producers who are patron members of the cooperative. That restriction limits the pool of prospective purchasers for any cooperative equity interest that a cooperative member seeks to sell. Corporations and LLCs typically do not have similar restrictions. As a result, following a conversion, the equity holder will be able to pursue sale of his or her equity interest to a larger group of possible purchasers, including non-producers.

Notwithstanding the reasons listed above, conversions of open membership cooperatives within federated systems have not occurred with any frequency. Federated systems are particularly immune to conversions because federated cooperatives (1) employ field staff that maintains confidence in the co-op form of business organization and (2) hold regular annual meetings in which senior management and directors are inculcated with the strengths of the co-op form of business organization. Perhaps most importantly, many federated cooperatives have taken the position that they will not distribute patronage refunds to non-co-ops. As a result, a local cooperative that converts into some other form of business organization cannot expect to continue to receive patronage refunds from its interaction with a federated cooperative.

In addition to the reasons described above, analysis has also suggested that vaguely defined property rights within co-ops create disadvantages for co-ops that are central to understanding why co-ops occasionally convert their business structures to corporations or LLCs. The following section considers that impact.

II. Vaguely Defined Cooperative Property Rights

The property rights contained in LLC membership interests (or in shares in a corporation) are well defined and specifically benefit those members who hold equity in the enterprise. A member of the hypothetical LLC described in the table below knows that a membership interest is worth

³ Several cooperatives that have converted to other structures have subsequently obtained additional equity investment from outside equity investors, providing support for the validity of this rationale for the conversion of a cooperative in some circumstances.

approximately \$22,000 per share or unit, assuming valuation of assets and liabilities is accurate. LLC members further know that increases in business valuation will accrue to their benefit and cause their interest to appreciate in value above \$22,000. Similarly, a decline in business valuation will cause the value of their interest to fall below \$22,000.

On the other hand, in the theoretical dissolution of the cooperative in the table below, holders of equity (past and present members / patrons of the co-op) know they have a claim only on \$5,025,000 of equity. Those holders also know that their claims will not appreciate in value because the value of those interests is limited to the face value of the allocated equity and par value common stock. The value of the claims of equity holders will never be more than \$5,025,000 in this case. In fact, inflation will cause those interests to depreciate in value until the equity is redeemed. Unlike the LLC where the membership interest includes a claim on all residual rights and claims in the total value of \$22,000 per share or unit, here in the case of the co-op the allocated, non-appreciable interest is set at only \$5,025 per share or unit.

	Cooperative		LLC	
Common Stock or Units 1,000 @ \$25 /share or unit	\$25,000		\$25,000	
Allocated Equity	\$5,000,000		\$5,000,000	Distribute on basis of ownership
Retained Savings	\$7,000,000	Distribute on basis of historical patronage	\$17,000,000	
Difference between market and book value.	\$10,000,000			
Total Equity	\$22,025,000		\$22,025,000	
Price per Share or Unit	\$5,025		\$22,025	

The co-op's patrons hold the residual rights and claims on all the remaining \$17.0 million proceeds based on the historical patronage of all members and patrons as defined by the articles of incorporation and bylaws. Importantly, those claims are only known or finally determinable if and when the cooperative dissolves. Obviously, few members or patrons want to dissolve the co-op just for that determination and understandably so. Until the actual sale and dissolution of the cooperative, however any analysis of residual rights and claims is an abstraction because the ultimate amount of historical patronage and the make-up of the holders of those historical patronage rights cannot be determined. The longer the co-op operates, the longer the list of potential claimants on the cooperative's good will and going concern value. The articles of incorporation and bylaws may set parameters around the identity of historical patrons by limiting the universe of all potential claimants to, for example, those patrons who have patronized the cooperative over the past ten years.

