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An Agricultural Law Research Article

Part II: An Overview of Organizational and Ownership Options Available to Agricultural Enterprises

by

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Table of Contents

A.	Introduction to Part II	3
B.	Limited Liability Companies	4
1.	Business Law Status	4
a.	Formation	5
b.	The Operating Agreement	6
c.	Liability of Members	7
d.	Contributions to an LLC	8
e.	Management of the LLC	8
f.	Allocations of Profits and Losses, and Distributions	11
g.	Transferability of Membership Interests	13
h.	Terminating Membership Status	14
i.	Dissolution, Winding Up and Termination	15
2.	Tax Status	16
a.	In General	16
b.	Basis Adjustments	17
c.	The “at-risk” Rules	17
d.	Passive Losses	18
e.	The “Tax Matters” Partner	18
f.	Self-Employment Taxes	19
3.	Comparing the LLC with Other Organizational Forms.	22
C.	Corporation	25
1.	Business Law Status	25
a.	Traditional Corporation	25
b.	Statutory Close Corporation	26
c.	Formation	28
d.	Contributions	28
e.	The Limits on Shareholder Liability	29
f.	Management of a Corporation	31
g.	The Rights of a Shareholder to Recognize a Return on the Investment	32
h.	Transferability of Shares	33
i.	Termination of the Corporation	34
2.	Tax Status	35
a.	S Corporation	35
b.	C Corporation	36
D	Cooperatives	37
1.	Business Law Status	37
a.	Introduction	37
b.	General Comparison with the Corporate Form of Business	37
c.	The Essential Attributes of the Traditional Cooperative	39

d.	Ownership and Control of a Cooperative	40
e.	Income Distribution in a Traditional Cooperative	41
f.	Returns on Ownership Capital Are Limited	43
g.	Traditional Financing for Cooperative Operations	44
h.	Value-Added or Next-Generation Cooperatives	45
2.	Tax Status	50
E	Conclusion to Part II	52

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PART II: AN OVERVIEW OF ORGANIZATIONAL AND OWNERSHIP OPTIONS AVAILABLE TO AGRICULTURAL ENTERPRISES

Carol R. Goforth*

A. Introduction to Part II

This article is the second of two articles that together are designed to provide an overview of the available organizational choices for persons interested in owning and operating an agricultural enterprise. This article will cover limited liability companies, corporations, and cooperatives. The first document in the series examined sole proprietorships, general partnerships, limited liability partnerships (LLPs), limited partnerships and limited liability limited partnerships (LLLLPs).

As with the first article in this pair of articles, the information provided here is general in nature, and this article does not purport to address the specific rules which apply to each of the options in each of the 50 states. For example, all 50 states have statutes governing the formation and operation of limited liability companies. However, there is considerable variation between the states, so it is difficult to identify specific rules that will apply to every LLC. However, there are general principles which apply to most LLCs, and for most rules there are a limited number of default positions identified in the various state statutes. This article therefore attempts to identify the majority rule and the more prevalent deviations from this position. No attempt has been made to research the law of all 50 states, or to provide citations to all 50 statutes. Rather, as to most issues, the citations provided are to the Uniform or Model Act: in the case of LLCs, the citations are to the Uniform Limited Liability Company Act (U.L.L.C.A.), and for corporations, the citations are to the Model Business Corporation Act (M.B.C.A.). This article therefore focuses primarily on the general rules, even as to corporations, where there is significantly greater uniformity with regard to most of the issues discussed in the following pages.

This article is not intended as a substitute for the advice of experienced counsel familiar with the laws of the jurisdiction or jurisdictions in which any proposed agricultural business might operate. The purpose here is to provide general background information, and to offer sufficient insights so that a reader will be able to understand most of the attributes of the business forms discussed here.

Because it is possible that this article may be consulted by attorneys as well as those who do not have a legal background, the text will generally be written in a manner which is intended to be understandable by anyone. Footnotes will contain more detailed information and citations that are likely to be of interest primarily to persons who already have a legal background, even if their normal areas of expertise do not include the law applicable to business enterprises.

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Neither part of this series addresses non-profit organizations or trusts, even though both of these may be employed in connection with certain agricultural operations. Rather, the focus of these materials is on the business forms listed above. As with Part I of this series, both business and tax considerations will be introduced, although the primary focus of this article is on the business law rules applicable to each of the organizational forms considered here.

B. Limited Liability Companies

1. Business Law Status

The LLC is a creature of statute, recognized in each jurisdiction only by virtue of a legislative enactment. The first statute authorizing domestic LLCs was passed in Wyoming in 1977.¹ When the I.R.S. finally concluded in 1988 that limited liability should not be a determinative factor in denying partnership tax status to the new organization, the LLC began to receive significant attention elsewhere.² Shortly after determining that limited liability would not be a determinative factor in entity classification, the Service issued a public ruling concluding that LLCs organized under the Wyoming LLC Act would be classified as partnerships for federal tax purposes.³ This I.R.S. ruling resulted in a trickle of new legislation which turned into a virtual flood of statutes authorizing the new form of business entity by the early 1990's. In the spring of 1996, the last two states enacted LLC legislation, so that all fifty states, plus the District of Columbia, now permit the formation of LLCs.⁴

1. Wyo. Stat. §§ 17-15-101 to -136 (1989 & Supp. 1995).

2. Announcement 88-118, 1988-38 I.R.B. (Sept. 19, 1988). This study concluded that the limited liability aspect of LLCs should not, by itself, prevent an LLC from being classified as a partnership for tax purposes. See Turlington & Small, *Tax Aspects of Limited Liability Companies*, PLI Corporate Law and Practice Course Handbook Series, 805 PLI/Corp. 103 (Feb. 1, 1993). Despite the importance of this conclusion, however, there does not appear to have been any written report or analysis accompanying the simple release which did little more than state the conclusions reached by the Service.

3. Rev. Rul. 88-76, 1988-2 I.R.B. (Sept. 18, 1988).

4. Colorado and Kansas enacted LLC statutes in 1990. Colo. Rev. Stat. §§ 7-80-101 to 7-80-1101 (Supp. 1995); Kan. Stat. Ann. §§ 17-7601 to 17-7656 (1995). Nevada, Texas, Utah and Virginia followed suit in 1991. Nev. Rev. Stat. §§ 86.011 to 86.571 (1991); Tex. Rev. Civ. Stat. Ann. art. 1528n §§ 1.01 to 11.07 (West Supp. 1996); Utah Code Ann. §§ 48-2b-102 to 48-2b-158 (Supp. 1996); Va. Code Ann. §§ 13.1-1000 to 13.1-1073 (1993 & Supp. 1996). In 1992, ten more states passed statutes authorizing LLCs. Ariz. Rev. Stat. Ann. §§ 29-601 to 29-857 (Supp. 1995); Del. Code Ann. tit. 6, §§ 18-101 to 18-1107 (1993 & Supp. 1996); Ill. Ann. Stat. ch. 805 ¶¶ 180/1-1. to 180/60-1. (Smith-Hurd Supp.1996); Iowa Code Ann. §§ 490A.100 to 490A.1601 (West Supp. 1996); La. Rev. Stat. Ann. §§ 12:1301 to 12:1369 (West 1994); Md. Code Ann., Corps. & Ass'ns, §§ 4A-101 to 4A-1103 (1993); Minn. Stat. Ann. §§ 322B.01 to 322B.960 (West 1995 & West Supp. 1996); Okla. Stat. Ann. tit. 18, §§ 2000 to 2060 (West Supp. 1996); R.I. Gen. Laws §§ 7-16-1 to 7-16-75 (1992 & Supp.1995); W.Va. Code §§ 31-1A-1 to 31-1A-69 (1996).

In 1993 the following jurisdictions enacted LLC legislation: Ala. Code §§ 10-12-1 to 10-12-61 (Supp. 1995); Ark. Code Ann. §§ 4-32-101 to 4-32-1316 (Michie 1996); Conn. Gen. Stat. Ann. §§ 34-100 to 34-242 (West Supp. 1996); Ga. Code Ann. §§ 14-11-100 to 14-11-1109 (1994 & Supp. 1996); Idaho Code §§ 53-601 to 53-672 (1994 & Supp 1996); Ind. Code Ann. §§ 23-18-1-1 to 23-18-13-1 (Burns 1995 & Burns Supp. 1996); Mo. Ann. Stat. §§ 347.010 to 347.740 (Vernon Supp. 1996); Mich. Comp. Laws Ann. §§ 450.4101 to 450.5200 (West Supp. 1996); Mont. Code Ann. §§ 35-8-101 to 35-8-1307 (1995); Neb. Rev. Stat. §§ 21-2601 to -2645

a. Formation

An LLC is formed by filing an organizational document, often called "Articles of Organization," with the Secretary of State or other appropriate official.⁵ These articles perform a similar function and contain similar information to articles of incorporation or a certificate of limited partnership. Like its corporate and limited partnership counterparts, the articles for an LLC contain relatively little information. Most states will have standard forms that can be used for this purpose and can usually be obtained from the office of the secretary of state or similar official. The actual date of formation may be when articles complying, with the applicable statute or, in some cases, substantially complying are received by the appropriate state official or, in other cases, when the document is actually filed. In most states a later effective date is also possible.⁶

In every state the articles must include the name of the LLC. The name of a nonprofessional LLC may generally not be the same as or deceptively similar to the name of any other LLC, limited partnership, or corporation organized in or transacting business in the state where the LLC is to be formed or to a name that has previously been reserved by someone else. In most states, the name of a nonprofessional LLC must contain the words "Limited Liability Company" or "Limited Company" or the abbreviations for those terms.⁷

In most states there is no express limitation on the use of a member's name in the LLC, as there is with respect to the use of a limited partner's name in the limited partnership. The use of the limited partner's name may open up that limited partner to potential personal liability to creditors of a limited partnership. The absence of a similar limitation in the LLC acts on the use of a member's name is simply another illustration of the potential differences in the roles of the limited partners and the LLC members in the management of the respective entities.

(Supp. 1995); N.H. Rev. Stat. Ann. §§ 304-C:1 to 304-C:85 (1995); N.J. Stat. Ann. §§ 42:2B-1 to 42:2B-70 (West Supp. 1996); N.M. Stat. Ann. §§ 53-19-1 to 53-19-74 (Michie 1993 Repl. & Cum. Supp. 1996); N.C. Gen. Stat. §§ 57C-1-01 to 57C-10-07 (1993 & Supp. 1995); N.D. Cent. Code §§ 10-32-01 to 10-32-155 (1995); Or. Rev. Stat. §§ 63.001 to 63.990 (Supp. 1994); S.D. Codified Laws Ann. §§ 47-34-1 to 47-34-59 (Supp. 1996); Wis. Stat. Ann. 183.0102 to 183.1305 (West Supp. 1995).

In the next three years, the remaining states enacted LLC statutes. See Alaska Stat. §§ 10.50.010 to .995 (Michie Supp. 1995); Calif. [Corporations] Code §§ 17000 to 17705 (West Supp. 1996); D.C. Code Ann. §§ 29-1301 to -1375 (1996); 1995 S.B. No. 2723 (Hawaii) (enacted 6-7-96); Ky. Rev. Stat. Ann. §§ 275.001 to .455 (Michie Supp. 1994); Me. Rev. Stat. Ann. tit. 31 §§ 601 to 762 (1996); Mass. Gen. L. ch.156C §§ 1-68 (Law. Coop. Supp. 1996); Miss. Code Ann. §§ 79-29-101 to 79-29-1204 (Cum. Supp. 1995); N.Y. Limited Liability Company Law §§ 204 to 1309 (1995); Ohio Rev. Code Ann. §§ 1705.01 to .58 (1995); 15 Pa. Cons. Stat. §§ 8901 to 8998 (1995); Tenn. Code Ann. §§ 48-201-101 to -248-606 (Michie Supp. 1995); 1995 H.B. 112 (Vermont) (enacted 5-22-96); Wash. Rev. Code §§ 25.15.005 to .902 (1996).

Obviously, it would be a significant undertaking to refer to each of these state laws as to every issue discussed here, and likely to lead to more confusion than anything else. Therefore, the following materials recite the general rule, and offers citations only to the Uniform LLC Act, which was promulgated by the N.C.C.U.S.L. too late to be influential in the initial wave of LLC statutes, but which is being considered in a number of jurisdictions as they move to update their statutes.

5. U.L.L.C.A § 202(a) & (c).
6. U.L.L.C.A § 202(b).
7. U.L.L.C.A § 105.

Another universal requirement is that the articles include the name and address of the LLC's registered agent for service of process in the state.⁸ A registered agent may generally be an individual who is a resident of that state or a business entity formed in the state, and is, in either case, authorized to accept service of process for the LLC. In most jurisdictions, the address given may be the agent's business, residence, or mailing address, but not a post office box.

In many states, the agent must acknowledge and accept appointment as agent, although this is not a universal requirement. Even in states that include this requirement, the acceptance by the agent typically need not be included in the articles. A separate signed document will work just as well, although many state statutes specifically provide that the LLC cannot be validly formed until such an acceptance is received by the state official.

Another typical requirement is that the articles include the address of the registered office of the LLC.⁹ In most states, the LLC is required to continuously maintain a registered office in the state that may, but need not, be the same as the place of business of the LLC. Because many statutes require certain minimal records to be kept at this office and available for inspection, most states require the address to include street and location rather than a post office box.

In a few states, the articles must include other information such as the general purpose for which the LLC is to be formed or the latest date on which the LLC is to dissolve.¹⁰ Optional provisions are usually allowed as well, so long as they are not inconsistent with the requirements of the applicable statute.

In most states the articles may be signed by one or more persons who need not be members of the LLC.¹¹ The term "persons" for this purpose is liberally defined in the LLC statutes to include individuals, partnerships, other LLCs, trusts, estates, associations, corporations, other legal entities, and custodians and nominees.¹² Often the statute will include specific information requirements such as the address of any person organizing the LLC or the capacity in which any individual signs the document.¹³

b. The Operating Agreement

Notwithstanding the requirement that each LLC be formed via the filing of articles, the heart of the LLC is the "operating agreement," which generally governs the conduct of the business and affairs of the LLC.¹⁴ Some state statutes require a written operating agreement. In most jurisdictions,

8. U.L.L.C.A § 203(a)(3).

9. U.L.L.C.A § 203(a)(2).

10. U.L.L.C.A § 203(a)(5).

11. U.L.L.C.A § 202 contains no requirement that signatories of the organizational document be members of the LLC.

12. U.L.L.C.A § 101(14).

13. U.L.L.C.A § 203(4).

14. U.L.L.C.A § 103(a).

however, an operating agreement is optional and is only required if the members wish to vary the default rules provided for in the state statutes. Moreover, most state statutes permit the operating agreement to be oral, although there is certainly some variation on this point.

The interrelationship of the operating agreement and the provisions of the LLC legislation is probably most akin to that between a limited partnership agreement and the statutory provisions of the limited partnership act. The statutes provide rather complete models for the LLC and the limited partnership, but are, in a variety of places, expressly made subject to a different agreement of the parties. With respect to many issues, an operating agreement will probably simply incorporate, either expressly or impliedly, the default provisions of the applicable LLC Act. However, significant flexibility is usually allowed the parties to vary the statutory default approach by agreement.

c. Liability of Members

There are three principle aspects of the LLC that most commentators agree are behind the increasing popularity of the LLC as a choice for new businesses:

(1) it can be taxed as a partnership (or disregarded as a separate entity if there is only a single member);¹⁵

(2) it is an extremely flexible form of business both in terms of options when creating the business and options about how it is to operate; and

(3) it offers all members limited liability.¹⁶

Under the default rules of every state, members of an LLC have no personal liability solely because of their status as a member. They will, however, be liable for the amount or value of any agreed-upon contributions,¹⁷ for any debt they have guaranteed or for which they have otherwise agreed to act as surety, and for any personal misconduct in which they engage.

Presumably, members of an LLC will also be liable if the veil of limited liability is pierced, a concept that originally developed in the context of corporate-shareholder liability but that has recently been applied to the LLC context in certain circumstances.¹⁸ In all probability, the risk of liability in this situation is greatest when the LLC is grossly undercapitalized from the outset, and the members act in a manner which is inconsistent with the recognition of the LLC as a separate entity (such as by commingling personal and business funds, failing to document loans to and from the entity, and the like). Such facts would tend to show that the members have treated the LLC as their “alter-ego,” rather than as a distinct legal entity, or that the LLC serves as an instrumentality by which the members are perpetrating a fraud or other wrong on members of the public. In some jurisdictions,

15. See *infra* B.2. of this document.

16. In an LLC, “member” is the term used to denote an owner, in much the same way that “partner” refers to an owner in a partnership and “shareholder” means an equity participant in a corporation.

