Minnesota Association of Cooperatives

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TO: Minnesota Cooperative Leaders

FROM: Bill Oemichen, President & CEO *Bill Oemichen*
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RE: New Minnesota Statutes Chapter 308B - Minnesota Cooperative Associations Act

I. Introduction.

A. The Chapter 308B Statute Was Proposed to Provide Flexibility to Minnesota Cooperatives Attempting to Raise Equity for Modernization or Expansion.

The recently concluded Minnesota Legislative Session ended with a major milestone for the Minnesota Association of Cooperatives (MAC). The Legislature passed, and Governor Pawlenty signed into law, legislation creating a second Minnesota cooperative law that provides significant tools for patron members seeking outside equity capital for the creation, modernization, or expansion of a cooperative. MAC sought passage of the new law because Minnesota cooperatives have experienced difficulty raising equity capital for cooperative creation, modernization or expansion under the current restrictive Minnesota cooperative law and because some cooperatives are converting to non-cooperative forms like LLC's to gain greater access to equity.

New Chapter 308B essentially authorizes outside equity investment in the cooperative in return for limited voting rights to provide for more flexible financing alternatives for cooperatives. New Chapter 308B does not replace Chapter 308A. Patron members now have two choices when determining what type of Minnesota cooperative they wish to create.

This new law places Minnesota, the leading cooperative state in the nation, at the forefront of the evolution of national cooperative law. Just today, the National Council of Farmer Cooperatives in a press release cited the new Minnesota law as a primary reason why national cooperative law needs to be reformed.

The new law was primarily written by attorneys in the Minneapolis office of Lindquist & Vennum, one of the leading cooperative law firms in the nation. The attorneys drafted the new law following an extensive series of meetings MAC hosted with Minnesota cooperatives across the state in the summer and fall of 2002. Attorneys from Dorsey & Whitney also provided MAC with legal guidance on this issue.

B. Chapter 308B Provides Significant Protections for Patron Members.

It's vital to understand that the new statute creates a number of protections for patron members through mandated minimum levels of voting control within the board of directors, by votes of the membership and in determining financial rights. These protections are established through a series of floors such as a requirement that patron members retain at least 50% voting control of the board of directors. Members, in the bylaws, may set the exact percentage. However, the members do not have the discretion to lower the minimum floors established in the statute.

II. Investment Members Authorized. Unlike current Chapter 308A, Chapter 308B cooperatives may have two classes of members: patron members and investment members. Patron members have the financial right to no less than 60% of the cooperatives' profit allocations and distributions unless patron members vote to reduce their financial rights. Even if they do, non-patron investor members may receive no more than 85% of the cooperative's profit allocations and distributions even if their ownership interest is greater than 85%. Also, it is important to note patron members may also become investment members.

III. Taxation and Conversion. A Chapter 308B cooperative may be taxed as a partnership under Subchapter K of the Internal Revenue Code and receive pass-through treatment, or elect to be taxed as a cooperative under Subchapter T with a deduction from taxable income to the cooperative for patronage-sourced income. Choosing subchapter K tax treatment provides the potential benefit of pass-through treatment of profits from non-member business and the avoidance of double taxation of non-member business under Subchapter T.

It is unlikely existing, profitable Chapter 308A Minnesota cooperatives taxed under Subchapter T would convert to a Chapter 308B cooperative taxed under Subchapter K because the IRS would likely view the conversion as a liquidation of the Chapter 308A cooperative with a sale of assets. According to tax and legal experts, an appraisal of the cooperative's value may result in considerable gain taxed to members without distributed income to pay the tax.

IV. Cooperative Governance. The statute provides flexibility in governance through reliance on the cooperative's bylaws, with certain mandated minimum levels of governance rights for patron members. This flexibility allows the cooperative's members to determine the appropriate governance structure through bylaws rather than having the Legislature determine all of the key governance issues.

Chapter 308B requires the patron-members to hold at ***least*** 50% of the voting powers on "general matters of the cooperative." This means patron-members retain considerable influence over cooperative decisions, particularly when combined with a Chapter 308B provision that provides that patron-members generally vote as a bloc in board decisions or decisions by the general membership.

The new statute sets a minimum patron member voting rights floor. Patron members of a cooperative can set significantly higher levels of patron member control in the bylaws.

A Chapter 308B cooperative must establish an Audit Committee which may consist of the entire Board.

