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Nature and Formation of Co-ops

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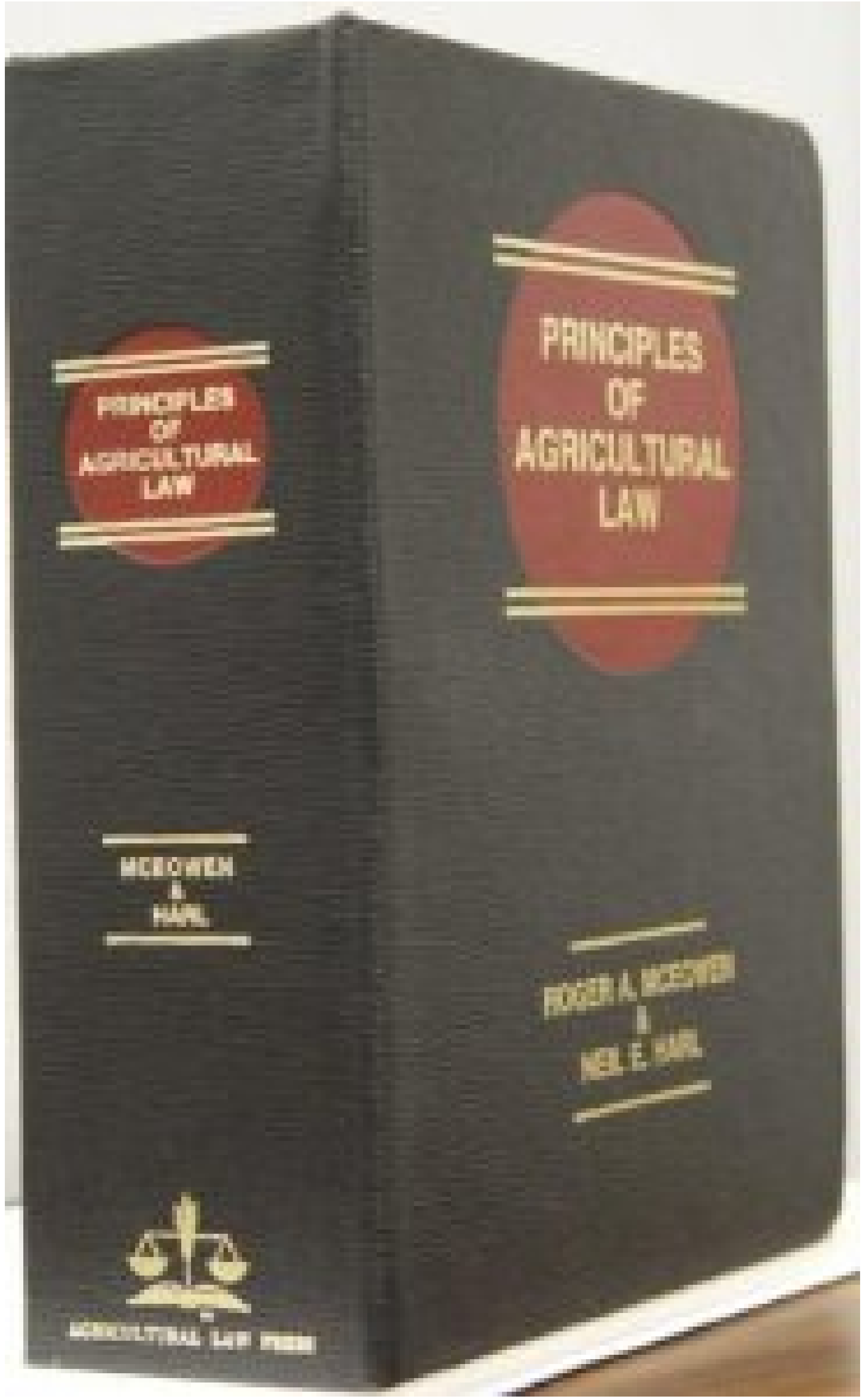
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CHAPTER 10 - COOPERATIVES

COOPERATIVES

- Overview
  - A co-op is a business entity that distributes its income to its members in accordance with those member's use of the co-op
  - Co-ops are designed to provide members with some extent of economic market power
    - Production and marketing of agricultural commodities
    - Procuring supplies and services

Which of the following is analogous to Co-op definition?