17. Some state statutes require any such agreement to be in a writing signed by the member in order to be enforced against such person.

18. See, *i.e.*, Memorandum Decision in *Bastain v. RJM Associates, LLC*, 29 Conn. L. Rptr. 646 (June 4, 2001)

fraud or similar misconduct must be proven in order to pierce the corporate veil and presumably the same standards will apply in such states to LLCs.¹⁹

With regard to the flexibility inherent in the LLC form of business, as mentioned earlier, the LLC statutes tend to include default rules on most of the issues that are likely to arise in the course of business operations. However, virtually all of these rules are subject to the contrary agreement of the members.

d. Contributions to an LLC

For example, consider the issue of contributions to an LLC. Most state statutes permit an LLC to accept contributions in the form of property, services rendered, or a promissory note or other obligation to contribute cash or property or to perform services in the future.²⁰ Even in jurisdictions where corporations are restricted from issuing stock in exchange for future services or a promise to pay in the future, most LLC statutes authorize contributions to take any form. Some statutes also require the members to agree to a value for all non-cash contributions and to keep a record of the value of each member's contributions. If, however, an LLC wanted to limit contributions, it could certainly do so. The requirement that the LLC keep a record of each member's contributions may or may not be subject to contrary agreement, depending on the state, but as a practical matter there is likely to be little reason to object to such a requirement.

e. Management of the LLC

More difficult is the issue of what an investor receives in return for a contribution to an LLC. By far the most common statutory model provides that the members of the LLC will have direct management power--this is a member-management model with members having power to bind the company to ordinary business contracts, akin to that found in general partners of a general partnerships.²¹ Under this model, members start out with both actual authority to make management decisions and apparent authority or agency power to bind the LLC by acts that appear to be carrying on the ordinary business of the LLC.²²

Some state statutes presume that each member will have a vote equal to that of every other member (the model adopted for general partnerships), but most statutes allocate voting power in accordance with the relative value of each member's contribution to the LLC (more akin to the limited

19. For a more detailed discussion of the issue of piercing the veil in the context of the LLC, see David L Cohen, *Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation For the Limited Liability Company?* 51 OKLA. L. REV. 427 (1998); Susan Muller Rogge, Note, *Hollowell v. Orleans Regional Hospital: Piercing the Corporate Veil of a Louisiana Limited Liability Company and Successor Liability*, 47 LOY. L. REV. 923 (2001); Shaun M. Klein, Comment, *Piercing the Veil of the Limited Liability Company, from Sure Bet to Long Shot: Gallinger v. North Star Hospital Mutual Assurance, Ltd.*, 22 J. CORP. L. 131 (1996).

20. U.L.L.C.A. § 401.

21. U.L.L.C.A. § 404. The uniform act makes this the default rule, as do most statutes. U.L.L.C.A. § 203(a)(6).

22. U.L.L.C.A. § 301(a)(1).

partnership model), unless the members have agreed otherwise.²³ All of the state statutes allow the members to change how voting power is allocated, and such provisions are frequently included in operating agreements. Particularly in jurisdictions which presume equal voting power, it is common to see attempts to bring voting rights more into line with the members' investments. A major drafting concern for this alternative is to choose a mechanism whereby the relative value of capital contributions can be determined readily and accurately. If an LLC is going to be operated informally, with different forms of consideration being accepted as capital contributions, this may be difficult to accomplish in a manner that is satisfactory to all concerned. In other cases, the members may desire to provide a mechanism which allows the LLC to charge varying amounts to members who buy into the enterprise at different stages. If voting power is presumed to be equal, or even if it is pro-rata based on the value of the members' contribution, it will take a specific agreement to accomplish this objective. One option is to provide in the operating agreement that the LLC will issue voting interests in exchange for defined contributions. Providing for such interests is particularly desirable if it is anticipated that these interests (sometimes called units or percentage of ownership) are transferrable. In any event, it is probably a good idea to carefully consider how voting power in an LLC is to be allocated.

It is not enough, of course, to merely decide on how voting power is allocated. A related issue involves the type of matters which require either super-majority or unanimous agreement. As with many issues, there is significant variation among state statutes about what issues are presumed to require more than majority approval, although it is accurate to say that state statutes often presume that it will take a unanimous vote to do things that would fall outside the ordinary way of doing business.²⁴ These might include a presumption that it will take unanimous agreement to amend the articles or the operating agreement of the LLC, to admit new or substitute members, to voluntarily dissolve the LLC, to merge or consolidate the LLC with another business entity, to sell all or substantially all of the LLC's assets, or to agree to continue the LLC despite what would ordinarily be an event of dissociation.

State statutes may also require unanimity to do things such as compromising an obligation by a member to make additional contributions, or settling disputes or agreeing to arbitration. After consulting the particular state statutes, it may be appropriate to make changes to the default rules concerning what types of actions would normally require unanimous approval.

Finally, most statutes are silent on the issue of formalities that may be imposed in connection with member-management.²⁵ Most state LLC statutes have omitted any presumptions or requirements with regard to issues like whether the LLC must hold annual or other regular meetings, who has the power to call special meetings, and such things as notice, quorum, and voting procedures. Most statutes do not even specifically presume that formal votes will be taken, so any desired formalities should be spelled out in the operating agreement for the LLC. If members want to guarantee that they are consulted in advance about certain issues, the requirement for meetings may be appropriate. Otherwise, the ability to operate a business without the relatively rigid procedures typically required of corporations is another benefit of the LLC form of business.

23. U.L.L.C.A. § 404(a)(1).

24. U.L.L.C.A. § 404(c).

25. The uniform act, for example, does not address this issue.

As an alternative to member-management, all state statutes provide that the members may elect a manager-management model akin to that of directors in a corporation. (In fact, a minority of jurisdictions presume that this is the management structure for any LLC formed under the statutes of that state.) Under this model, the members agree to delegate actual and apparent authority to managers, usually by including a provision to this effect in the articles. While most state statutes require that any election to choose manager-management must be included in the articles,²⁶ there is no requirement that the articles specify how managers are to be selected or replaced, or how they are to manage. Some of these issues are addressed by other statutory presumptions; some of them are not addressed at all in most state statutes.

Manager-management means that the managers will have both the actual power to manage and the apparent authority to bind the business by acts which appear to be carrying on the ordinary course of the LLC's business.²⁷ Members, as such, have neither actual nor apparent authority by virtue of their status as owners of the business.²⁸ In most states, managers are presumed to have equal voting power with every other manager.²⁹ Some statutes do not address this issue. Typically, the LLC statutes are silent as to most of the procedures and requirements that will have to be imposed if manager-management is selected. Most statutes neither impose default qualifications on who may be selected as manager, nor specify how managers are to be selected, how long they will serve, how they will be replaced, whether or how they can be removed, or any formalities with regard to voting, notice, meeting, quorum, or record-keeping. Generally, then, these are issues that probably should be addressed in the LLC's operating agreement. Particularly where the manager-management model is chosen, it will probably be desirable to impose some formalities with regard to decision-making and record-keeping in order to protect the interests of members who are not managers.

Even with manager-management, most state statutes retain some issues which are presumed to require approval of all or a majority of members.³⁰ These may include a decision to amend the articles or the operating agreement of the LLC, to admit new or substitute members, to voluntarily dissolve the LLC, to merge or consolidate the LLC with another business entity, to sell all or substantially all of the LLC's assets, or to agree to continue the LLC despite what would ordinarily be an event of dissociation. If the parties wish to reserve different decisions for the members, or wish to allocate the responsibility to decide on these kinds of issues to managers, they are generally free to do so in the LLC's operating agreement.

Despite the fact that most statutes speak only of member-management or manager-management as the primary management options, one of the hallmarks of the LLC is its extreme flexibility, and thus either of these models may be chosen with the operating agreement nonetheless delegating actual authority over some or even all decisions to others. This "hybrid" management can exist no matter what management structure is generally chosen. Thus, if the default rules call for member-management, and the members do not elect to change this in the articles, they may nonetheless choose to allocate some actual power to "managers" (however denominated) by

26. U.L.L.C.A. § 203(a)(6).

27. U.L.L.C.A. § 301(b)(1).

28. U.L.L.C.A. § 301(b)(1).

29. U.L.L.C.A. § 404(b)(1).

30. U.L.L.C.A. § 404(c).

inclusion of a provision to that effect in the operating agreement. Similarly, even if the articles purport to choose manager-management, the operating agreement may reserve some (or even all) actual authority to the members. In fact, there are virtually no limitations on how the parties might choose to allocate actual authority over decision making. However, the one thing which appears to be unavoidable under most state statutes is that under the member-management model members will have apparent authority to bind the LLC by acts that appear to be in the ordinary course of the LLC's business, and in the manager-management model managers will have such power.

f. Allocations of Profits and Losses, and Distributions

The other major considerations in making a contribution to an LLC are likely to be economic. From an individual member's standpoint, the economic claims of the member against the LLC may have paramount importance among all the issues with which the member will be concerned. Therefore, it is critical that economic claims, above all other matters, are clearly defined and understood. Most state statutes provide that members are presumed to share in income or losses in proportion to the value of their contributions to the enterprise, but a number of states presume that members will share equally, regardless of the relative value of contributions made to the LLC by the members.³¹ The former rule appears to be more often the desired approach, and so it is very common in jurisdictions with a presumption of equal sharing in profits and losses to specify an agreed-upon allocation in the operating agreement.

Some important terminology with regard to a member's economic interest in an LLC bears noting. A domestic LLC (that is, an LLC formed under the laws of any American jurisdiction) will generally be taxed as a partnership.³² This means that it is important to distinguish between allocations (or allocable shares) and distributions. Each year, the LLC will calculate its total income or loss.³³ It will then file an informational return that will show how the LLC's income or losses have been allocated among the members.³⁴ An allocation is the proportion of any item of income, gain, loss or deduction that is attributed to each member and has nothing to do with amounts that may actually be distributed or paid out. Thus, members in an LLC are likely to be very concerned with the allocation of profits, the allocation of losses (which can have significant tax benefits), and distributions.

Although the state default rules vary considerably, every state allows the members of the LLC to establish rules governing the allocation of profits and losses and rules applicable to the timing and amount of distributions. The default allocative and distributional rights of the members can be modified by appropriate provisions in the operating agreement. Allocations can be modified from the default rule to provide for per capita allocations, allocations based on relative value of contributions, allocations based on ownership interests or percentages, or otherwise. Moreover, state law does not

31. U.L.L.C.A. § 405.

32. Under the current federal tax regulations, this is the presumption for all LLCs having 2 or more members. Treas. Reg. §§ 301.7701-1 through -3, 26 C.F.R. 301. While a contrary election to be taxed as a corporation is possible, it is unlikely because partnership taxation avoids the double tax often associated with the corporate form. See part C.2 in the first document in this series. For a more detailed discussion of the tax issues applicable to LLCs, see *infra* part B.2 of this document.

33. I.R.C. § 703 requires the determination of an entity level "taxable income" by entities taxable as partnerships.

34. I.R.C. § 6031(a) requires the filing of an informational federal income tax return.

restrict the right of parties to allocate distinct items of gain and loss differently from the members' usual sharing ratios, although there are complicated and rigorous requirements imposed by the Internal Revenue Code and Treasury Regulations in order for such allocations to be respected for tax purposes.³⁵

The parties are generally free to divide up the economic pie of the LLC in whatever manner they choose, and the flexibility afforded here (a characteristic carried over from the partnership) is one of the most attractive features of the LLC. However, any variation from the default rules should be clearly expressed in the operating agreement.

In addition, the members are likely to have a significant interest in the distributions from the LLC, both interim and liquidating. Distributions are generally based on cash flow rather than "profits" in either an economic or tax sense. Some operating agreements may contain an express formula for determining the amount of cash flow available for distribution. Other agreements will not contain specific formula provisions, assuming instead, as a general matter, that the LLC will not distribute what it does not have, and that those charged with managing the LLC should generally have discretion to declare distributions as they deem advisable.

Equally important to the determination of the amount available for distribution is when the distributions are to be made. Most state statutes say this will be as provided in the operating agreement or as the members in a member-managed or managers in a manager-managed LLC may decide.³⁶ In other words, there are no specific "default" provisions concerning the timing of interim distributions. The most informal way of handling the timing issue is to say nothing about it in the operating agreement. In that event, those in charge of management of the LLC, either members or managers, will decide when distributions will be made. On the other hand, the operating agreement may mandate that distributions be made when available cash flow permits. The availability of the cash flow could be assessed on whatever schedule the operating agreement provides, such as monthly, quarterly, etc.

The choice of whether to specify in the operating agreement when distributions are to be made will probably depend primarily on whether the LLC is member-managed or manager-managed. If the LLC is being managed by representatives of the members rather than the members themselves, the members may want the operating agreement to provide greater assurances that distributions will, in fact, be made with some regularity.

In the case of liquidating distributions by an LLC, most state statutes protect the rights of creditors by giving them a higher claim to the LLC assets than members have and generally providing that their claims will not be discharged before they are notified (actually or constructively) and given an opportunity to present their claims to the LLC.³⁷ In most cases, however, no express limitations are placed on interim (nonliquidating) distributions made by the LLC to its members.

35. The "special allocation" rules are the same ones which apply to all tax partnerships. This issue is discussed more fully in part C.2. of the first document in this series.

36. The uniform act requires unanimous approval for interim distributions in the absence of an agreement to the contrary. U.L.L.C.A. § 404(a)(6).

37. U.L.L.C.A. § 806(a).

It is not logical to assume, however, that LLCs are generally free to circumvent creditors' claims by simply distributing assets to its members in interim distributions that would leave the LLC unable to pay those creditors' claims on dissolution. Most states have adopted fraudulent conveyance laws that would operate to prevent any such strategy from being effective.³⁸ These acts give creditors a variety of remedies, ranging from the right to avoid any transfers in violation of the act, to injunctions against future transfers and the appointment of a receiver. These acts tend to treat as fraudulent any transfer made with "actual intent to hinder, delay, or defraud any creditor," or where the transfer is made "[w]ithout receiving a reasonably equivalent value in exchange," and the debtor's assets were unreasonably small.³⁹ The federal bankruptcy laws have similar provisions governing preferential transfers.⁴⁰ These standards provide limitations on interim distributions that should protect creditors' interests.

g. Transferability of Membership Interests

Turning now from the economic claims of a member against the LLC, there is another attribute of LLC membership interests that is likely to be of interest to persons considering this form of business: the extent to which such interests are transferable. In most states, the LLC statutory provisions on transferability of ownership interests have been modeled after the UPA, and provide that a transfer of an LLC membership interest operates only to transfer the economic rights, unless the remaining members unanimously agree to accept the transferee as a substitute member.⁴¹ Of course, the members are free to agree otherwise. They may provide in advance that a membership interest is freely transferable and that any transferees will automatically be accepted as members of the LLC by the simple expedient of a provision to that effect in the operating agreement. Alternatively, they may provide that a limited class of persons (such as immediate family members or employees) will be entitled to full membership upon the acquisition of any membership interest.

Alternatively, the members could condition transferability by imposing transfer restrictions upon membership interests, which if met, would permit the transferee to become a member. Thus, the operating agreement could require a member to first offer any membership interests to existing members, or to the LLC itself, and only if these offers are rejected would a sale to a third person be recognized as entitling the transferee to membership status. The purchase rights accorded to the existing members could be structured as an option or as a right of first refusal. Such provisions are especially common in the corporate context, but where it is desirable to provide transferability of interests in order to entice additional investors into contributing to the capital funds of an LLC, such provisions may also be appropriate in this setting. Alternatively, the operating agreement might also be drafted to further restrict the transferability of membership interests, thereby limiting the ability of members to transfer even the economic rights of ownership.

38. See the General Notes to the Uniform Fraudulent Transfers Act, which indicate that versions of the statute have been adopted in Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Maine, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Dakota, Texas, Utah, Vermont, Washington, West Virginia, and Wisconsin.

39. Unif. Fraud. Trans. Act. § 4.

40. 11 U.S.C.A. § 547.

41. U.L.L.C.A. §§ 502, 503(a).

h. Terminating Membership Status

The rights of a member to withdraw from an LLC may also be an issue in some cases. However, this is an issue which will vary considerably from jurisdiction to jurisdiction, as there is considerable disagreement among the state statutes as to the default rule.