Professor Cook from the University of Missouri in Columbia attributes the challenges that cooperative have raising new equity or conserving what equity already exists to the fact that property rights in good will and going concern value are vaguely defined. Residual rights and claims in a

cooperative are unassigned, unmarketable, and untradeable.⁴ As the discussion in the previous paragraph illustrates, the owner of those residual rights and claims may not be known until dissolution of the co-op clarifies those rights and claims based on historical patronage. Professor Cook describes these vaguely defined property rights by reference to the free-rider, horizon and portfolio problems.

The free-rider problem deters older patrons from providing new equity because newer patrons acquire a claim on goodwill and going concern value without the patron investing any equity in the cooperative. For example, a patron whose historical business with the cooperative constituted 0.01 percent of the cooperative's patronage business will have a claim on \$1,700 of the co-op's goodwill and going concern value of \$17 million. And that claim will exist regardless of how little or much equity the patron contributed to the co-op, *even if the patron never earned or contributed even \$1 of equity to the co-op*. The patron's claim arises at the expense of older patrons and members whose previous contributions of equity are the reason the co-op exists now at all.

The "horizon problem" deters investments of equity in the cooperative because financial returns (present and future) from those investments are not assigned to, and will not be capitalized into or appreciate the value of, that equity, leaving the equity unmarketable and untradeable. Holders of equity have no incentive to invest new equity into the cooperative. And the sooner their existing equity is redeemed, the better off members will be because the act of redemption will stop the equity from depreciating in value .

The "portfolio problem" deters investments of equity in traditional cooperatives because the risk preferences of holders of equity will always lean toward receipt of cash now rather than appreciation in the future that will be unassigned, unmarketable, and untradeable. Once again, holders of equity have no incentive to invest new equity into the cooperative, and they have no incentive to wait patiently for the redemption of their old equity because until it is redeemed, the equity will only depreciate in value.

The decisions of co-op members to vote in favor of a conversion are entirely rationale when viewed from the perspective of the free-rider, horizon and portfolio problems. The conversion of the co-op into a corporation or LLC sharpens the ownership of property rights that were previously vague and undefined. In doing so, the conversion will encourage investment of new equity capital from members. The conversion will also create an incentive for existing members and patrons not only to patiently wait for redemption of equity, but to benefit from appreciation in the going concern and good will value of the corporation or LLC

III. Overview of Conversion Procedures and Legal Issues

A. Typical Conversion Procedure. A cooperative whose leaders have determined that a conversion is an appropriate step will logically seek to minimize the procedural steps required

⁴ Michael L. Cook & Constantine Iliopoulos, *Ill-Defined Property Rights in Collective Action: The Case of U.S. Agricultural Cooperatives*, in INSTITUTIONS, CONTRACTS AND ORGANIZATIONS: PERSPECTIVES FROM NEW INSTITUTIONAL ECONOMICS 335 (Claude Ménard ed., 2000).

to effect the conversion. In its most basic form, a cooperative conversion typically is completed by merging the cooperative into an LLC or corporation formed to continue the cooperative's business.

Working with its legal and financial advisors, the cooperative will begin the process by forming a wholly-owned subsidiary organization that will be the surviving entity following the conversion. One of the key decisions that must be made by a cooperative pursuing a conversion is whether it should convert to an LLC or a corporation. Although there are numerous factors that should be considered in making this decision, cooperatives for whom tax efficiency following the conversion is the most important factor are likely to pursue conversion to an LLC. This choice is driven by the fact that LLCs are usually taxed as partnerships under Subchapter K of the Internal Revenue Code. This treatment allows the LLC to benefit from "pass-through" tax treatment in which the entity does not pay tax, but the entity's income and loss are "passed-through" to the LLC's members. A cooperative that is motivated to pursue a conversion in the hope of obtaining greater liquidity for the equity interests held by its members is more likely to consider conversion into a corporation. In that structure, the corporation pays tax at the entity level on its income and the stockholders are taxed again when the corporation distributes any dividends to its stockholders. However, a corporation is eligible for listing on a stock exchange, such as the New York Stock Exchange, or through NASDAQ, while LLCs taxed as partnerships typically are not.