1. Owned by one person
2. Owned by two person
3. Publicly owned by many people
4. Owned by its members

Example 1: Suppose a Co-op is owned by 10 members (A, B, C.., J). Last year, member J's use of the Co-op was 35%, member I's use was 25%, and all other members' use was 5%. If the Co-op had a $100,000 income last year and wishes to distribute all last year income to its members, how much should each member receive?

1. Each member gets $10,000
2. Member J & I get $50,000, all other members get the other $50,000
3. Member J gets $35,000; Member I gets $25,000; all other members get $5,000

COOPERATIVES

- Similarities to other businesses
  - Have physical facilities
  - Perform similar functions
  - Follow sound business practices
  - Incorporate under state law
  - Draw up bylaws and necessary legal papers
  - Elect board of directors
- Distinctly different from other business
  - Their purpose, ownership, control and distribution of benefits

In general, what makes a Co-op different?

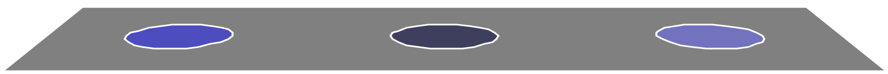
A. Their physical facilities
B. The business practices that must be followed
C. Their purpose, ownership, control and distribution of benefits
D. The board of directors
E. All of the above

COOPERATIVES

- Democratic Ownership and control by users
  - Democratic control means that a member has one vote regardless of the degree of investment in the Co-op (few exceptions for some states)
- Control and Distribution of benefits
  - Profits are distributed in accordance with a particular member’s use (also know as patronage)
  - Profits are distributed in a way that maximizes members’ interests

Example 2: Suppose a Co-op is owned by 10 members (A, B, C.., J). Member J's use of the Co-op is 35%, member I's use is 25%, and all other members' use of the Co-op is 5%. Suppose a member of the board of directors needs to be elected. If the Co-op has democratic control, how many votes does each member have?

1. Each member has one vote
2. Member J's vote weights 2.5 votes; Member I's vote weights 2.5 votes; all other members' vote weights 0.5 votes each
3. Member J's vote weights 3.5 votes; Member I's vote weights 2.5 votes; all other members' vote weights 0.5 vote each



COOPERATIVES

- Co-op attempts to market patron's commodities at the highest possible price and purchase quality inputs at the lowest possible cost.
  - Resulting net income belong to patrons
  - Typically, at least 20% of net income is paid out as a cash patronage refund and the balance is retained patronage refund.
  - Retained patronage refund is redeemed when the user stops using the cooperative.

Example 3: Suppose a Co-op is owned by 10 members (A, B, C.., J). Suppose last year the Co-op had a $100,000 income and wishes to distribute 20% to its members and retain the other 80%. What is the another name for the income that will be retained?

1. Cash refund
2. Cash redeemed
3. Retained refund
4. Democratic control

Nature of Co-ops

- Co-ops are voluntary business organizations chartered by state law that enable persons to join together for
  - Mutual help
  - Purchasing
  - Collective marketing
- Agricultural Co-ops
  [1] Marketing Co-ops
  [2] Value-Added Co-ops
  [3] Supply Co-ops

[1] Marketing Co-ops

- Designed to assist in the marketing of its members' agricultural products
- Function either as a purchaser of its members' products at the prevailing market rate or as a pooling agency
- Co-op functions as a purchaser
  - The products may be combined with similar products for resale
- Co-op functions as a pooling agency
  - Individual farmers or ranchers, farm or ranch corporations, LLCs and partnerships, contract with the co-op to sell their product at a prescribed contract price, less an amount for marketing cost based on volume.

[1] Marketing Co-ops (Cont.)