The issue here is whether a member can voluntarily withdraw from an LLC. When most state LLC statutes were originally drafted, there were tax incentives in place to make the LLC look as much like a general partnership as possible. Thus, virtually all of the original LLC statutes provided that members in a LLC had the ability to withdraw at any time, even in contravention of a provision in the operating agreement prohibiting such withdrawal. This was in accord with the model followed by the UPA.

On the other hand, the tax justification for imposing the general partnership model on the LLC has since disappeared, and a growing number of states have recently modified their LLC statutes to change the default rule relative to rights of members to withdraw.⁴² In such states, members generally have the ability to withdraw, but only if the operating agreement does not provide otherwise. If the operating agreement does restrict withdrawal rights, the member cannot simply quit.

These withdrawal rights create issues for both the member and the LLC. From the member's perspective, even though the LLC would not normally create personal liability for members, what if a non-managing member finds out that the LLC is operating in such a way that the veil of limited liability is likely to be pierced? In such a case, the member may very well wish to withdraw. Alternatively, the member may be concerned with avoiding tax liability. The LLC in question may be earning income, but failing to distribute it. Thus, the issue may be avoidance of tax liability. A provision restricting the member's ability to withdraw may be very undesirable in these situations.

From the point of view of the LLC, it may be extremely inconvenient to have a member withdraw at certain points in time. The LLC may wish to avoid having to calculate value of a member's interests as of certain points in time, or may fear that there will be significant but unprovable costs associated with withdrawal in violation of a contractual obligation to remain with the company that can best be resolved by a prohibition on voluntary withdrawal.

In any event, the right of members to withdraw, and the consequences of such withdrawal, are issues that probably should be specifically considered and agreed upon in advance. If members do have the ability to withdraw, notice requirements and any obligation on the part of the LLC to pay for the value of the withdrawing member's interest should probably be spelled out in the operating agreement.

42. Some states have chosen to eliminate the rights of members to withdraw voluntarily as the default rule. See, e.g., Okla. Legis. 145 § 6 (1997) (to be codified at Okla. St. tit. 18 § 2036); Or. St. § 63.205 (both eliminating power to withdraw unless provided in operating agreement). Other states have enacted legislation which provides that in the event of withdrawal, there is no "right" to be paid off, but instead the withdrawing member continues as an assignee of the interest. See, e.g., Colo. Rev. Stat. § 7-80-603; Mo. Stat. § 347.103; 1997 Neb. Laws L.B. 631 (to be codified at Neb. Stat. § 21-2619(3)); Gen. Stat. N.C. § 57C-3-02. Finally, some states have chosen to discourage voluntary withdrawal by eliminating a withdrawing member's right to distributions at the time of withdrawal. See Cal. Corp. Code § 17252(b); 31 Me Rev. Stat. § 672. See also Mich. Stat. § 450.4509 (eliminating the right to a distribution if the withdrawal is wrongful).

i. Dissolution, Winding Up and Termination

In most states, the rules governing dissolution, winding up and termination bear a substantial similarity to the rules applicable to other forms of enterprise. The events that trigger dissolution in the absence of an agreement are often very similar to the events that trigger dissolution of a general partnership, although a growing number of states seem to be reducing the number of events that automatically trigger dissolution. The statutes often list things like withdrawal, bankruptcy, incapacity or death of a member; agreement of all members; expiration of a stated term or completion of a specific undertaking; or anything specified in the operating agreement as constituting an event triggering dissolution. Some state statutes have been amended to narrow the list of things triggering dissolution, and every state statute allows the members to either subtract from or add to this list.

In addition, most LLC statutes have default rules governing the right of members to waive an event as a trigger for dissolution, and the members have the further right to provide in the operating agreement that any number of remaining members at the time of any such event will have the power to continue the business.

The LLC statutes also generally contain provisions for judicial dissolution, with considerable variation as to what constitutes sufficient grounds for a court to order dissolution of an LLC. Often this statute is very general, providing only that the court may order dissolution whenever it is not reasonably practicable to carry on the business of the LLC in conformity with the operating agreement or for any other equitable reason.

Once dissolution is triggered, most LLC statutes appear to follow the corporate model governing the winding up and termination of the business. There are provisions for the filing of articles of dissolution and the giving of notice to known and contingent creditors. There are provisions covering the distribution of assets and the possibility that creditors might later come after members for any amounts received as liquidating distributions.

2. Tax Status

a. In General

LLCs that have two or more members will be eligible entities under the current tax regulations. This means that under federal law they will be presumed to be taxed as partnerships, but any given LLC may elect to be taxed as a corporation.⁴³ Some state statutes impose a specific tax status on LLCs, regardless of how they might be classified for federal income tax purposes. LLCs having one member are authorized in some states. Under federal law, such LLCs will be taxed as sole proprietorships (that is, they will be disregarded for tax purposes) unless an election to be taxed as a corporation is filed.

Assuming an LLC is classified as a partnership, the LLC itself will not be subject to federal income tax, although an informational filing is required. For filing purposes, an LLC uses the same tax forms as a partnership: I.R.S. Form 1065 and Schedule K-1 for each member. The current versions of these forms contain questions designed to elicit whether the filing entity is a general partnership, a limited partnership, or a limited liability company. These questions do not affect the filer's tax liability but are simply a means of collecting statistical information.

43. Treas. Reg. §§ 301.7701-1 through -3, 26 C.F.R. 301.

Instead of taxation at the entity level, the members of the LLC, as tax partners, will be liable for income tax with respect to their distributive or allocable share of the LLC's items of income, gain, loss, deduction, and credit.⁴⁴ In an LLC, just as in a partnership, distributions of cash and property do not usually result in taxable gain to members, since members have already been taxed on their share of the LLC's income or have received their share of its losses.

As with partners, members in an LLC are generally free to agree among themselves how they will share profits and losses. This agreement will normally control the amount of each member's share of taxable income or loss, so long as these allocations satisfy the "substantial economic effect" test.⁴⁵ Assuming that test is met, the members may make special allocations of profits and losses in ratios different from their ordinary sharing ratios.

In general, an LLC is eligible to make the same elections that a partnership is eligible to make and is subject to the same rules that would apply to partnerships. However, certain tax provisions that apply to partnerships are based on the existence of a general partner or on the contrasting roles of general partners and limited partners.⁴⁶ Since an LLC has neither general nor limited partners, a question arises regarding the application of such provisions to LLCs. The bulk of the discussion that follows deals with some differences between the tax rules as they would apply to a traditional partnership and an LLC.

b. Basis Adjustments

One of the advantages of partnership taxation is the ability of tax partners to utilize losses to offset other income. One of the traditional limitations on a tax partner's right to utilize losses to offset income is that a tax partner can deduct his or her share of entity losses only to the extent of the tax partner's adjusted basis in its membership interest.⁴⁷ For this reason, the issue of whether a member is entitled to increase his or her basis as a result of the incurrence of indebtedness by the LLC is potentially quite significant.

Generally speaking, a member (as a tax partner) is only entitled to increase his or her basis in the amount of such member's "share" of the LLC's indebtedness. The regulations contain detailed rules describing the determination of the appropriate share of the debt for this purpose,⁴⁸ and the results will vary depending on whether the debt is considered to be recourse or nonrecourse debt. The regulations distinguish recourse from nonrecourse debt on the basis of liability of the members (or tax partners).⁴⁹ If no member bears the economic risk of loss, then the debt is nonrecourse debt. In

44. I.R.C. §§ 701, 702.

45. See I.R.C. § 704(b) and regulations promulgated thereunder. This topic is discussed in considerably more detail in part C.2. of the first article in this series.

46. For a more complete listing of partnership provisions of uncertain application to LLC members, see Steven G. Frost, *"Square Peg, Meet Round Hole": Classifying LLC Members as "General Partners" or "Limited Partners" for Federal Tax Purposes*, 73 TAXES 676 (1995).

47. I.R.C. § 704(d).

48. See Treas. Reg. §§ 1.704-2(b), 1.752-2.

49. See regulations promulgated pursuant to I.R.C. § 752.

an LLC, since no member has personal liability, presumably all debt would be nonrecourse under this standard, including debt that, from a commercial standpoint, would probably be viewed as recourse because the lenders have the right to look to the general assets of the enterprise to satisfy the debt. No rulings, however, have yet confirmed this analysis in the LLC context. An LLC may be advantageous if nonrecourse debt is desirable in a particular transaction, but the down-side is that such indebtedness is unlikely to increase the member's basis.)

c. The "At-Risk" Rules

The ability of individuals and certain closely held corporations to deduct losses of tax partnerships, and thus LLCs, is also limited by the "at-risk" rules.⁵⁰ In general, members may deduct losses only to the extent that they are "at risk" with respect to the entity. For an LLC, the question is whether a members' obligations other than capital contributions will be considered an amount at risk since, as described above, the debt of an LLC will normally be nonrecourse. Although the law is less than clear, it appears that a member will be at risk for the share of LLC debt that the member guarantees.⁵¹

d. Passive Losses

The passive loss rules prohibit certain taxpayers from using net losses from passive activities to offset other taxable income. A "passive activity" is defined as any activity in which the taxpayer does not "materially participate."⁵² Taken together, the Internal Revenue Code and Treasury regulations set out a system of rules pursuant to which it is possible to determine when a partner is deemed to materially participate in the operation of a business. There are seven possible alternatives pursuant to which a general partner will be found to meet this test, but the rules applicable to limited partners are significantly narrow. The Internal Revenue Code presumes that limited partners do not materially participate⁵³ in a business and there are only three ways in which a limited partner can prove otherwise:

(a) The limited partner can work for the company for more than 500 hours in the year in question;

(b) The limited partner may have materially participated in five out of the ten preceding taxable years, or

(c) In the case of a personal service activity, the limited partner can have materially participated in any three preceding taxable years (whether or not consecutive).⁵⁴

50. I.R.C. § 465.

51. Compare Prop. Treas. Reg. § 1.465-24(a)(2) with Prop. Treas. Reg. § 1.465-6. See also *Gefen v. Commissioner*, 87 T.C. 1471 (1986) (limited partner held at risk when guarantee ran directly to partnership's creditor); *Abramson v. Commissioner*, 86 T.C. 360 (1986) (limited partner who guarantees nonrecourse debt is at risk).

52. I.R.C. § 469(c).

53. I.R.C. § 469(h)(2)

54. Temp. Treas. Reg. § 1.469-5T(e)(2).

A "limited partnership interest" is defined as an interest with respect to which the liability of the holder is limited under state law to a determinable fixed amount.⁵⁵ It is as yet unclear whether LLC members are encompassed within this definition. If they are, then LLC members will be restricted to the three methods described above for limited partners to materially participate, rather than all seven methods available to general partners. The I.R.S. is studying the application of the material participation tests to LLC members. Until its position is clarified, however, LLC members should plan to meet the stricter tests for limited partners.

e. The "Tax Matters" Partner

The Internal Revenue Code provides a comprehensive system for determining, at the partnership level, the tax treatment of partnership tax items in unified administrative and judicial proceedings.⁵⁶ If the LLC is a tax partnership, the partnership audit provisions should apply in their entirety to the LLC. There is one complication with respect to the designation of a "Tax Matters Partner" (TMP), however. The Code⁵⁷ provides that the TMP is (a) the general partner designated as the TMP as provided in regulations or (b) if none, the general partner having the largest profits interest. If this rule cannot be applied, the statute provides that the TMP is to be selected by the Secretary of the Treasury.

Since an LLC has no general partner, it is uncertain whether the Secretary has the right to select the TMP. On December 23, 1996, a regulation was finalized regarding the designation or selection of a TMP for an LLC.⁵⁸ For purposes of applying this regulation to an LLC, only a member-manager is treated as a general partner and a member of an LLC who is not a member-manager is treated as a partner other than a general partner. In the regulation, a "member-manager" is defined as a member of an LLC who alone or together with others is vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the organization was formed. The regulation provides, however, that if there are no elected or designated member-managers, each member will be treated as a member-manager. Thus, if this regulation is finalized, it will mean that if the LLC appoints a manager, that manager will be the only general partner and, thus, the only person eligible to be a TMP. If, on the other hand, no managers are appointed, all members are treated as managers and thus are eligible to be appointed as a TMP. Practitioners should be sure to have the members agree in writing regarding the designation of a TMP.

f. Self-Employment Taxes

As currently written, the Internal Revenue Code imposes a special tax on net earnings from self-employment.⁵⁹ This self-employment tax applies to the "net earnings from self-employment" derived by an individual, subject to certain exceptions. The Code defines "net earnings from

55. Temp. Treas. Reg. § 1.469-5T(e)(3).

56. I.R.C. §§ 6221 - 6231.

57. I.R.C. § 6231(a)(7).

58. Treas. Reg. § 301.6231(a)(7)-2.

59. I.R.C. § 1401.

self-employment" to include an individual's distributive share, whether or not distributed, of income or loss from any trade or business carried on by a partnership of which the individual is a partner, unless a specific exception applies.⁶⁰ The tax liability attaches to a partner's distributive or allocable share of trade or business income, which may be significantly different from (and greater than) the cash actually distributed to a partner. In other words, if a partner's share in the annual profits of the tax partnership amounts to \$100,000, that amount will be allocated to the partner for tax purposes. It does not matter whether any or all of that amount is actually distributed to the partner; the entire amount is taxable as income, and may also be considered self-employment income. The tax on self-employment income is meant to mirror both the employer's and employee's share of FICA, and is approximately 15½ per cent of a general partner's share of trade or business income.⁶¹

The reason that this is an issue for LLCs is that the tax regulations treat allocations to general partners differently from allocations to limited partners. Although the general rule is that partners are to be taxed on their allocable share of income, items of income or loss allocated to limited partners generally are not to be treated as net earnings from self-employment,⁶² except for guaranteed payments as defined by the Code.⁶³ As a result, limited partners generally enjoy an exemption from the self-employment tax, while general partners do not. The question is how this rule applies to LLCs, which under state law have neither general nor limited partners but members instead.

The Code does not specifically address whether members of an LLC should be treated as limited partners, and arguments can be made on both sides of the issue depending on how the LLC is formed and operated. If the members of an LLC are actively involved in the management of the business, it would seem inappropriate to treat those members as limited partners.⁶⁴ On the other hand, if the members are in fact no more than passive investors, it would seem equally inappropriate to subject their distributive share to the self-employment tax except to the extent of any guaranteed payments.

On December 28, 1994, the Internal Revenue Service issued proposed regulations (the "1994 proposed regulations") which first addressed the issue of whether members of an LLC should be subject to self-employment taxes.⁶⁵ Pursuant to the 1994 proposed regulations, a member of an LLC was to be treated as a limited partner, and thus not subject to the self-employment tax, if certain conditions were met. First, the member could not be a manager, meaning not only that the member

60. I.R.C. § 1402(a).

61. The actual rate is based on two separate taxes, the old-age, survivors, and disability insurance (OASDI) tax of around 12½% and the Medicare tax of nearly 3%. As with FICA, the OASDI tax applies only to income below a specified level, which in 2001 was \$80,400. The Medicare tax does not have any cap.

62. I.R.C. § 1402(a)(13).

63. See I.R.C. § 707(c).

64. For example, the Service has ruled privately that members of an LLC who actively engage in the performance of professional services engaged in by the LLC must include their distributive share of the LLC's income and loss in their net earnings from self-employment. P.L.R. 9432018.

65. Prop. Treas. Regs. § 1.1402(a)-18.

could not be a designated manager, but also that the LLC could not have member-management.⁶⁶ Second, under those regulations, an LLC-member would be treated as a limited partner and thus exempt from the self-employment tax regulations only if the LLC in question could have been formed as a limited partnership rather than an LLC in the same jurisdiction and the member in question could have qualified as a limited partner in such a limited partnership.

Public comments on the regulations pointed out likely administrative and compliance problems, as well as the fact that these rules might result in disparate treatment of individuals based on form rather than substance.⁶⁷ As a result, on January 13, 1997, the Internal Revenue Service and Treasury Department withdrew the 1994 proposed regulations, and issued new proposed regulations (the "1997 proposed regulations").⁶⁸

The 1997 proposed regulations would have adopted a substantially simplified approach to determining who would be a "limited partner" for purposes of the self-employment tax calculations required under the Code. Under these regulations, a member in an LLC classified as a partnership for federal tax purposes would be treated as a limited partner unless the member: (1) has personal liability⁶⁹ for the debts of or claims against the partnership by reason of being a partner; (2) has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or (3) participates in the partnership's trade or business for more than 500 hours during the taxable year.⁷⁰ There were also built in exceptions in the case of members who held more than one class of interest in the tax partnership or members who received guaranteed payments for their services to the tax partnership.⁷¹ In such cases, if all of the requirements of the particular

66. Prop. Reg. 1.1402(a)-18(c)(3) states, "[A] manager means a person who, alone or together with others, is vested with the continuing exclusive authority to make management decisions necessary to conduct the business for which the LLC was formed.... If there are no elected or designated managers of the LLC, each member will be treated as a manager for purposes of this section."