Once the cooperative has selected whether it will convert into an LLC or a corporation, the subsidiary is formed and the necessary conversion documents are prepared. The most important document is the merger agreement between the cooperative and its wholly-owned subsidiary. The merger agreement contains the terms upon which ownership interests in the cooperative will be converted into LLC units or corporate shares. In addition, the merger agreement typically provides that upon filing of notice of the merger with the appropriate state office, the cooperative will be merged into the LLC or corporation and that organization will be the surviving entity following the merger.

Given the magnitude of the change, state law will require that the cooperative's members vote to approve the merger with and into the wholly-owned subsidiary. Such a vote usually occurs at a special meeting of the cooperative's members. Before coop members vote on the proposed conversion, they typically receive a disclosure document fully describing the proposed conversion, the reasons for the conversion and a comparison of their rights as members of the cooperative before the proposed conversion and their rights as members of an LLC or stockholders in a corporation if the proposed conversion is completed.

If the coop's members vote in favor of the proposed conversion, the merger documents necessary to make the conversion effective are filed. Once that occurs, the cooperative ceases to exist and its assets and liabilities become the assets and liabilities of the surviving LLC or corporation. The equity interests held by coop members prior to the conversion become interests in the surviving LLC or corporation upon the terms and conditions stated in the merger agreement.

A conversion completed as described above is clearly subject to the state law governing cooperatives and mergers between cooperatives and LLCs and corporations. However, a proposed conversion

also has legal implications under securities and tax laws. Those implications are discussed in the following sections and must be carefully considered by the cooperative and its advisors in analyzing and planning for any proposed conversion.

B. Securities Law Implications. In considering and voting for or against a proposed conversion, a cooperative member must make an investment decision. That is, the coop member must decide whether or not they are willing to exchange the equity interest they hold in the coop for either an LLC unit or a share of stock in a corporation. The fact that a proposed conversion involves such an investment decision has implications under applicable law for both securities registration and disclosure requirements.

A proposed conversion involves the issuance of new LLC units or new shares of stock by the surviving entity. Those new issuances are viewed by federal and state securities laws as the offer and sale of securities by the surviving entity. As such, the offer and sale must either be registered with the Securities and Exchange Commission or be able to rely upon an appropriate exemption from securities registration. Cooperatives considering a proposed conversion will initially consider the availability of an exemption from securities registration, as proposed conversions completed under a securities exemption will not be subject to the time and expense arising from detailed review of the proposed conversion by the SEC's staff. Although the federal securities laws contain a wide variety of exemptions, only two different exemptions appear to have been used in connection with cooperative conversions. If the cooperative seeking conversion has a very small number of members, it may be possible to rely upon the private placement exemption for transactions not involving any "public offering". This exemption, however, will not be available if LLC units or corporate shares are to be issued to a large number of former coop members in the proposed conversion.

Another exemption that has been used by cooperatives seeking to convert is the "intrastate" exemption; the intrastate exemption is available when LLC units or corporate shares are to be issued to residents of only the state where the surviving entity is organized. Other requirements of reliance upon the intrastate exemption from federal securities registration are that the surviving entity have a significant majority of its assets within the state where it is organized and that it generate a significant majority of its revenue within that state.

If an exemption from securities registration is not available for the proposed conversion, it will be necessary to register the offer and sale of LLC units or corporate shares by the surviving entity with the Securities and Exchange Commission. This is an extended and expensive process in which the surviving entity files a registration statement with the SEC. That registration statement contains the disclosure document that will be provided to members in connection with the vote on the proposed conversion. Only after the SEC staff has declared the registration statement "effective" following extensive review, comments from the SEC staff and any necessary amendments may the disclosure document be distributed to the cooperative's members to solicit their vote for or against the proposed conversion.