- Generally, members agree to market their products through the co-op by the use of marketing contracts.
  - Seldom used by grain marking and farm supply co-ops
- Marketing contracts may require the members to sell all or any specified part of their production through the co-op for a specific period of time, usually not to exceed ten years.
- The co-op obligations under the marketing contract are to sell the product and return the price to the member, deducting expenses and other costs as specified in the agreement.
- A bargaining co-op is another type of marketing co-op.
  - Do not take physical possession of the commodity
  - Actual sale may be made by the member to the buyer, but on terms agreed to by the co-op
  - Commonly used by dairy farmers and vegetable producers

[2] Value-Added Co-ops

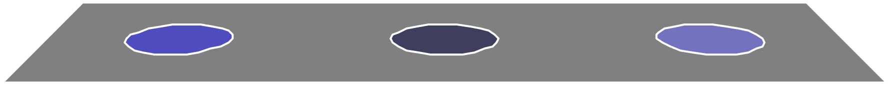
- Value-Added or "new wave" cooperatives
- Upper Midwest and Northern Plains
- Up-front investment in direct proportion to use
- Co-op engaged in processing, marketing or input manufacturing
- Example: A cooperative that adds value to a farmer's product by feeding the product to animals (cattle, hogs, fish, chickens, etc.) and selling the animals (or animal products)

[3] Supply Co-ops

- Designed to secure supplies and equipment needed by the membership at the lowest possible per unit cost
- Purchase the products needed by its members, such as machinery parts, fertilizer, feed or petroleum products, at wholesale prices
- Products are sold to its members
- Net earnings are distributed to the members based on the volume of business transacted by the member with the co-op
- Some portion may be retained by the co-op and paid at a future date as equity redemption

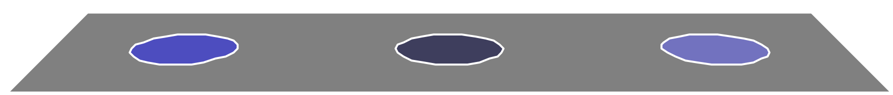
Example 4: Suppose all the members of a marketing Co-op are beef producers. Which of the following is a function of a marketing Co-op?

1. Buy pasture and feed for its members
2. Sell the fed cattle for its members
3. Slaughter the fed cattle and process the meat so that its member get a better price



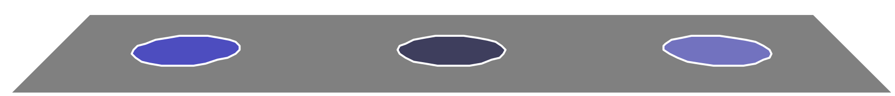
<u>Example 5:</u> Suppose all the members of a marketing Co-op are beef producers. Which of the following is a function of a <u>supply</u> Co-op?

1. Buy pasture and feed for its members
2. Sell the fed cattle for its members
3. Slaughter the fed cattle and process the meat so that its member get a better price



Example 6: Suppose all the members of a marketing Co-op are beef producers. Which of the following is a function of a value-added Co-op?

1. Buy pasture and feed for its members
2. Sell the fed cattle for its members
3. Slaughter the fed cattle and process the meat so that its member get a better price



Formation of Co-ops

- Many states limit membership in an agricultural co-op to “agricultural producers”
- Membership is achieved either through purchasing a share of stock or a member certificate, depending upon whether the co-op is stock or nonstock co-op
- The objective is to take advantage of the benefits of membership rather than to seek a return on investment
- Members elect directors. Directors hire manager or chief executive officer (which may need to be members)

Why would you like to join a Co-op?

1. To benefit from the cash refunds at the end of the year
2. To benefit from the tax exemptions
3. To benefit from the co-op services provided to its members
4. To become a member of the board of directors

In general, who can join an <u>Agricultural</u> Co-op?

1. Anybody (regardless if they are Ag producers)
2. Only ag producers who have losses
3. Only ag producers who have gains
4. Ag producer only

Status That Affect Co-ops

- Special provisions govern co-op taxation
- The status of co-op financial instruments under state and federal securities laws
- The special treatment of agricultural co-ops under antitrust laws
- Eligibility to borrow from Farm Credit System (FCS) banks
- These and other status are important not only to the formation of an agricultural co-op, but to its ongoing operation

Formation of Co-ops

1. Local producers meet to discuss potential economic benefits of doing business as a co-op and determine the interest in and need for a co-op
2. If a majority of producers vote to transact business through a co-op, a steering committee is established
3. The steering committee analyzes market supply and demand and cost data
4. A meeting is held to discuss the results of the data obtained
5. A business plan is developed

Formation of Co-ops

6. Preparation of necessary legal papers for incorporation
7. Bylaws are adopted and ratified
8. A board of directors is elected
9. A membership drive is conducted
10. Capital is acquired
11. A manager is acquired or designated
12. Facilities are acquired
13. Operations begin