Thus, absent the formal designation or election of one or more managers for a given LLC, all of that entity's members will be deemed to be managers for purposes of the self-employment tax calculations, with the result that none will qualify for the limited-partner exception to the self-employment tax.

67. See Notice of Proposed Rulemaking, Definition of Limited Partner for Self-Employment Tax Purposes, 61 Fed. Reg. 1702 (Jan. 13, 1997).

68. *Id.*

69. Personal liability in this context is defined in § 301.7701-3(b)(2)(ii) of the Procedure and Administration Regulations.

70. Prop. Treas. Reg. § 1.1402(a)-2(h)(2).

71. Proposed Treas. Reg. § 1.1402(a)-2(h)(3). This provision reads as follows: An individual holding more than one class of interest in the partnership who is not treated as a limited partner under paragraph (h)(2) of this section is treated as a limited partner under this paragraph (h)(3) with respect to a specific class of partnership interest held by such individual if, immediately after the individual acquires that class of interest:

- (i) Limited partners within the meaning of paragraph (h)(2) of this section own a substantial, continuing interest in that specific class of partnership interest;
- and,

exception were satisfied, it should have been possible for a member to avoid paying self-employment taxes on his or her entire distributive share. These same standards applied to all tax partnerships,⁷² except service partnerships.⁷³ These regulations were intended to ensure that similarly situated individuals were treated similarly under the self-employment tax provisions and are likely to achieve that result.

Unfortunately, there was substantial political opposition to these proposed regulations, and they were never adopted. The Taxpayer Relief Act of 1997, enacted by Congress as Public Law 105-34, prohibited the I.R.S. from enacting these proposed regulations or issuing any further proposed or temporary regulations on the matter prior to July 1, 1998. The Congressional moratorium has now expired without Congress' taking any action to clarify the self-employment tax status of LLC members. With the I.R.S. also taking no further action to resolve the questions, practitioners lack clear guidance as to an LLC member's self-employment tax obligations. The 1997 proposed regulations do, however, remain the latest pronouncement on the subject from the I.R.S., and as such may offer some insights into how the service might decide to treat allocations to LLC members.

However, the law here is clearly uncertain, and there is no guarantee that the Internal Revenue Service will respect any decision to treat a member's share of LLC income as anything other than self-employment income, unless the membership of the LLC is set up so that all income funnels through another entity, such as an S corporation. This substantially complicates the structure required to be formed and maintained and may result in other, unintended tax or business consequences that are less desirable.

3. Comparing the LLC with Other Organizational Forms.

From a tax standpoint, the LLC, in comparison with the corporation, is generally the entity of choice. This is so regardless of whether the corporation is taxed under subchapter C or subchapter S of the Internal Revenue Code. However, the lack of uniformity among the state LLC statutes may make the corporation more attractive for an enterprise doing business in multiple states.

An LLC offers significant advantages over an S corporation from a tax standpoint. First, there is no limit on the number of members of an LLC, although an LLC with more than 500 members is likely to be taxed as a corporation since it will be presumed to be publicly traded.⁷⁴ Therefore, if interests in the entity are expected to be very widely held, the LLC form (just like the

(ii) The individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by the limited partners described in paragraph (h)(3)(i) of this section.

Id.

72. *Id.*

73. If substantially all of the activities of a partnership involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides services as part of that trade or business will not be considered a limited partner. Prop. Treas. Reg. § 1.1402(a)-2(h)(5).

74. I.R.C. § 7704.

partnership form) may be problematic. There is, however, no prohibition against LLCs having a large number of members.

Similarly, there is no restriction on the type or character of members of an LLC as there is for S corporation shareholders.⁷⁵ While S corporations may not have nonresident alien shareholders, nonresident aliens may own LLC interests. While S corporation shareholders are limited to individuals or certain types of trusts, LLC interests may be owned by individuals, corporations, partnerships, and pension plans. The relaxed ownership criteria of an LLC are one of the most important reasons for preferring LLCs over S corporations.

In addition, because LLCs are treated as partnerships for tax purposes, the members of an LLC enjoy a variety of tax advantages not available to S corporation shareholders.⁷⁶ One benefit is that no election need be filed in order for an LLC to receive the benefit of partnership tax status. In contrast, in order for a corporation to obtain S corporation treatment, it must file an election on or before the fifteenth day of the third month of its taxable year.⁷⁷

Perhaps most importantly, LLCs, because they are taxed as partnerships, can use special allocations, pursuant to which, for example, taxable income and loss and distributions of cash or property may be allocated among the members in ratios different from the ratio of their respective capital contributions.⁷⁸ In contrast, if S corporations attempt to incorporate with provisions similar to special allocations, they would almost certainly violate the "one class of stock" rule applicable to S corporations.⁷⁹

Finally, the S corporation tax rules are extraordinarily complex and contain many traps for the unwary, particularly with respect to the qualification tests. A form of doing business which does not require application of these rules, such as the LLC, may therefore be a more attractive option, particularly since the LLC offers the same essential features of limited liability and flow-through taxation.

When compared to a C corporation, the LLC is even more advantageous, because the LLC is eligible for partnership taxation with all that implies, in contrast to the double-taxation imposed on corporate earnings which are later distributed as dividends. The ability of members to share in losses and to easily avoid any entity-level tax is a very significant tax advantage of the LLC form.

A C corporation pays tax on its earnings at the corporate rate, and, upon distribution to the shareholders, the shareholders pay tax on the dividends at their individual rates. The combined burden of corporate level tax at the 1999 rate of 35 per cent and individual level tax at the rate of 39.6

75. I.R.C. § 1361.

76. For example, LLCs, because they are taxed as partnerships, can take advantage of the benefits afforded by a § 754 election. Under I.R.C. § 754, a member can step up its basis in its share of the LLC property to reflect that member's outside basis in the membership interest. No comparable election is available for S corporations.

77. I.R.C. § 1362.

78. I.R.C. § 704(b).

79. I.R.C. § 1361.

per cent was 60.74 per cent. There are obvious advantages to partnership tax treatment, pursuant to which only a single tax is paid at the member level.

From a nontax standpoint, a corporation (whether an S corporation or a C corporation) may have an advantage over an LLC with respect to the more settled nature of the law that governs it and the routine nature of its administration. An LLC, being a new form of doing business, raises issues regarding the application of laws and legal doctrines to it. For example, questions of the application of the concepts of fiduciary duties, corporate opportunity doctrine and its treatment under SEC, bankruptcy, and other federal laws may be uncertain.

On the other hand, the corporation has built-in formalities and a relatively rigid management structure. To the extent that the parties desire a less formal form of business, the LLC is likely to be comparatively advantageous. In fact, the lack of formalities and inherent flexibility of the form of business was one of the primary advantages touted by those responsible for the widespread enactment of LLC legislation.

The key difference between partnerships and LLCs is that an LLC offers limited liability to all of its members, whereas in traditional partnerships, even a limited partnership, at least one partner (the general partner) has liability exposure. In contrast, no member of an LLC has personal liability for the debts of the LLC, barring guarantees or other special arrangements between members and creditors. Although this problem can be handled in a partnership by using a corporate general partner, if the corporate general partner is a C corporation, tax will be imposed on the profits of the partnership at the corporate level to the extent they are allocated to the corporation. Even if the corporate general partner is an S corporation, so that no entity level tax is imposed on the corporation's share of the profits, the use of such a structure raises issues not present for an LLC.⁸⁰ This particular advantage under state law applies only to traditional partnerships, and not necessarily to LLPs or LLLPs.

In addition, general partners in a partnership, even limited partnerships, LLPs, and LLLPs, always have certain rights which may not be ideal. First, such partners always have agency power or apparent authority to bind the business by acts which appear to be carrying on the usual business of the partnership. In certain cases, it may be desirable to limit this authority, an option not available under partnership law but possible if an LLC utilizes managers to manage the business. Second, general partners always have the power to withdraw from the business, even if such withdrawal is in violation of the partnership agreement. Such withdrawal triggers technical dissolution and may make it more likely that the business will have to be wound up unless a sufficient number of remaining partners specifically elect to continue. This may be a problem for some businesses, and while partnership law does not permit a partnership agreement to effectively prohibit withdrawal, LLC statutes do provide for this option. These advantages apply when LLCs are compared with general partnerships, limited partnerships, LLPs and LLLPs.

One advantage of LLCs over limited partnerships and LLLPs is that LLC members can participate in management of the LLC without risking their limited liability status. In contrast, if a limited partner participates in the control of the partnership, he may lose his status as a limited partner. Significantly, this ability to manage without losing liability protection may mean that LLC members can

80. For example, in Rev. Proc. 89-12, 1989-1 Cum.Bull. 798, the I.R.S. has taken the position that a corporate general partner in a limited partnership must have an interest of at least one percent in all partnership tax items and contribute at least one percent of the capital in order for the partnership to be classified as a partnership. Similarly, issues are raised regarding the net worth or capitalization of a corporate general partner. These issues are generally not present for an LLC.

participate in management for purposes of the "material participation" tests of the passive loss rules without losing their liability protection. Material participation by a member may cause what would have otherwise been treated as passive income or loss to become active income or loss and thereby be available to offset against other active income or loss.

Finally, with regard to LLPs and LLLPs, there are a couple of reasons why LLCs may be preferable. First, LLPs and LLLPs may not offer general partners complete protection against entity-level debts. Statutes in a number of states still provide partners in such enterprises only protection against liabilities arising out of the misconduct of others.⁸¹ The partners in such jurisdictions would normally retain personal liability for ordinary business debts. Second, there is much more inconsistency between various states with regard to LLPs and LLLPs. Not only do the states differ in regard to the type of liability to which partners may be exposed, some states do not even offer limited partnerships the possibility of registering as LLLPs. Thus, the risks of doing business in multiple jurisdictions are heightened. In addition, LLP and LLLP law appears to be more likely to change in the next few years as more states adopt the new revisions to the Uniform Partnership Act. Thus, there is greater uncertainty associated with this form of business, potentially making the LLC a more stable option.

This is not to say that the LLC is right for every business. Because of the extreme flexibility of this form of business, it will often cost more in terms of legal fees to set up the business in the appropriate manner. In addition, it is still less familiar than the corporate form for many legal advisors and tax practitioners, and this may also have an impact on fees. Some accountants apparently advise clients that the S corporation is generally cheaper to run than an LLC, at least from a tax and accounting standpoint. Finally, there are tax rules which may make the LLC less desirable in certain instances. Foremost among these are the rules applicable to self-employment taxes, although there are also other considerations which may be important in any given situation. For these reasons, it is always important to seek professional advice about the optimal choice of business entity in any given situation. The materials presented here should help the reader understand the basic issues and range of possibilities and make preparing for any such consultation easier.

C. Corporation

1. Business Law Status

a. Traditional Corporation

The corporation is probably the form of business entity which comes most readily to mind for most people.⁸² It is formed by filing articles of incorporation (which may also be called the corporate

81. For a more detailed discussion of the liability of general partners in an LLP see part E.1 of the first article in this series. For a similar discussion applicable to LLLPs, see part F.1. of the first article in this series.

82. Although the corporation is also a creature of statute, every state has had a corporate statute for many decades. There is also a great deal of similarity between state corporate statutes. Rather than citing to multiple state statutes, these materials will cite to the current Model Business Corporation Act, a model statute promulgated by the NCCUSL. This statute has been extremely influential, and versions of the model act or its predecessors, have been adopted in many states. Nonetheless, there is still some variation from state to state, particularly with regard to details. Therefore, when a particular issue comes up in regards to the

charter) with the appropriate state officials. A corporation may also have written bylaws that will govern how the corporation is run on a day-to-day basis.

The equity owners of a corporation are called shareholders who, in their capacity as shareholders, have only very basic voting rights. They can elect the managers of the corporation (called directors); they are entitled to vote on most decisions that would require an amendment to the articles of incorporation, and they must approve certain fundamental transactions involving a change in structure of the corporation such as dissolution, mergers, consolidations, or mandatory share exchanges. Generally speaking, any legal person (including individuals, associations of persons and legal entities like LLCs) can be a corporate shareholder. In most states, investment in a corporation can be in the form of property, cash or services. However, a number of states do exclude promises to provide property or perform services in the future from the list of permissible contributions. In addition, there may be tax consequences for contributing services and certain forms of property to a corporation.

In the traditional corporation, day-to-day management decisions are vested with a board of directors, which generally requires the scheduling of meetings, the taking of formal votes on corporate resolutions, and the keeping of minutes reflecting corporate decisions. Because this level of complexity and formality is not particularly desirable or necessary in many small corporations, some state statutes allow smaller corporations to elect to have shareholders retain management authority by including a provision to that effect in the corporation's articles of incorporation. In the case of a small corporation with such an election, the shareholders could have direct management authority. Not all state statutes would permit or recognize such an election, however.

The right to share in the corporation's net profits depends on the stock held by each shareholder. Every holder of the same class of stock is entitled to a pro rata proportion of any distribution to the holders of that class of stock, although different classes of stock can have different priorities and claims to distributions. For the most part, the actual distributions (typically in the form of dividends) depend on the board of directors, who generally have very broad discretion in declaring dividends. Dividends are ordinary (taxable) income to shareholders.

Shareholders are not liable for losses of the corporation, and therefore are not entitled to report any loss on their personal taxes as a result of losses at the corporate level.

Absent agreement to the contrary, a shareholder may sell or otherwise convey shares at any time to any other legal person. The buyer or transferee becomes a shareholder, with all the rights such a position entails. While a shareholder who has control over the corporation cannot knowingly sell the control shares to someone who intends to come in and "loot" the corporation, there are very few limits on a shareholder's right and power to transfer shares.

The primary advantage to a corporation, aside from the fact that it is likely to be the entity with which practitioners and many business people have the greatest degree of familiarity and for which there are probably the greatest number of planning aids such as form books and treatises, is that all shareholders have limited liability for corporate debts. In other words, a shareholder stands to lose his or her investment in the corporation if the corporation acquires debts greater than its assets, but absent highly unusual circumstances, will not be compelled to pay additional sums to make good on those debts. Obviously, if the shareholder has signed a personal guarantee the shareholder will have

corporate law of a particular jurisdiction, the statutes of that jurisdiction should always be consulted as a starting point.

personal liability, and equally obviously, if the shareholder has no significant personal assets, the risk that those assets might be subject to entity-level debt is not particularly significant. However, for many business owners, protection against personal liability for entity level debt is a significant advantage.

b. Statutory Close Corporation

In recent years, a few states have adopted special statutes designed to govern closely held corporations that make a special election to be covered by these statutes rather than the general corporation statutes of the state. For the most part, the benefits of electing to be treated as a statutory close corporation are that the formalities required for management of a traditional corporation, such as the election and operation of a board of directors, are dispensed with.

There are actually three patterns which have developed in state laws relating to closely held corporations. Some states have adopted a unified strategy, where the same corporate laws are applicable to both large and small corporations. Under this approach, there are no special statutory provisions applicable to closely held corporations. The same rules and requirements apply to both small, closely held corporations, and large, publicly traded companies organized in such jurisdictions.

The second possible statutory approach is for a state to adopt an entirely separate set of statutes applicable to closely held corporations, or at least applicable to closely held corporations that elect to be treated as statutory close corporations. There is a model close corporation statute, but it has been adopted by very few states, and there is a great deal of variation between even those states that have a close corporation act.

The third approach is a combination of the first two. In states adopting this approach, most of the general corporation laws are applicable to all corporations, regardless of whether they are closely held or publicly traded. However, in such jurisdictions, there are also a few statutory provisions which apply specifically and exclusively to closely held corporations. In many cases, a closely held corporation is required to make a special election to be subject to these special rules. For example, in some states, corporations whose shares are not publicly traded are specifically authorized to adopt shareholder agreements which leave management power in shareholders' hands.⁸³ Such agreements would be void as against public policy in publicly held corporations, or even in closely held corporations absent such statutory authorization.

Shareholders of closely-held corporations, ranging from family businesses to joint ventures owned by large public corporations, frequently enter into agreements that govern the operation of the enterprise. In the past, various types of shareholder agreements were invalidated by courts for a variety of reasons, including so-called "sterilization" of the board of directors and failure to follow the statutory norms of the applicable corporation act.⁸⁴ The more modern decisions reflect a greater willingness to uphold shareholder agreements.⁸⁵

83. For example, the current version of the Model Business Corporation Act, as promulgated by N.C.C.U.S.L., contains such a provision. M.B.C.A. § 7.32.