The second key implication arising from the fact that coop members voting on a proposed conversion are making an investment decision is the need for appropriate disclosure to the members in connection with the vote. As indicated above, it is essential to provide that disclosure so that members can be fully-informed as they make their decision to vote for or against the proposed conversion. If the proposed conversion is registered with the SEC, the form of the disclosure is heavily regulated, with extensive regulations specifying the type of information that must be included and the manner in which that information is to be presented. If the proposed conversion can be completed in reliance upon an exemption from securities registration, there is more flexibility in the manner in which information may be presented to the cooperative's members. In addition, the disclosure materials for use in an exempt offering are not required to be filed with or review by the SEC staff.

C. Tax Law Implications. When a coop considers the possibility of a conversion to some other form of business enterprise, it must carefully consider the tax implications of future operation of the business in the new organizational structure. As noted above, operation as an LLC can provide “pass-through” taxation in which no entity level tax is paid on income generated by the business. Operation as a corporation generally subjects the income generated by the business to tax at the entity level and again when dividends are distributed to the corporation's stockholders.

In addition to the tax implications of operation of the business following the conversion, it is essential to consider the tax implications of the conversion itself. If the cooperative is seeking to convert into a corporation, it is likely that the conversion can be completed as a tax-free reorganization in which the conversion itself does not trigger tax recognition.

The situation is significantly different if the cooperative plans to convert into an LLC. Although cooperatives have special tax attributes not available to other corporate entities, cooperatives formed under virtually all cooperative statutes are corporations. Under the Internal Revenue Code, it is generally not possible to merge a corporate entity into a “pass-through” entity such as a partnership or LLC on a tax free basis. Instead, the applicable rules and IRS rulings characterize such a merger as a “deemed liquidation” of the cooperative followed by a subsequent “re-organization” of the LLC by the former cooperative members. This characterization is used as the basis for taxing such a transaction even though the formal steps to complete the proposed conversion do not involve the liquidation of the cooperative, but a merger of the cooperative into the surviving LLC.

The impact of this tax characterization of a proposed conversion can be significant, particularly if the cooperative holds property that has appreciated in value. The analysis begins by calculating the tax that the cooperative as an entity is likely to incur if a conversion is completed. The amount of this tax is determined by comparing the fair market value of the cooperative's assets immediately before the conversion takes place with the cooperative's tax basis in those assets. If the fair market value is greater than the tax basis, the difference will be subject to tax at the entity level upon the conversion *even though the transaction does not generate any cash or other resources to pay the applicable tax.*

The second part of the tax calculation is to determine the gain, if any, that will be taxed to the coop's members upon the conversion. This amount is calculated by comparing the fair market value of the

LLC units received by a coop member in the conversion with that member's tax basis in his or her equity interest in the cooperative. If the fair market value of the LLC units received by a member exceeds that member's tax basis in his or her cooperative interests, the difference will be subject to tax on the coop member, even though the transaction does not generate any cash distribution that the coop members can use to pay the tax imposed on them. The effect, then, is that tax can be imposed at both the entity level and at the member level when the proposed conversion is completed.

As the amount of tax is determined when the conversion is completed and because the transaction does not involve a sale of any cooperative assets for cash consideration, it is necessary for the cooperative to obtain the assistance of an appraisal firm or investment banker to provide an opinion as to the fair market value of the various elements of the tax calculation. (The appraisal firm typically prepares an estimate of those values that is included in the disclosure distributed to the cooperative members; a definitive valuation is then completed as of the date that the conversion becomes effective.) Given the possibility of significant tax implications, it is essential that a cooperative's leaders obtain expert advice in estimating the potential tax liabilities and in comparing those tax costs with the expected benefits of the proposed conversion.

Conclusion

A cooperative considering the possibility of conversion to some other form of business enterprise must be aware that it is following a path that involves significant legal requirements and business uncertainties. The analysis necessary to thoughtfully pursue such a transaction must include a careful weighing of the expected benefits of the proposed conversion and the potential costs and risks associated with the possible conversion. A conversion will require a cooperative to comply with complex state, securities and tax laws. Given the challenges of such compliance, a cooperative conversion should not be adopted lightly, but should be pursued only after careful consideration of the best interests of the members and the business enterprise.