Management

- Board of directors
  - Policy-making body
  - Elected by membership
  - Establish policy
  - Report to members
  - Hire manager (chief executive officer)
  - Give direction to the manager
  - Accountable for conducting business affairs
  - Audit and evaluates the co-op’s financial condition

Management

- Manager (chief executive officer)
  - Supervises daily operations
    - Manages human capital and physical resources
  - Supervises and coordinate business activity
  - Develops plans to reach objectives
  - Take steps to carry our board policy

Financial Structure

- Co-ops use unique methods to raise capital and operation funds.
- To begin or expand operations, a typical co-op is capitalized by
  - Seeking capital investments from members
  - Retaining patronage funds
  - Borrowing debt or capital
  - Or a combination of these methods

Financial Structure

- Stock and Membership Purchases
  - Members purchasing common stock, preferred stock, membership certificates, bonds, promissory notes or debentures

Financial Structure

- Patronage-Based Financing
  - Co-ops distribute net earnings to members at least annually.
  - Part is paid cash and part is retained as new equity investment.
  - When patronage refunds are not paid in full in cash, the co-op is generally authorized to make refunds to patrons in the form of written notices of allocation (commonly called retained patronage refunds)

Financial Structure

- Patronage-Based Financing
  - Members are allowed to slowly “earn” their equity investment over time
  - Large stock redemptions are generally not made unless the co-op has enough profits to create “new” equity to replace “old equity”
  - While it might seem appropriate to redeem equity when a member ceases active farming or ranching, or dies, some co-ops do not have earnings and liquid assets sufficient to make such disbursements
  - Directors generally have great discretion to redeem patronage refunds and per-unit retains upon a member’s retirement or death
  - Courts generally support decisions of directors not to repurchase stock or redeem patronage refunds and per-unit retains

Financial Structure

- Borrowed Capital
  - Co-ops borrow from FCS banks and other lenders
  - Eligible agricultural co-ops have access to certain FCS banks for long-term capital improvement loans and short-term operating loans
  - To be eligible borrower, a co-op must transact at least 50% of its business with members
  - In addition, 80% voting control must be held by farmers
    - Reduced to 60% for certain service and farm supply co-ops

How does a co-op finance itself?

1. Seeking capital investments from members
2. Retaining patronage funds
3. Borrowing debt or capital
4. All of the above

Directors’ Responsibilities

- Responsibility for co-op functions varies depending on size of the association
  - In small cooperatives, individual members share most of the responsibilities
  - In large cooperatives, most of the operational functions are conducted by a board of directors
- Co-op board functions similarly to a corporate board of directors
  - Typically, principles of corporate law apply to cases involving co-op boards and their directors

Directors' Responsibilities

- To obey to articles of incorporation, bylaws, statutes and laws
- To be loyal and act in good faith
  - Do what is proper for the co-op
  - Treat stockholders and patrons fairly
  - Protect the shareholders' investments
  - Avoid conflict of interest
  - Keep privileged information confidential

Directors' Responsibilities

- To care
  - Requires directors to act with diligence, care, and skill
  - Attention to co-op matters
  - Reliance on officers and employees
  - Delegation of duties

Directors' Responsibilities

- Common law liability
  - Fraud: Concealing information that should be disclosed to members
  - Conversion: Absence of authorization, inaction involving a wrongful property transfer
  - Tort: Damages resulting from negligence or intentional acts
  - Corporate waste: Loss of funds through gross negligence
  - Nuisance: Create offensive odors, dust, noise or other pollution

Directors' Responsibilities

- Shareholder derivative suits
  - Shareholders may sue when there is:
    - An actionable wrong to the corporation perpetrated either by outsiders or insiders; and
    - The wrongful refusal of the corporation's management to bring an action to rectify the wrong.
  - A shareholder derivative action may be brought to correct a broad range of conduct of outsiders, directors, officers or other insiders.

Shareholder Derivative Suits

- For what actions can shareholders bring lawsuits?
  - Mismanagement
  - Misappropriation of assets
  - Dilution of equity by improper issuance of additional stock
  - Actions that affect value of stockholder ownership

Questions?

Thank You!