84. See, e.g., *Long Park, Inc. v. Trenton-New Brunswick Theatres Co.*, 297 N.Y. 174, 77 N.E.2d 633 (1948).

85. See, e.g., *Galler v. Galler*, 32 Ill.2d 16, 203 N.E.2d 577 (1964).

Notwithstanding the increasing prevalence of close corporation provisions, very few corporations actually register as close corporations or take advantage of statutory provisions authorizing smaller corporations to dispense with or limit the authority of the board of directors. There are a number of reasons that make such reluctance rational. First, there is very little case law dealing with close corporations, and no lawyer wants his or her client to be the “guinea pig” on which the law is tested. For example, if a corporation chose to dispense with a board of directors, instead relying on direct management by the shareholders, would this increase the chances of the shareholders’ being held personally liable for corporate debts? Would the courts be more likely to pierce the corporate veil? Would dissenting shareholders be able to sue for simple mistakes in judgement? We simply do not know the answer to these questions because there are no cases dealing with these issues.

Moreover, it is not just the courts that are unfamiliar with these “close corporations.” Any time a corporation tries to open an account or borrow money from a bank, the bank is almost certain to produce standard forms which reflect directors’ resolutions and authorizations. Few banking officials are ready to deal with “corporations” that do not have directors or adopt formal resolutions.

In addition, there is so much variation from state to state in terms of what is permissible for a close corporation, that whenever the corporation is likely to do business across state lines, choice of law problems are likely to arise.

In the final analysis, to date few corporations have chosen to travel down this road. The bulk of the materials which follow, therefore, deal with the rules applicable to traditional corporations, both closely held and publicly traded. In the agricultural sector, most of such corporations would be closely held, although this is certainly not universally true.

c. Formation

The corporation is a creature of statute. Normally, the statutory requirements must be complied with in order for a corporation to come into existence, and in most states the corporation comes into existence when the articles are filed by the Secretary of State or other appropriate state official.⁸⁶ The articles of incorporation, sometimes called the corporate charter, contain very basic information about the corporation and are not intended to govern the day-to-day operation of the business.⁸⁷ The articles contain information such as the name of the company, often the address of the principal office in the state, a registered office and agent for service of process, detailed information about the stock which the corporation is authorized to issue, information about the incorporators, and possibly the purposes for which the corporation is to be formed. The articles may, but generally are not required to, include the names of the initial directors of the corporation.

Once the articles are filed, the organizers will typically meet to select the initial directors unless they were named in the articles. Once the directors have been named, the organizers are out of the picture.⁸⁸ The initial directors authorize the enactment of bylaws that will govern the day-to-day operations of the corporation. They will also authorize the issuance of shares and take whatever actions are necessary to get the corporation started.

86. *Accord* M.B.C.A. §§ 1.23 & 2.03(a).

87. M.B.C.A. § 2.02.

88. M.B.C.A. § 2.05(a)(1).

d. Contributions

It is very common for persons interested in forming a corporation to obtain commitments from potential investors when the corporation is formed. In order to avoid any question about the legality of this type of subscription arrangement, many corporate statutes specifically validate subscription agreements.⁸⁹

In addition, the corporate statutes commonly address such issues as the process that should be undertaken in connection with the issuance of shares, the types of consideration that can legally be received by the corporation, and any minimum price that must be paid.⁹⁰ Most modern statutes allow shares to be issued in exchange for cash, property, services, services to be performed or a promise to pay money in the future. However, a few states still continue the rule which was more prevalent in earlier times that shares may not be issued for future consideration. Most states that retain this rule do so because of state constitutional provisions that are difficult to modify rather than any policy reasons for restricting the type of consideration that can be used.

With regard to the minimum consideration to be received, the law is generally that shares may be issued for any consideration determined by the directors to be adequate, provided that such amount may typically not be less than the par value of the shares as specified in the corporate articles.⁹¹ "Par value" does not mean economic value; it is merely a floor below which a corporation may not issue its shares. Most states authorize no-par stock, but there may be adverse consequences associated with this, including the imposition of higher-than-necessary franchise taxes. However, a relatively low par value (\$.10 or even a fraction of a cent) is not at all uncommon.

With regard to establishing the value of non-cash property to be contributed in exchange for stock, most states provide that the determination of the directors will be conclusive, absent fraud or collusion.⁹² Thus, it is always wise for the directors to adopt resolutions authorizing the issuance in exchange for specified consideration, which the directors should find to be of either a specific value or value at least equal to the par value of the shares.

Finally, there is no requirement that all shares must be issued for the same consideration or even consideration having the same value as that accepted in exchange for other shares. All of such decisions are within the sound discretion of the directors.

e. The Limits on Shareholder Liability

It is easy to state the rule that shareholders of a corporation have limited liability.⁹³ However, there are some important caveats and limitations that need to be understood, because this limitation on personal liability is not absolute. First, a shareholder is liable for the agreed-upon value of his or her

89. M.B.C.A. § 6.20.

90. M.B.C.A. § 6.21(b) & (c).

91. M.B.C.A. § 6.21(c).

92. M.B.C.A. § 6.21(c).

93. M.B.C.A. § 6.22.

contributions.⁹⁴ If the contribution has not been fully paid in, the corporation or a receiver appointed to run the corporation may recover such amounts if they have not been paid to the company. In addition, the agreed-upon contribution must be equal in value to the par value of the shares to be issued in exchange therefor. If it does not, the shareholder faces potential liability for “watered stock.” Similarly, under the law of some states, there are restrictions on the type of consideration that may legally be paid, and failure to comply with these restrictions may result in excess personal liability. Finally, even if the contribution has been fully paid in, the shareholder stands to lose the value of such contribution in the event that the business fails. Generally speaking, a shareholder will only recover such value if all corporate creditors are paid in full.

In addition to liability for one’s contributions, a shareholder will also be liable for anything for which he or she agrees to be personally liable. Thus, if the shareholder executes a personal guarantee of a corporate loan, the guarantor’s status as shareholder will not prevent the creditor from recovering against the shareholder/guarantor.

Similarly, a shareholder retains personal liability for the consequences of his own tortious acts. This should not be surprising, since this rule applies regardless of the type of entity with which an owner is associated.

In addition, a shareholder may wind up with personal liability in the event that a court elects to “pierce the corporate veil” or, in other words, to disregard the existence of the corporation in order to impose such liability. Speaking in general terms, courts in every jurisdiction agree that they should pierce the corporate veil if there is sufficient proof that the corporation has been used in the furtherance of crime, to facilitate fraud, or to justify a similar wrong. Additionally, courts may pierce the veil when shareholder(s) have themselves failed to recognize the separate existence of the corporation and, instead, have relied upon it solely to insulate themselves from personal liability that ought to exist.

Some courts specifically require proof of fraud, inequity or wrongdoing in addition to the shareholder’s failure to respect the independent existence of the corporation. In any of these cases, once the corporate veil is pierced, the corporation is no longer viewed as a legal entity. Instead, the corporation is viewed as an association of persons, exposing the personal assets of the stockholders, and often the personnel connected with the wrongful activity such as corporate directors, to claims by creditors seeking compensation.

When deciding whether to pierce the corporate veil and subject the corporate insiders to personal liability, all courts look at the question of whether the shareholder(s) have properly respected the corporation’s legal existence.⁹⁵ Sometimes, this is spoken of in terms of whether the corporation

94. M.B.C.A. § 6.22(a).

95. In figuring out what the first part of the analysis requires, the relatively recent case of *National Soffit & Escutcheons Inc. v. Superior Systems, Inc.*, 98 F.3d 262, 265 (7th Cir. 1996), provides a good example of many of the relevant considerations. In this case, the Seventh Circuit concluded that a plaintiff must demonstrate (1) that the corporate form was “ignored, controlled or manipulated, and that it was merely the instrumentality of another, and (2) that the misuse of the corporate form would constitute a fraud or promote injustice.” In order to support such conclusions, the court established eight factors to consider when determining whether to employ its equitable power to pierce the corporate veil. These factors include (1) the undercapitalization of the corporation (2) the absence of corporate records; (3) the fraudulent representation by the corporation’s shareholders or directors; (4) the use of the corporation to promote fraud, injustice, or illegal

can properly be viewed as the “alter ego,” or “mere instrumentality” of the shareholders. In other cases, courts address whether the unity of interest and ownership are strong enough to make the corporate identity indiscernible from that of the individual. Sometimes, courts ask whether the corporation is a mere shell or dummy. In some jurisdictions, after this first part of the test has been employed, the courts will also consider whether an inequity would result if the bad acts are treated as those of the corporation alone. Some states require even greater proof of fraud or other wrongdoing.

Finally, there are other circumstances in which a shareholder may be liable for at least some amounts; for example, a shareholder may have to repay illegal distributions or payments which violate either the bankruptcy preference rules or the state’s fraudulent conveyances act. Similarly, a shareholder may find that his or her claims against his or her corporation are subordinated to the claims of other creditors under the theory of equitable subordination. However, these are not rules which impose substantive liability for unlimited amounts, as can be the case when the corporate veil is pierced.

f. Management of a Corporation

Corporate statutes are pretty clear on the subject of management: under normal circumstances, all management authority is to be exercised by or under the authority of the board of directors.⁹⁶ The formalities associated with actions by the board of directors are one of the indicia of separate existence of the corporation and thus deserve special attention.

Generally speaking, directors are required to hold meetings at least annually or more often as the bylaws may require.⁹⁷ Moreover, all state statutes provide for special meetings.⁹⁸ Generally speaking, there are notice, quorum, and record-keeping requirements for directors that should be carefully respected.⁹⁹ Many of these formalities will be foreign to individuals in a business. However, the formalities need to be observed in order to minimize the risk that the corporate veil will be disregarded. Because it is not reasonable to expect individuals who are not familiar with business operations to remember all of the details of these formalities, many attorneys list the most important formalities (meeting times, quorum, voting, and notice requirements, etc.) in the company’s bylaws. This has the virtue of creating a document which explains how the corporate directors should proceed.

For those who are exploring the possibility of becoming minority participants in a corporate venture, it is important to emphasize how complete is the directors’ authority. In essence, the

activities; (5) the payment by the corporation of individual obligations; (6) the commingling of assets or affairs; (7) the failure to observe required formalities; and (8) the other shareholder acts or conduct. In *National Soffit*, the shareholder was actually another corporation. However, the basic rule is the same: such liability should exist if the subsidiary acted as a mere instrumentality of its parent.

96. M.B.C.A. § 8.01(b).

97. M.B.C.A. § 8.20.

98. M.B.C.A. § 8.20.

99. M.B.C.A. §§ 8.22 & 8.24.

directors have full authority over the day-to-day operations of the corporation and need not consult with or accept advice from others.¹⁰⁰

With regard to the control that the shareholders do have, they generally have the power to nominate and elect directors, to remove them and to select their replacements. Directors may typically be elected with a plurality of the votes, and in a minority of jurisdictions shareholders are presumed to have cumulative voting privileges.¹⁰¹ Even in jurisdictions where cumulative voting is not presumed, the articles may provide that shareholders will have this right.

g. The Rights of a Shareholder to Recognize a Return on the Investment

Typically, a shareholder who invests in a corporation expects a return on that investment in one of two forms: dividends or appreciation in the value of shares. However, closely held corporations are often structured so as to pay out significant amounts of earnings in other ways.

A primary motivation for avoiding dividends is that dividends are subject to double taxation: net corporate earnings are taxed once, at the corporate level, and then again, as ordinary income, when paid to shareholders.¹⁰² In contrast, if the investor also works as an employee and receives a return in the form of wages, to the extent that the wages are a reasonable business expense of the corporation, those amounts are deductible by the corporation.¹⁰³ This means that, while the shareholder will still have to treat the payment as income and pay individual income taxes on it, the corporation will not have to pay corporate income tax on money paid out in the form of wages. Similarly, if the investor lends funds to the business and receives interest, the interest is a deductible business expense.¹⁰⁴ Rental payments may receive similar treatment, so long as the rental amounts are not disguised payments toward eventual purchase of the underlying property.¹⁰⁵

The right of the corporation to deduct wages and interest is not unlimited. Only reasonable business expenses may be deducted by the corporation. This means that there may be disagreements between taxpayers and the I.R.S. as to what constitutes a reasonable business expense.

100. *Charlestown Boot & Shoe Co. v. Dunsmore*, 60 N.H. 85 (1880), exemplifies these rules. In that case, the court found that the directors were not liable for failing to heed the advice of an expert recommended and appointed by the shareholders in connection with the winding up of the business, even though failure to pay attention to those recommendations cost the corporation thousands of dollars.

101. Cumulative voting means that, rather than electing directors one at a time, all directors are elected in a single vote. Each shareholder is allowed to cast votes equal to the number of shares owned times the number of directors to be elected. A shareholder may cumulate those votes and cast them for a single individual, or break up the votes between nominees in any manner the shareholder desires. This cumulative voting has the effect of concentrating the voting power of the minority shareholders, provided that minority shareholders do indeed cumulate their votes for a single candidate.

102. I.R.C. §§ 62, 63 (defining gross and taxable income).

103. This would be allowed as an ordinary business expense. See I.R.C. § 162(a). However, the wages would be subject to employment taxes, which are generally not applied to dividends.

104. See I.R.C. § 163. Repayment of principal would not be income to the lender.

105. Rev. Rul. 55-540.

Notwithstanding these alternatives to dividends, the usual way for shareholders to realize income through their investment is in the form of dividends. Corporate statutes generally authorize directors to pay dividends, in their discretion, so long as the payment is consistent with the corporate bylaws and does not render the corporation insolvent.¹⁰⁶ In fact, every state corporate statute references in some way the prohibition of dividends that would render the corporation unable to pay debts as they come due, or which would leave the corporation with debts that exceed assets or that would impair the corporation's capital. The precise nature of the limitation varies from state to state, but the general import of the rule is clear: dividends are to be paid if and when declared by the directors and only so long as they will not render the corporation insolvent.

Shareholders may also benefit from appreciation in the value of their shares. This is not a taxable event unless and until the shares are liquidated, either as part of a repurchase from the corporation or as part of a sales transaction. Generally speaking, shareholders are free to sell their shares to whomever they wish and are entitled to retain whatever price they receive. The limitations on this are that shareholders may not sell their shares to a third party who is known or should be known as someone who will loot the corporation; they may not accept a premium for the sale of directors' positions; and they may not sell in contravention of a reasonable restriction on transferability to which they have agreed or of which they had notice when they acquired their shares. Share transfer restrictions are dealt with in the next section of this article.

h. Transferability of Shares

Corporations traditionally possess the attribute of free transferability of interests. In other words, a shareholder's interest in the corporation (typically in the form of shares) can usually be sold to any other person, on any terms that the shareholder desires, unless the shareholder has voluntarily agreed to restrict these rights. Moreover, a transferee becomes a full shareholder with all the rights of the transferor. No consent by any other party is normally required to make this transfer complete. Contrast this with the partnership form of business, where a partner is normally entitled to sell only his or her right to profits, and a transferee acquires only limited rights under the default rules. Under this model, it takes affirmative agreement (either in advance or at the time of the transfer) in order to achieve transferability of an equity interest in the business.

However, in many close corporations, free transferability may not be completely desirable. There are any number of reasons why a corporation or its founders may want to limit the rights of shareholders to freely transfer their shares. For example, a corporation may be concerned that such sales might violate the federal or state securities laws and compromise the corporation's own sales of its shares. Alternatively, a sale of shares to certain prohibited shareholders or to too many shareholders may deny a corporation its S status under subchapter S of the Internal Revenue Code. Even if the sale does not involve tax or securities law problems, the promoters or primary shareholders may worry about control getting away from those who have an immediate connection with the business. They may want to limit share ownership to employees of the company or to prohibit the sale to those with a significant ownership interest in or management responsibilities to competing enterprises.

For these reasons, it is common to see close corporations whose shareholders have entered into a shareholder agreement that restricts the free transferability of the shares. Generally speaking,

106. M.B.C.A. § 6.40(a) & (c).

such restrictions are valid if they are reasonable and comply with other statutory provisions such as required notice.¹⁰⁷

i. Termination of the Corporation

The process of terminating a corporation is spelled out in some detail in the corporate statutes. Unlike the situation with the partnership and LLC, most of these rules are mandatory and cannot be circumvented by agreement of the parties. However, the death, purported withdrawal or resignation, incapacity, etc. of a shareholder will not affect the viability of the corporation as an independent entity, so there is also less reason to try and circumvent the usual process of dissolution.