V. Patron Member Financial Rights. A Chapter 308B cooperative has the flexibility to determine patron and investor member financial rights. Unless modified at the cooperative's inception, patron members are entitled to at least 60% of the cooperative's financial rights to profit allocations and distributions. This number may only be later reduced if the patron members affirmatively vote for the reduced patron member financial rights. Significantly, the statute mandates an absolute 15% floor on patron member financial rights. This means that even if patron members vote for a change that reduces their financial rights to less than 60%, the patron members must still receive at least 15% of the cooperative's profits even if investor members (who do not patronize the cooperative) own more than 85% of the equity. This provision is intended to ensure a minimum level of distribution for patron members.

The new statute sets a floor. Patron members of a cooperative can set significantly higher levels of patron member financial rights in the bylaws.

VI. Why Cooperatives Might Organize Under the New Chapter 308B. Many Minnesota cooperatives have expressed interest in utilizing a cooperative form of governance for a joint venture. Minnesota cooperatives have noted that the limitations of Chapter 308A meant they had to choose to organize related businesses as LLC's. Under Chapter 308B, two cooperatives and an outside investor can form a new Chapter 308B cooperative, be taxed like an LLC and still potentially qualify for Capper-Volstead Act antitrust immunity protection.

Minnesota agricultural producers have pointed out that the current law limits their ability to obtain debt financing because of the difficulty raising equity through preferred stock offerings and their inability to raise equity capital from non-patron investors or even from patron members who want to further invest in the cooperative. Chapter 308B allows for the ability to raise equity from non-patron investors and patron members to meet minimum equity requirements and pay more than 8% return on the investment.

Several electric cooperatives have asked for a new cooperative statute that allows them to create joint ventures with other electric cooperatives, or other cooperatives, in a cooperative form, rather than as an LLC. Chapter 308B provides significant flexibility for joint ventures. For example, two electric cooperatives can join with a non-cooperative business in a Chapter 308B cooperative for the purpose of conducting joint right-of-way maintenance, security services, etc.

Chapter 308B also allows non-agricultural businesses such as senior housing, electric, telecommunications, health care, and purchasing cooperatives to be more freely created and have the equity provided by members and non-members. For example, a telecommunications cooperative could raise non-patron member equity to help finance the installation of cable in their community.

VII. Potential Issues to Consider.

A. Antitrust Protection May Be An Issue for New Chapter 308B Cooperatives Marketing Agricultural Products. Minnesota cooperatives should carefully consider how the new Chapter 308B might apply to existing and future cooperative business activities. For example, existing agricultural cooperatives marketing agricultural products enjoy antitrust immunity protection under Capper-Volstead. Generally, antitrust immunity protection applies to "[p]ersons engaged in the production of agricultural products as farmers, planters, ranchmen, dairymen, nut or fruit growers." Furthermore, no member may be allowed more than one vote or dividends on preferred stock may not exceed 8% per year, and the cooperative may not market more products produced by non-members than members. Allowing non-patron investor members into the cooperative may place this immunity at risk and should be carefully considered by the cooperative's legal and tax experts.

More than several Minnesota agricultural cooperatives have argued this is not a significant issue if the cooperative cannot raise enough equity capital to get started or is involved in a non-agricultural production or marketing activity. Furthermore, since antitrust immunity is generally limited to the marketing of agricultural products, a majority of Minnesota's cooperatives currently do not currently enjoy this antitrust immunity protection.

B. Patron Member Decision-Making and the Need for Continuing Education. Patron members, at the cooperatives' creation, have the flexibility to determine what levels of control they wish to have relative to non-patron investor members. Therefore, it's important that patron members carefully consider such important issues as member voting, board of director voting and financial rights when incorporating as a cooperative. Certainly these issues should be carefully considered throughout the life of the cooperative as well. This suggests the importance of continuing education of patron board directors and members so that patron members fully understand their rights and responsibilities within the cooperative and make decisions based on full information.

C. Securities Issues Should be Carefully Analyzed. Finally, anyone exploring creation of a Section 308B cooperative should also closely examine federal and state securities laws. Minnesota law generally exempts cooperative securities from state securities registration requirement. Depending on how the new cooperative is set up, the cooperative may not be eligible to receive the benefits of the securities exemption.

VIII. MAC Education Conferences on New Chapter 308B Planned for this Summer. MAC is scheduling a series of educational conferences on new Chapter 308B for this summer. Notices will be mailed to MAC members and updates will be posted on MAC's website: www.wfcmac.org/coops/mac/mac.html

This memorandum is offered by the Minnesota Association of Cooperatives to members for the purpose of generally summarizing new Minnesota Chapter 308B and not for the purpose of offering legal advice. Members should consult competent legal or tax counsel for guidance.