One point about terminology is worth emphasizing: dissolution of the corporation does NOT mean the withdrawal of shareholders or directors from the enterprise. It is just the first step in the winding up and termination process. Even after a corporation is dissolved, it continues in existence for the purpose of conducting the winding up.

The usual process requires the corporate directors to recommend dissolution to the shareholders.¹⁰⁸ This must then be approved by the appropriate shareholder vote; usually a simple majority vote will suffice.¹⁰⁹ Following this vote, the corporation is entitled to file articles of dissolution, give notice to known claimants and publish notice to unknown or contingent creditors.¹¹⁰ The business continues until operations can be wound up, assets liquidated, and all debts paid off.

Although there is a five-year statute of limitations for contingent claims in most state corporate statutes,¹¹¹ this does not mean that the corporation must continue the winding up process for this entire period of time. Rather, the corporation typically distributes to the shareholders whatever is left after paying all creditors. If a subsequent claim is made, and it succeeds, shareholders who have received a liquidating distribution may be compelled to turn it over to the creditor, but they cannot be compelled to pay more than they received.¹¹² If the normal process is not possible, as for example would be the case where a majority of the directors refuse to refer the matter to a shareholder vote, or a majority of the shareholders oppose dissolution, the statutes also provide for judicial intervention.¹¹³

Most state statutes allow a shareholder to petition for judicial dissolution upon a showing of one or more of the following:

- (1) The directors or shareholders are deadlocked, and irreparable injury is occurring or is likely to occur;

107. M.B.C.A. § 6.27.

108. M.B.C.A. § 14.02(a).

109. M.B.C.A. § 14.02(b)(2) & (e).

110. M.B.C.A. §§ 14.03, 14.06, 14.07.

111. M.B.C.A. § 1407(c).

112. M.B.C.A. § 14.07(d)(2).

113. M.B.C.A. §§ 14.30 - 14.34.

(2) Those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent;

(3) The shareholders are deadlocked in voting power and have failed, for a specified period, to elect directors; or

(4) Corporate assets are being misapplied or wasted.¹¹⁴

In addition, creditors may obtain relief if it can be shown that they have a judgment or the corporation has confessed that the creditors' claims are owing, and the corporation is insolvent.¹¹⁵

Even where these grounds can be proven, the courts retain equitable power to decide whether or not to grant judicial dissolution. Courts appear rather reluctant to order a solvent corporation to be dissolved, imposing in the alternative numerous creative remedies designed to protect the injured shareholder. With regard to the proper interpretation of these provisions, "oppressive conduct" has generally been held to mean any intentional thwarting of the minority's reasonable expectations. "Deadlock" requires an absolute inability to agree and therefore an inability to make business decisions.

If judicial dissolution is ordered, the court may also order the dissolution to be conducted under the direction of the court or an appointed receiver. The same procedures that apply to traditional dissolution are then followed.

2. Tax Status

a. S Corporation

An S corporation is simply an otherwise ordinary corporation which is eligible for and has elected to be taxed under subchapter S of the Internal Revenue Code. For state law purposes, it is formed like any other corporation, and the provisions of the general business corporation statutes will apply. In cases where the corporation meets the requirements of any applicable close corporation statutes or provisions, those statutes may govern the corporation. The only differences between S and other corporations come from rules and restrictions imposed by subchapter S of the Internal Revenue Code.

The benefit of electing subchapter S status is that an S corporation is a flow-through entity. In other words, there is no entity level tax. Items of income and loss flow through to the shareholders and are taxed only at the shareholder level.

The disadvantage of an S corporation is that they are considerably less flexible than C corporations. An S corporation can have no more than 75 shareholders (until 1996, that limit was 35); the moment its shares are owned by more than 75 investors, the corporation loses its status as an S corporation and becomes taxable as a C corporation. Moreover, with certain limited exceptions, only individuals can be shareholders in an S corporation; other corporations or partnerships are ineligible to invest in an S corporation. Finally, an S corporation can have only one class of shares. This substantially limits the corporations' ability to structure different rates of return for different investors.

114. *Accord* M.B.C.A. § 14.30(2).

115. *Accord* M.B.C.A. § 14.30(3).

The only way to regulate rates of return is to give different shareholders a different number of shares. Other than that, all shares must have equal rights to share in the profits and losses of the corporation. In certain circumstances, the I.R.S. and courts have even declared certain forms of debt to be disguised classes of equity investment that render the corporation ineligible for S corporation status. Share transfer restrictions may also run afoul of the restrictive S corporation rules.

If an S election is timely filed,¹¹⁶ the corporation is then subject to taxation under subchapter S of the Internal Revenue Code. Subchapter S can be extremely complicated and will not be discussed in detail here. Some of the important attributes of subchapter S are that: (1) there will be no corporate income tax imposed; (2) shareholders will be taxed on amounts allocated to them; and (3) special allocations of income or loss are prohibited.

b. C Corporation

A C corporation is any corporation which has not made a valid S election. In other words, if a corporation is formed under state law and no special effort is made to elect special tax treatment under subchapter S of the Internal Revenue Code, the resulting entity will be a C corporation. This is true regardless of whether the corporation is formed under traditional corporation statutes or the newer statutory close corporation provisions. An entity formed as a corporation under state law may not elect to be taxed as a partnership under current tax regulations.

A C corporation is technically subject to double taxation. In other words, net income at the corporate level is subject to an entity level tax. When the corporate income is distributed to shareholders in the form of dividends, the dividends become ordinary income to the shareholder and are subject to personal income tax. To prevent the corporation from retaining earnings endlessly and thereby deferring the second level of tax indefinitely, the Internal Revenue Code imposes a special tax on excess retained earnings.

This does not mean there are no planning mechanisms which can limit the effect of this double taxation. If the shareholders are also the primary employees of the corporation, rather than paying out corporate income in the form of dividends, the shareholder/employees may be paid larger salaries or bonuses. Although the salaries are still taxable at the shareholder level, employee compensation is an expense for the corporation and is paid out of pre-tax dollars.¹¹⁷ Similarly, shareholders may lend money to the corporation. Interest payments by the corporation are deductible to the corporation, and so the only tax imposed is at the shareholder level.¹¹⁸ If the shareholder rents property to the corporation, rental payments are also subject only to tax at the shareholder level. These mechanisms can be very successful for smaller corporations in avoiding the double tax burden technically imposed on corporate earnings.

One drawback which is not as simple to plan around is the fact that corporate losses are not deductible at the shareholder level. Although the corporation can carry forward losses to offset future income, and under certain circumstances a shareholder may be able to declare a loss on the value of his or her shares if the corporation is liquidated at a loss, it is not generally possible for a shareholder in a C corporation to utilize corporate losses to offset personal income on a yearly basis.

116. Elections must usually be filed at both the federal and state levels.

117. I.R.C. § 162(a).

118. I.R.C. § 163.

D Cooperatives

1. Business Law Status

a. Introduction

Cooperatives, or co-ops, are a relatively common form of business enterprise in the agricultural sector.¹¹⁹ Readers may be less familiar with this organizational option because it is a relatively specialized form of enterprise, and there are far fewer cooperatives than there are corporations, partnerships or even LLCs. While cooperatives can and have been formed by consumers, producers, and workers, in no arena has the cooperative form of business been more important than in agriculture.¹²⁰ At least four types of agricultural cooperatives have developed in the United States: production, marketing, purchasing, and service cooperatives. Many modern cooperatives combine two or more of these functions, and some of the rules and characteristics traditionally associated with cooperatives are changing.

The small farming operation that is simply interested in setting up an ownership structure to facilitate investment opportunities, establish effective management, or to enable the efficient transfer of ownership as part of an estate plan, is not likely to be interested in the cooperative form of business. However, a group of farmers or others in the agricultural sector may be interested in forming a cooperative venture in order to facilitate production or marketing arrangements or to take advantage of economies of scale in connection with purchasing of goods or arranging for services.

All of the other forms of business described herein are suitable for ownership of individual operations; the cooperative form of business is not. Nonetheless, because of its historical importance to agriculture and its potential application in a wide range of agricultural settings, it will be considered here.

b. General Comparison with the Corporate Form of Business

Traditional cooperatives are often compared to corporations, perhaps because co-ops are typically incorporated under state law.¹²¹ In addition, the corporation offers a convenient point of comparison because corporations are so much more common and better understood.

Persons wishing to become equity participants in a corporation buy stock. Stock in such a venture gives the owners the right to elect directors, generally on the basis of the number of shares

119. By 1995, the gross value business volume of American farmer cooperatives amounted to \$112.3 billion. Charles A. Kraenzle, *Non-patronage Business Reaches \$17.9 Billion*, RURAL COOPERATIVES 30 (Mar./Apr. 1997) (http://www.wisc.edu/farmer/64_2_30.html).

120. Terence J. Centner, *Retained Equities of Agricultural Cooperatives and the Federal Securities Acts*, 31 U. KAN. L. REV. 245, 246 (1982).

121. USDA, *Cooperative Principles and Legal Foundations* 1 (1977) (citing Evans & Stokdyk, *The Law of Agricultural Marketing* (1937)).

owned.¹²² Share ownership also entitles the owners to share in earnings on a pro rata basis.¹²³ Absent agreement among the shareholders to the contrary, shares are freely transferable and capable of appreciating in value as the value of the corporation increases. These are, in fact, the essential attributes of corporate "stock" identified by the U.S. Supreme Court in the context of determining when "stock" will be considered to be a security under the federal securities laws.¹²⁴

Cooperatives do not generally share these characteristics. First, cooperatives may or may not issue "stock" to their members; equity participation in a co-op takes many different forms. In addition, while members may be required to buy some sort of "membership interest" as a condition to joining the cooperative, the majority of a traditional cooperative's equity comes from retained patronage earnings rather than external "investment" in stock or other ownership interests. Finally, even where "stock" is purchased, its function is typically only to give members the right to use the co-op's services and facilities. It does not determine voting rights or the right to share in profits from the venture, if any. Cooperatives generally operate on a one-vote per member basis, regardless of the relative investment of the members or the number of shares or membership interests owned.¹²⁵

Similarly, although members generally have equal voting rights in the cooperative, member income is based on patronage rather than equity ownership.¹²⁶ Distributions upon dissolution are also based on patronage rather than the members' proportionate capital investment.¹²⁷ Finally, membership rights (however denominated) are not usually freely transferable and typically do not have the potential for appreciation.

122. Corporations may also issue non-voting shares, but at least one class of shares must have equal voting rights. For a more thorough discussion of corporations, see *supra* part C.1. of this article..

123. Again, it is possible that the corporation will issue multiple classes of shares, each with different participation rights. However, in most states every share in the same class must entitle its owner to the same rights as are attributable to every other share in the same class.

124. *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985), identifying the following characteristics "usually associated with common stock as (i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value." *Id.* at 686, citing *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 851 (1975).

125. James Baarda, *State Incorporation Statutes for Farmer Cooperatives*, USDA/ACS, Cooperative Information Rep. No. 30, § 11.01 and Table 11.01 (Oct. 1982).

126. Thus, when a cooperative desires to return some of its net earnings to its patrons, it generally pays out patronage "dividends" (in cash or other property). Earnings returned to persons using the cooperative may also be known as patronage refunds, but are labeled "patronage dividends" in the Internal Revenue Code. I.R.C. § 1388(a). For convenience, the term patronage dividend will be used in this article.

However, the cooperative often does not pay out all of its earnings when they are earned; rather, the typical cooperative will retain at least a portion of each member's patronage dividends until a later date. Patronage dividends that are allocated to patrons but retained by the cooperative are generally known as a patronage retain or retained equities.

127. Statutes addressing the distribution of assets by an agricultural cooperative at dissolution apportion them in three ways: 1) according to property interests; 2) according to stock ownership; or 3) according to past patronage. See Baarda, *supra* note 125, § 17.03.02 and Table 17.03.02.

Four “operationally-unique cooperative principles” have been identified as being essential to the cooperative form of business.

“First, cooperatives are owned and democratically controlled by the producers who use their services. Second, the cooperative distributes its net income to producers in proportion to their use of the cooperative. Third, returns on ownership capital are limited. Fourth, producers who use the cooperative substantially finance its operation.”¹²⁸

This litany of attributes makes for ready comparison with the traditional, for-profit corporate form. In the case of a corporation, shareholder-owners generally have one vote per share, meaning that voting rights are held proportionately to each shareholder's equity investment in the enterprise. In addition, a shareholder's equity interest is typically acquired through investment in the stock itself, although the stock may (and hopefully will) appreciate in value. The investment may be recouped through dividends, or upon sale of the appreciated stock on the open market. Most stock is not redeemable, nor is redemption the typical way in which the value of an investment in corporate stock is realized. In general, therefore, a stockholder's income is generally based on stock ownership, as is the stockholder's right to participate in distributions upon dissolution and liquidation. The shares are generally freely transferable, unless the shareholders have agreed to limit this right. Moreover, there is generally no requirement that the owners of a business corporation “use” the corporation's facilities or products.

Although most cooperatives are incorporated under state statutes which specifically authorize their formation, the relationship between a cooperative and its members is more complex than that which typically exists between a corporation and its shareholders. An incorporated agricultural cooperative is a singular type of business organization, created not only through organizational documents filed with the appropriate state officials, but also through contractual relationships between the cooperative and its members. These relationships involve mutual dependency: the members depend upon the cooperative and the cooperative depends upon its members. The purpose of this structure may relate to the provision of services or to fulfill marketing, processing or supply functions.

c. The Essential Attributes of the Traditional Cooperative

As mentioned in the preceding section, there are four attributes which generally typify the traditional cooperative structure:

1. Cooperatives are owned and democratically controlled by persons who utilize the cooperative's services (sometimes called patrons).
2. The cooperative distributes its net income to patrons in proportion to their use of the cooperative rather than in proportion to their equity investment.
3. Returns on ownership capital are limited.
4. Patrons who use the cooperative substantially finance its operation through retained earnings.

128. *Id.*

A consideration of each of these four attributes can offer significant insights into the nature of a cooperative.

d. Ownership and Control of a Cooperative

Generally speaking, members in a cooperative are required to make at least a token financial investment upon joining the cooperative.¹²⁹ For agricultural cooperatives, membership is typically limited to those who produce the agricultural products which are the focus of the cooperative venture in question.¹³⁰

Often a relatively small initial investment in the venture is all that is required of members. For cooperatives with stock, this investment often takes the form of a mandatory purchase of common stock.¹³¹ Typically, members are expected or allowed to buy a single share of such stock. On the other hand, because cooperatives may be formed on a stock or non-stock basis, the initial investment by members may not result in the issuance of "stock," and instead may take the form of a straightforward membership or initiation fee.¹³² Even for cooperatives organized on a stock basis, membership or initiation fees may be required in lieu of a mandatory purchase of stock or in addition to it. However, for the most part, these fees give rise to the same rights that purchasers obtain upon buying membership interests in the form of stock.

This membership typically gives each member of the co-op an equal right to participate in its management. Hence, the cooperative is often heralded as a particularly democratic form of enterprise because the level of investment does not change the voting power of any member.

e. Income Distribution in a Traditional Cooperative

In a traditional cooperative, members or patrons generally share in the co-op's earnings in proportion to their utilization of co-op services relative to that of other co-op patrons. Thus, the right to share in profits depends not on the member's initial investment in the enterprise but on the level of that member's use or patronage. Moreover, while the co-op may refer to amounts paid to members as "dividends," this does not mean that such payments are calculated like typical corporate dividends, that depend on the number of shares owned. Rather, these are patronage dividends,¹³³ which depend on the level of each member's patronage relative to the levels of patronage of all other members.

129. Lewis D. Soloman & Melissa B. Kirgis, *Business Cooperatives: A Primer*, 6 DEPAUL BUS. L.J. 233, 242 (1994).

130. Jon K. Lauck & Edward S. Adams, *Farmer Cooperatives and the Federal Securities Laws: The Case for Non-Application*, 45 S.D. L. REV. 62, 69 (2000) (noting that "the purchase of equity is often limited by statute to the cooperative's member-patrons...").

131. See generally Neil E. Harl, 14 AGRICULTURAL LAW § 133.01[1] at 136-4 (Matthew Bender, Nov. 1996).

132. Lewis D. Soloman & Melissa B. Kirgis, *Business Cooperatives: A Primer*, 6 DEPAUL BUS. L.J. 233, 239-45 (1994).

133. As mentioned earlier, such earnings returned to persons using the cooperative may also be known as patronage refunds, but are labeled "patronage dividends" in the Internal Revenue Code. I.R.C. § 1388(a).

Members do not generally share in 100 per cent of the cooperative's earnings. Each year, the board of directors determines how much of the net earnings to allocate to patrons as patronage dividends. At the end of each fiscal year the cooperative typically "declares" sums retained in excess of costs and payable to members. Under current rules, the cooperative must pay at least a certain minimum of such available funds if it wishes to qualify for special federal income tax treatment.¹³⁴ Any earnings not allocated are retained by the cooperative as unallocated reserves. These "patronage retains" are then used to fund co-op operations.

Retained equities are returned to members as provided by the cooperative's bylaws or other written agreement between the cooperative and a particular member.¹³⁵ Such bylaw provisions may give the board of directors discretion to call for the payment of equities, may establish a definitive equity redemption program, or may include a combination of such provisions. In addition, state statutes may also affect the redemption of equities.

Although not all cooperatives have specific, systematic plans for the retirement of retained equity, those co-ops that do have such a plan in place generally use one of three basic alternatives: the revolving fund, the base capital plan, or the percentage of all equities plan.¹³⁶ The most prevalent of these is the revolving fund (sometimes also known as the revolving capital plan). This type of plan will typically establish a period of time, usually between seven to fifteen years, for the cooperative to retain patronage dividends or per-unit retains. As these dividends or retains are accumulated, they are allocated to the members' accounts. All members who accrue equity during any given year are treated alike and will be repaid after the period of years established by the plan. The plan will therefore pay the oldest equities first and chronologically thereafter in the order that they are accrued. State statutes may modify the typical payout by requiring payments to certain qualifying persons (such as deceased or inactive members) out of order. Obviously, if the cooperative has insufficient funds to pay off all allocated retains that are "due" to be paid in a given year, such repayments will have to be deferred.

It is also possible for a single cooperative to have more than one revolving fund plan at the same time. If a cooperative wishes, it is possible to distinguish among the amounts owed to members based upon the sources of the investment. For example, marketing cooperatives may distinguish fund plans by the type of commodity marketed. Supply cooperatives may distinguish among the plans by sorting them based upon major products supplied or by membership and nonmembership in the co-op. The various plans will often have differing payout schedules.

The second option for equity redemption by cooperatives is slightly more complicated. For cooperatives wishing to establish a base capital plan, the cooperative first establishes a base period, generally five to ten years. The base period represents the period of time over which each member is expected to assist in financing the cooperative based upon current levels of useage. Each year, the

134. I.R.C. §1388.

135. These amounts go by many names, such as deferred patronage refunds, patronage refunds, patronage dividends, final pool settlement, net margins, net savings, capital credit, book credits, certificates, revolving fund certificates, certificates of equity, and certificates of ownership.

136. The following information on the ways in which retained equities are typically retired or repaid comes from Terence J. Centner, *Retained Equities of Agricultural Cooperatives and the Federal Securities Acts*, 31 U. KAN. L. REV. 245, 253-54 (1982). See also Sharlene F. Roberts-Caudle, *Agricultural Cooperative Member Equity: You Don't have to Die for it!* 7 SAN JOAQUIN L. REV. 1 (1997).

cooperative projects its capital needs for the coming fiscal year and determines the amount of equity it needs to withhold from patronage dividends or per-unit retain allocations. For each base period, the cooperative calculates both the total monetary value of all business done with the cooperative and the value of each member's business with the cooperative. The value of each member's use of cooperative services is divided by the total value used, and the resulting percentage represents that member's proportionate use of the cooperative's services during the base period. Next, each member's percentage is multiplied by the amount of needed equity. This establishes a suggested share of equity which should be invested by that particular member. This amount is then compared to the amount of equity that the individual member has actually invested in the cooperative to determine whether the patron is underinvested or overinvested. The cooperative will then redeem more of the equities of the overinvested patrons and retain more of the current year's equities of the underinvested patrons.

In the third major scheme for redeeming members' equities, the cooperative simply retires a portion of all of the outstanding equities each year. To determine the total amount to be redeemed, the cooperative calculates the funds available for the redemption and divides this amount by the total allocated equity which is outstanding. The resulting percentage is then multiplied by each member's equity. Because this arrangement by itself never results in the complete redemption of a deceased or inactive member's equities, this type of plan is generally accompanied by provisions for retirement in full, after a given period, of the accounts of deceased or inactive patrons.

If there is no plan, the directors generally have wide latitude in making decisions about whether and when to redeem retained equities, making this an issue that can lead to disputes between dissatisfied members or former-members and the co-op's directors. However, courts are generally reluctant to intervene in business decisions made by a co-op's directors,¹³⁷ particularly where the co-op's own organizational or operating documents gives the directors discretionary authority.¹³⁸

137. The business judgement rule is a judicially-created doctrine which shield most board decisions from judicial scrutiny. A court will, however, intervene if it determines that the board or officer acted outside the scope of office, with gross negligence, or was guilty of culpable mismanagement. *Parish v. Maryland & Virginia Milk Producers Ass'n*, 277 A.2d 19, 48 (Md. 1971). Similarly, there may be legal redress if the director affirmatively abused her or his discretion. *Lake Region Packing Ass'n v. Furze*, 327 So. 2d 212 (Fla. 1976). The court in this case held that "corporate directors generally have wide discretion in the performance of their duties and a court of equity will not attempt to pass upon questions of the mere exercise of business judgment which is vested by law in the governing body of the corporation." *Id.* at 216. If members "can demonstrate that the directors of the Association abuse their discretion or breach their trust by establishing charges to the producers at an inordinately low rate in relationship to the competitive market, by permitting the accumulation of excessive reserves, or by any other conduct, respondents have recourse to the courts" *Id.* at 217.

138. Courts have uniformly upheld redemption decisions made by boards of directors where decisions were subject solely to director discretion and such discretion was authorized by the relevant cooperative statutes and bylaws, although board decisions must comport with the business judgment rule standard. *See, e.g., Lake Region Packing Ass'n v. Furze*, 327 So. 2d 212 (Fla. 1976) (former members unable to force distribution of deferred patronage refunds where bylaws and articles gave discretion to the board); *Claassen v. Farmers Grain Coop.*, 490 P.2d 376 (Kan. 1971) (board of directors given discretion to refuse member permission to withdraw interest from the cooperative if, in the opinion of the cooperative, it might disturb the financial condition of the cooperative, even though other member's interest had been redeemed upon death); *Driver v. Producers Coop., Inc.*, 345 S.W.2d 16 (Ark. 1961) (although court forced board of directors to comply with the charter and bylaws which set a scheme for retiring former members' interests, board still allowed to exercise discretion).

Generally speaking, members have limited rights to share in earnings of a cooperative; those rights are substantially divorced from the level of their investment and are, instead, dependant on patronage.

Distributions upon dissolution are also typically based on patronage rather than the members' proportionate capital investment. Members generally are not entitled to transfer their membership interests to third parties, and instead must rely upon the co-op to repurchase or redeem their interests. The amount paid generally depends primarily on the level of patronage retains that have accumulated.

f. Returns on Ownership Capital Are Limited

The third characteristic traditionally associated with the cooperative form of organization is that returns on ownership capital are limited. There are multiple reasons why members do not expect a greater return on their investment or ownership interest.

First, the traditional cooperative is inherently not-for-profit, and thus there is often not much in the way of "returns" available to be allocated to capital. Traditional cooperatives exist only to provide economies of scale or other economic benefits to those who use the co-op and its services. It is generally not geared towards making a profit on invested funds. Any retained equities or per-unit retain allocations arise from the provision of goods or services by the co-op, such as marketing of members' produce. Such funds are simply monies withheld by the cooperative from the purchase price of the crop it marketed for its members.¹³⁹ These amounts are not "profits," as such.

Second, returns are allocated on the basis of patronage and not as a return on the members' capital investment. This may be just a different way of looking at the same point that was discussed above. If the only "earnings" are those attributable to retains that would otherwise be owed back to the members as a result of a transaction conducted for the member, it is not surprising that eventual allocations to the members do not involve anything that would qualify as a "return" on their capital investment. And without such a return, the investment itself is not worth much in its own right.

In addition, there are various statutory and regulatory barriers to paying out significant amounts as a return on capital. For example, in order to qualify for favorable tax treatment, a farming cooperative that issues capital stock may not pay interest on that stock at any rate in excess of the greater of "the legal rate of interest in the State of incorporation or 8 percent per annum . . . on the value of the consideration for which the stock was issued."¹⁴⁰ Similarly, the Agricultural Marketing Act¹⁴¹ defines cooperative association in such a manner that only associations which pay either per cent or less on stock or membership capital are covered. State laws may impose additional restrictions on dividends or interest on capital.

139. "The sole return on this capital is reflected in the proceeds received by the producer from the sale of [the products]." Mid-American Dairymen, Inc., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,110 (Feb. 2, 1977).

140. I.R.C. § 521(b)(2).

141. The Agricultural Marketing Act is codified at 12 U.S.C.A. § 1141 *et seq.*

Fourth, traditional cooperative ownership interests are generally not freely transferable. Thus there is little, if any, possibility of appreciation, since members are typically prohibited from transferring their stock or membership interest to anyone other than the cooperative itself, which will generally do nothing more than buy back the stock or membership interest at its original purchase price.

g. Traditional Financing for Cooperative Operations

Regardless of whether or not the initial purchase is in the form of stock, most of the equity¹⁴² in a traditional cooperative is generated by the cooperative's retention of a portion of the sales price of goods sold through the cooperative or a portion of any savings realized as a result of purchases through the cooperative.¹⁴³ Members in the cooperative are normally entitled to receive shares of the cooperative's earnings based on how much they use the cooperative's facilities or services. Many agricultural cooperatives simply retain a portion of the amount which would otherwise be paid to the members for their product on a per unit basis. This form of "investment" is often referred to as a patronage retain and may or may not be represented by certificates.¹⁴⁴ An important aspect of cooperative financing is that no interest is paid on the monies held as retained equities.

The prevalence of this as a method of financing is attributable to a number of factors. First, although cooperatives are required by federal tax laws and state incorporation laws to pay patronage dividends each year to their members,¹⁴⁵ they are not required to pay the entire dividend in cash.

142. There are a number of reasons why farmers' cooperatives may be unable to raise sufficient capital by selling membership interests. "Since the purchase of equity is often limited by statute to the cooperative's member-patrons, however, this financing option can be limited. This option is especially limited in times of economic distress when farmers have very little working capital." Jon K. Lauck & Edward S. Adams, *Farmer Cooperatives and the Federal Securities Laws: The Case for Non-Application*, 45 S.D. L. REV. 62, 69 (2000)

In addition, the greater the capital needs of the cooperative, the less satisfactory equity financing may be as a source of operating funds. See Ralph W. Dutrow *et al.*, UNITED STATES DEPT OF AGRIC., FINANCIAL PROFILE OF 15 NEW AGRICULTURAL MARKETING COOPERATIVES 7 (1981) (Agricultural Cooperative Service, ACS Service Report No. 27, May 1981).

One obvious alternative to equity financing is debt. The commercial practices of an agricultural operation, whether it is organized as a cooperative or otherwise, are beyond the scope of this document.

143. Farmer Coop. Service, USDA, Legal Phases of Farmer Cooperatives 471-80 (1976).

144. See generally Mary Beth Matthews, *Current Developments in the Law Regarding Agricultural Cooperatives*, 1 DRAKE. J. AGRIC. L. 173, 174 n.10 (1996), citing Mary Beth Matthews, *Financial Instruments Issued by Agricultural Cooperatives*, USDA/ACS, Cooperative Information Rep. No. 68, March 1988. Accord Harl, *supra* note 131 at § 136.01[1] at 136-5 to -6.

145. See, e.g., I.R.C. § 1388.

For a general discussion of patronage dividends, see Irving Clark & Phillip L. Erickson, *Taxation of Cooperatives*, 229-2nd TAX MGMT. (BNA); Donald A. Frederick & John D. Reilly, *Income Tax Treatment of*

Federal tax laws require at least 20 per cent be paid in money or by qualified check in order for the entire patronage dividend to be a deductible expense for the cooperative.¹⁴⁶ The amount not paid in cash is kept by the cooperative and credited to the member in one of several ways. For example, a member may receive "stock," credit on a capital account, an equity certificate, or some other evidence of his or her retained patronage in the cooperative.¹⁴⁷ Retained patronage dividends (however denominated) thus provide an easy way for members to contribute equity capital to the cooperative.¹⁴⁸ The principal manner of recouping these types of equity investment is through eventual redemption of these interests by the cooperative, rather than by sale of the interests in a market.

h. Value-Added or Next-Generation Cooperatives

Beginning in the early 1990's, commentators began to report on the spread of value-added cooperatives, often referred to as new wave or new generation cooperatives.¹⁴⁹ In some ways, these value-added cooperatives operate like traditional cooperatives, but there are some significant differences.

The purpose of these cooperatives is clear: "to develop new value-added products and to gain access to an increased share of the consumers' food dollar."¹⁵⁰ They have appeared "in virtually every sector of agricultural production," including so-called "niche markets" like bison processing, and more traditional arenas such as corn sweetener production, sugar beet processing and pasta production.¹⁵¹

Like traditional cooperatives, these value-added co-ops operate on the traditional cooperative principle of one-member, one-vote.¹⁵² Similarly, a very significant motivating factor in the decision to participate in a value-added cooperative is the desire to gain the benefits of membership, typically a guaranteed market for a particular commodity. In fact, membership in such ventures is "typically

Cooperatives: Background, USDA, Agric. Coop. Serv., Info. Rept. No. 44, pt. 1 (Nov. 1993); Donald A. Frederick & John D. Reilly, *Income Tax Treatment of Cooperatives: Patronage Refunds*, USDA, Agric. Coop. Serv., Info. Rept. No. 44, pt. 2 (Dec. 1993); and John E. Noakes, *Taxation of Agricultural Cooperatives* in 14 Neil E. Harl, *AGRICULTURAL LAW*, ch. 135 (1996).

146. I.R.C. § 1388(c)(1).

147. See Terence J. Centner, *Retained Equities of Agricultural Cooperatives and the Federal Securities Acts*, 31 U. KAN. L. REV. 245, 246 (1982).

148. *Id.* at 247.

149. The USDA has published a "guide" to creating next generation cooperatives: William Patrie, *Creating 'Co-op Fever': A Rural Developer's Guide to Forming Cooperatives*, USDA, Rural Bus.-Coop. Serv., Rept. No. 54, (July 1998). So has the Illinois Institute for Rural Affairs: Mark J. Hanson, *Starting a Value-Added Agribusiness: The Legal Perspective* (ILL. INST. FOR RURAL AFFAIRS, Jan. 2000).

150. Andrea Harris *et al.*, *New Generation Cooperatives and Cooperative Theory*, 11 J. COOPERATIVES 15 (1996).

151. *Id.*

152. *E.g.*, Robert Cropp, *New Generation Cooperatives Defined*, notes from presentation to the New Generation Cooperatives Conference at the University of Wisconsin (Apr. 1, 1996) (available online at <http://www.wisc.edu/uwcc/info/bob.html>).

limited to one commodity group."¹⁵³ Finally, as with traditional cooperatives, earnings in a value-added enterprise are also distributed to members on the basis of patronage.¹⁵⁴

The differences between traditional and value-added co-ops, however, may be profound. First, membership in new generation cooperatives is generally "closed" or "restricted," with total membership based on the volume of raw product that the cooperative can adequately process or refine.¹⁵⁵ The attributes of membership also differ from that in a traditional co-op because a member's equity in a value-added enterprise will equal that member's patronage, since a member is generally required to purchase not only a membership interest but also delivery rights. These "rights" (which also entail an obligation to deliver a specified amount of the applicable commodity) may be assigned on the basis of the number of shares of common stock or may depend on the purchase of preferred shares.¹⁵⁶ The delivery rights and obligations may attach as a result of ownership of the stock pursuant to the terms of the cooperative's organizational documents or may be separate from the stock, as part of a contract entered into between the member and the co-op. In any event, the extent of each member's delivery obligations are generally tied to that member's investment level.¹⁵⁷ Thus, while it is true that a member in a value-added cooperative will share in earnings on the basis of

153. Andrea Harris *et al.*, *New Generation Cooperatives and Cooperative Theory*, 11 J. COOPERATIVES 24 (1996).

154. The difference, of course, is that patronage is itself typically linked to equity participation so that earnings in a value-added venture will vary directly with both patronage and investment.

155. Dennis A. Johnson, *Surfing the New-Wave Cooperatives*, 62 no.7 FARMER COOPERATIVES (Oct. 1995) (<http://www.wisc.edu/uwcc/info/farmer/627surf.html>) (Citing "[d]efined or selected membership rather than open membership" as a characteristic of new-wave cooperatives).

156. *E.g.*, Ralph K. Morris, *Legal and Financial Aspects of New Generation Cooperatives: Legal Implications*, notes from presentation to the New Generation Cooperatives Conference at the University of Wisconsin (Apr. 1, 1996) (available online at <http://www.wisc.edu/uwcc/info/morris.html>).

157. It is also worth mentioning that the delivery obligations do not always guarantee that the member will in fact be delivering the member's own produce. Some members' agreements for next generation cooperatives expressly authorize the cooperative to buy on the account of the member commodities that the member fails to deliver. *See, e.g.*, Golden Growers Cooperative Growers Agreement ¶ 1(a). Such provisions, of course, mean that delivery obligations can be fulfilled with a cash payment. Also, consider the following discussion about the reasons that participants had for declining to purchase or for selling shares in Dakota Growers Pasta Company, a noted next generation cooperative:

All participants agreed that the cooperative's success had exceeded expectations, but it was not clear at the beginning that this would be the case. Inability to raise durum was an important factor in the decision of two of the session participants. Also, there was discussion about the fact that disease problems in the area have made it difficult for farmers to raise durum that meets the standards of the plant. Even farmers who belong or have belonged to the cooperative have not been able to deliver durum they have produced. Rather, they have been forced to purchase elsewhere the durum they were obliged to deliver. Finally, there was some lively discussion about the fact that purchasing these shares is much like purchasing shares in any business, especially in light of the problems members have in growing durum that can be delivered to the plant. One session participant noted that he might prefer to diversify his investments by purchasing stock in companies outside of the agricultural sector.

Kim Zeuli *et al.*, *Dakota Growers Pasta Company and the City of Carrington, North Dakota: A Case Study*, A Report for the USDA Fund for Rural America, 28 (Mar. 1998).

patronage, it is equally accurate to say that the members' sharing ratios are fixed by the members' relative investments.

This difference is also reflected in the nature of a member's investment in a value-added co-op. Because processing most agricultural commodities is an expensive, capital-intensive proposition, "minimum capital requirement for [new generation cooperative] membership is often high."¹⁵⁸ In exchange for a greater initial capital investment, farmers hope for a greater rate of return. Thus, successful value-added co-ops pay out much of their earnings on an annual basis rather than retaining significant amounts.¹⁵⁹ In fact, expansion is typically funded by new investment in additional delivery or membership rights, not retained patronage dividends.

In order to attract more funds up front, value-added deals are generally structured so that the "delivery or membership rights have value and can be traded."¹⁶⁰ With this framework, there is no necessity to wait for redemption by the cooperative in order to recover the initial investment.¹⁶¹ The market will determine the value of the interests,¹⁶² and members are able to benefit from any appreciation in value.¹⁶³

On the other hand, just as there is an increased potential for profits, there is also increased risk. One farmer, who serves as a board member in a successful value-added co-op, has been quoted as saying that "investing in value-added ag processing 'is just like investing in the stock market. You have to be in it for the long haul, and you shouldn't invest money that you can't afford to lose.'"¹⁶⁴

158. Andrea Harris *et al.*, *New Generation Cooperatives and Cooperative Theory*, 11 J. COOPERATIVES 19 (1996).

159. For example, Dakota Growers Pasta Company has paid out approximately \$2 per share since formation in 1992. Lon Tonneson, *Are We Rich Yet?* 1999 *The Farmer/Dakota Farmer* 8 (Jan. 1999). Minnesota Corn Processors paid members "\$.30 to \$1 per bushel from 1984 to 1995." *Id.* at 9. In 1996, another cooperative, Golden Oval Eggs produced a return on investment of approximately 44%. *Id.* at 10. North American Bison Cooperative paid \$41.09 per head in 1998. *Id.*

160. *Id.* See also Andrea Harris *et al.*, *New Generation Cooperatives and Cooperative Theory*, 11 J. COOPERATIVES 15 (1996), talking about the transferability of delivery rights in most value-added cooperatives.

161. Robert Cropp, *New Generation Cooperatives Defined*, notes from presentation to the New Generation Cooperatives Conference at the University of Wisconsin (Apr. 1, 1996) (available online at <http://www.wisc.edu/uwcc/info/bob.html>).

162. *Id.*

163. Ralph K. Morris, *Legal and Financial Aspects of new Generation Cooperatives: Legal Implications*, notes from presentation to the New Generation Cooperatives Conference at the University of Wisconsin (Apr. 1, 1996) (available online at <http://www.wisc.edu/uwcc/info/morris.html>). For a detailed discussion of changes in market value for some of the most- and least- successful value-added agricultural cooperatives in recent years, Lon Tonneson, *Are We Rich Yet?* 1999 *THE FARMER/DAKOTA FARMER* 8 (Jan. 1999).

164. *Id.* at 12, citing Sandy Ludeman, Minnesota Corn Processors board member.

As described above, there are several characteristics that can be used to distinguish between traditional and value-added cooperatives. One possible list¹⁶⁵ of the distinguishing characteristics of such value-added enterprises is as follows:

1. Substantial equity investment by members;
2. Closed or restricted membership;
3. Delivery rights or obligations tied to equity investment;
4. Recognition of the transferability of delivery rights;
5. Value-added payments made to members as they are earned; and
6. Expansion funded by new investment rather than patronage retains.

These characteristics create a very different type of investment than that made in connection with traditional cooperatives.

First, there is the dollar amount at stake. Value-added cooperatives face potentially significant problems in raising sufficient equity, since a "tremendous amount of capital is required for modern agricultural processing and marketing facilities, so even maximum effort by the farmer-members of new cooperatives is unlikely to generate sufficient equity funds to construct and operate these facilities initially."¹⁶⁶ Because lenders expect equity investors in such enterprises to contribute approximately 50 per cent of the total capital requirements of the venture,¹⁶⁷ this means that initial investments in value-added cooperatives are often quite substantial.¹⁶⁸

165. The list is an amalgamation of items taken from lists of distinguishing characteristics suggested by Ralph K. Morris, Esq., of Doherty, Rumble & Butle in Minnesota, and Dennis A. Johnson, President and CEO of the St. Paul Bank for Cooperatives. See Ralph K. Morris, *Legal and Financial Aspects of new Generation Cooperatives: Legal Implications*, notes from presentation to the New Generation Cooperatives Conference at the University of Wisconsin (Apr. 1, 1996) (available online at <http://www.wisc.edu/uwcc/info/morris.html>). and Johnson, *supra* note 155.

166. Ralph W. Dutrow *et al.*, United States Dep't of Agric., *Financial Profile of 15 New Agricultural Marketing Cooperatives 7* (1981) (Agricultural Cooperative Service, ACS Service Report No. 27, May 1981).

167. One source has estimated that "most financial institutions will require at least 40 to 60 percent equity from the owners." Cindy Thyfault, *Developing New Generation Co-ops: Getting Started on the Path to Success*, 63 No.4 RURAL COOPERATIVES (July/Aug. 1996) (available online at <http://www.wisc.edu/uwcc/info/develngen.html>).

Another source suggests that most value-added cooperatives "raise between 30 and 50 percent of their total capital requirements" by selling such shares. Andrea Harris *et al.*, *New Generation Cooperatives and Cooperative Theory*, 11 J. COOPERATIVES 15 (1996). The same source suggests that "[r]emaining capital requirement are met through debt or the issue of preferred shares." *Id.*

168. Consider, for example, Mountain View Harvest, a value-added cooperative designed to assist wheat growers by purchasing a bakery and transforming the produce "into a value-added food." Dan Campbell, *Show me the Dough*, RURAL COOPERATIVES 24-26 (May/June 1997) (available online at http://www.wisc.edu/uwcc/info/farmer/64_2_24.html). "To join Mountain View Harvest, a grower had to purchase at least one share in the co-op for \$12,500. They also had to pay a \$500 membership fee and agree to deliver 900 bushels of wheat to the co-op for each share purchased." *Id.*

Similarly, Dakota Growers Pasta Company set an initial share price of \$3.90, and members were required to purchase a "minimum of fifteen hundred shares at the initial share price during the cooperative's equity drive." Andrea Harris *et al.*, *New Generation Cooperatives and Cooperative Theory*, 11 J. COOPERATIVES 15 (1996). This translates to a minimum equity investment of \$5850 for wheat growers wishing to participate.

Second, because delivery rights or obligations are tied to equity investment, the member's earnings will depend on the total investment in the enterprise. A value-added cooperative typically ties the delivery rights and obligations of each member to the number of shares acquired by that member. Thus, although payments to the member may be on the basis of patronage (*i.e.*, the volume of commodities delivered), the payments will also reflect the dollar investment made in the business. This makes the payments look much more like traditional dividends, which are tied only to the amount invested and not at all to the level of patronage. Contrast this with the traditional co-op, where payments reflect the level of patronage and are unrelated to the level of investment.

Third, there is a general recognition that the delivery rights in a value-added co-op have a value. This value comes about because membership in a value-added enterprise is generally "closed" or, in other words, limited to a pre-determined number of investors. The number of investors is determined by the total volume of crops or other agricultural goods that can be processed by the co-op. Once investors have purchased the right to deliver that volume of the relevant commodity, the only way to join the cooperative is if an existing member agrees to sell delivery rights or if the cooperative decides in the future to expand and sell additional membership (and delivery) rights at that time. If a particular enterprise is successful, the right to have a guaranteed market for produce and the right to receive value-added payments may be quite valuable. Allowing these delivery rights to be sold on the open market means that there is the possibility of appreciation over the initial cost of investment.

Further enhancing the possibility of appreciation is the fact that most value-added co-ops do, in fact, pay out profits as they are earned. Unlike traditional cooperatives, where the bulk of equity financing comes from patronage retains, a value-added co-op runs primarily on paid-in capital. If the co-op decides to expand, these operations are financed by selling additional equity interests rather than retaining a portion of the business' earnings. This practice makes purchase of an interest in a value-added enterprise more attractive and, if the enterprise is profitable, enhances the price that interest will bring on the market.

2. Tax Status

Non-exempt cooperatives are taxed in accordance with subchapter T of the Internal Revenue Code (the "Code"). The general pre-requisite to subchapter T tax treatment is that the business must be "operating on a cooperative basis."¹⁶⁹ The phrase is not defined by the Code or applicable regulations, but case law provides some insight into what is meant by this language. The cases tend to emphasize cooperative principles such as: (1) subordination of capital; (2) democratic control by members; and (3) the right to share in pecuniary benefits based on participation in the enterprise.¹⁷⁰

An equivalent minimum investment of \$5000 was required for investment in 21st Century Alliance Inc. by wheat farmers looking for the opportunity to sell their product as flour. Traci Carl, *Farmers Grow into the Food-Processing Business*, J. REC. (Okla City) (Mar. 11, 1997) (available from Westlaw at 1997 WL 14388141).

The New Horizon Cooperative permits members to deliver corn to the co-op, which is then fed to chicken that lay eggs which are sold on the market. Shares in this co-op were first offered in February of 1999 at \$3,000. Perkins Jerry, *Golden Eggs? Co-ops United Farms*, DES MOINES REG. 3 (Apr. 16, 2000) (available on Westlaw at 2000 WL 4955217).

169. I.R.C. § 1381(a)(2).

170. These three principles were enunciated by the Tax Court in *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305, 308 (1965), which is probably the most frequently cited opinion on the issue. This case held that a workers' cooperative association was entitled to subchapter T tax treatment as a non-exempt

There are multiple tax benefits to achieving cooperative status. First, there are certain amounts that do not have to be included when the cooperative calculates its taxable income. For example, subchapter T provides a deduction from gross receipts for amounts paid out or allocated as patronage refunds.¹⁷¹ In order to qualify for this special tax treatment, such patronage dividends must be made in accordance with a pre-existing obligation requiring the cooperative to apportion such payments on the basis of patronage, based either upon the quantity or value of business conducted with or for the cooperative.¹⁷² In addition, such payments or allocations must reflect earnings on member transactions.¹⁷³

Second, Subchapter T generally provides a single level of tax to be assessed on cooperative earnings. While members pay income tax on their share of the cooperative's net income, no entity-level tax will be paid on these amounts.¹⁷⁴

However, income derived from non-member business is recognized by the I.R.S. and the courts as a proper source of income for cooperatives, and is subject to regular corporate tax rules. Under the corporate tax structure, if this income is distributed to members, it is subject to double taxation (once at the corporate level and then again when distributed to shareholders as dividends). In addition, dividends on capital shares are taxable income for non-exempt cooperatives, even if paid from member-derived earnings.¹⁷⁵

On the other hand, certain farmer's cooperatives are exempt from income taxes under section 521 of the Code.¹⁷⁶ In order to qualify for this exemption, the farmers' cooperative must be "organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for

cooperative). The I.R.S. takes the position that 'operating on a cooperative basis' also requires that the cooperative do no more than 50 percent of the value of its business with customers not entitled to patronage dividends

171. I.R.C. § 1382(b).

172. I.R.C. § 1388(a). A pre-existing obligation to return net proceeds to members according to patronage may be implied under law or the terms of the co-op's articles or bylaws. See *Farmers Coop. Co. v. Birmingham*, 86 F. Supp. 201 (N.D. Iowa 1949). See also *Treas. Reg. § 1.1388-1(a)*.

173. I.R.C. § 1388(a). Under subchapter T, deductible patronage dividends do not include amounts paid either (1) out of earnings other than from business done with or for patrons, or (2) out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions. *Id.*

174. I.R.C. § 1385(a). In the case of consumer related transactions, no tax need be paid by either the cooperative or its members. I.R.C. § 1385(b). In providing this complete exclusion from income tax, the Senate Report to the Revenue Act of 1962, Pub. L. No. 87-834 stated:

This is in accord with the concept that patronage dividends represent price adjustments. Therefore, the patronage dividends in these cases represent downward price adjustments of personal, living or family items and should no more lead to taxable income than bargain purchases of such items elsewhere.

175. I.R.C. § 1382(c).

176. I.R.C. § 521.

the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses."¹⁷⁷ In addition, if the organization issues capital stock, the interest rate may not exceed the greater of "the legal rate of interest in the State of incorporation or 8 percent per annum . . . on the value of the consideration for which the stock was issued," and substantially all stock "(other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) . . . [must be] owned by producers who market their products or purchase their supplies and equipment through the association."¹⁷⁸

Finally, the cooperative is limited in the amount of business it can conduct for non-members and non-producers. The exemption will be available only so long as the association does not market the products of, or purchase supplies and equipment for, nonmembers in an amount exceeding "the value of the products marketed [or supplies and equipment purchased] for members," provided also that "the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases."

Thus there may be significant advantages to structuring an agricultural cooperative in the manner specified by section 521 of the Internal Revenue Code. Even if the cooperative is not tax exempt, there are specialized tax rules which should probably be explained by an expert after review of the specific facts of any given situation.

E. Conclusion to Part II.

The materials in this article focus on the limited liability company (LLC), the corporation, and the cooperative form of business. The sole proprietorship, the general partnership, the limited liability partnership (LLP), the limited partnership, and the limited liability limited partnership (LLLLP) were addressed in Part I of this series.

These materials should make it clear that each of these forms of business offer some advantages and at least some disadvantages. In any given case some of these options will not be available or will clearly be less desirable than other alternatives. Moreover, although the corporation is more likely to be familiar than the LLC, the extreme flexibility of the latter, coupled with generally advantageous tax treatment, makes the LLC particularly promising as a choice of ownership option. The co-op, addressed in the penultimate section of this article, is not appropriate for ownership of a single farming operation but may be of interest to groups of farmers or others in the agricultural sector who may wish to associate to obtain the benefits of economies of scale or risk-sharing benefits of such an association.

Although these materials focus on the typical default rules under state law and the more common variations from those rules, when it actually comes to choosing and forming a business out of which to run an agricultural operation or cooperative, there are likely to be a number of issues that go beyond what is discussed in this article. The expense of formation or of customization should not be overlooked; some of these forms of organization are likely to work well only if experienced legal counsel assists in the preparation of written documentation, which can be costly. Moreover, there are

177. I.R.C. § 521(b)(1).

178. I.R.C. § 521(b)(2).

tax and accounting considerations that may also be important in choosing an optimal format for an agricultural (or any other) enterprise. These materials provide only an introduction to these topics.

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