Chapter 4

Legal Business Organizations

The last chapter considered different types of marketing enterprises a group of producers can consider forming. This chapter examines the different types of legal entities these marketing organizations can adopt. Each group will need to decide whether to organize as a cooperative, a limited liability company, a partnership, or possibly with no formal legal organization at all. This decision will affect how the organization operates internally and how it relates to those outside the organization. The decision will help determine who controls the organization, who receives income and suffers losses, who will be liable for any losses experienced by the organization, who pays income taxes and how much, and whether the organization will have the ability to raise capital.

This chapter first discusses some of the things you should think about when considering different types of business organizations and then presents some of the business organization alternatives.

Important considerations

What should I think about when determining what type of legal organization to use for our joint producer venture?

At the most basic level, you should consider the ultimate goals of the organization. Is the business being formed for the sole purpose of making money or are there other goals, such as bringing jobs to the community, raising food with a particular set of values, or protecting the environment? With these goals in mind, you must then answer two basic questions before moving on.

- *Who will control the organization?* Who are the stakeholders in the organization and how can they ultimately affect the operation? Possible candidates include the people who contribute capital, the producers who provide the product, employees, and the community where the business is located.
- *How much capital does the organization need and who will contribute the capital?* Does the organization plan to process and market its own products, which may require a large amount of capital? Or is the joint producer organization a bargaining agent or an information network that does not require a lot of capital to operate?

Important abbreviations for this chapter

Coop – Cooperative
LLC – Limited liability company
LP – Limited partnership
LLP – Limited liability partnership

These two ideas, capital and control, are intricately related because those who contribute capital usually expect to exert some level of control. A number of other questions flow from these two ideas.

- *Who owns the organization?* Who has equity or ownership rights in the business being created?
    - What type of profit-sharing rights do the owners have? Equity rights typically provide owners the right to certain profits. Sometimes, for instance in many cooperatives, the return on the equity investment is limited by statute.
    - Is the ability to sell or transfer shares limited? Organizations may choose to restrict who can own an equity interest. For example, the bylaws of the entity may require that the equity may pass only to other members of the organization or to members of the community.
    - Who is liable for injuries caused by the organization? The business structure usually determines who must pay for damages caused by the business. Generally cooperatives, corporations, and limited liability companies shield their stockholders or members from losses exceeding the amount the shareholder or member has invested. Certain types of partnerships can also work this way.

- *Can a corporation be set up for the sole purpose of avoiding liability?* One of the main advantages of being part of a corporation, LLC, or coop is the organization, rather than the individuals who own it, is liable for the business' debts. This concept of "limited liability" is a major consideration in why people form these type of entities. But courts will not allow people to form corporations with the intent of committing fraud or furthering an injustice. In these situations, the court will "pierce the corporate veil." In other words, the court will look past a scheme that uses the corporation as a cover for an individual's bad acts and make the individual liable.

  For example, a number of years ago in Vermont, two brothers who ran a dairy farm formed a corporation to purchase feed for the operation. The corporation did not have any real assets because the farm, buildings, and equipment were held by another entity. When the feed bills began to pile up, the feed company sought payment from the two brothers for over $150,000. The brothers said they did not have to pay the feed bill because they did not buy the feed, rather the corporation did. But the court still found the brothers liable for the debts. In choosing to ignore the corporation, the court pointed to the following facts: the corporation was undercapitalized and the brothers owned all of the assets of the business, the brothers moved money between their personal accounts and the corporate accounts without any corporate resolutions or documentation, and the brothers had created the corporation with the intent of isolating any business debt from their personal assets. *Agway, Inc. v. Brooks*, 790 A.2d 438 (Vt. 2001).

In a Wyoming case where an oil and gas LLC caused environmental damage to a cattleman's ranch, the court determined it could "pierce the veil" of the LLC. The court used the same analysis as used in piercing a corporate veil: when "corporations fail to follow the statutorily mandated formalities, commingle funds, or ignore the restrictions in their articles of incorporation regarding separate treatment of corporate property, the courts deem it appropriate to disregard the separate identity and do not permit shareholders to be sheltered from liability to third parties from damages caused by the corporations' acts." *Kaycee Land and Livestock v. Flahive*, 46 P.3d 323 (Wy. 2002).

- *Who can participate in the organization?* The organization can be set up to prefer or restrict membership to a certain class of people, for instance only those who provide livestock to the business or those who live in a certain community.

- *Who manages the organization and makes the decisions?* Most formal organizations have at least two levels of decision makers: the board of directors and the management. Generally, the board of directors make major financial and structural decisions while management handles the day-to-day affairs and reports to the board. Such decisions can include:

    - How to implement a major business strategy once it has been decided on;
    - Who to hire and fire;
    - How to deal with employees, suppliers, and buyers; and
    - Reporting on the financial performance of the business.

What does a board do?

A board of directors is a group of people legally charged to govern a corporation. In a for-profit corporation, the board of directors is responsible to the stockholders. From a more progressive perspective, the board is also responsible to other stakeholders, that is, everyone who is interested in or can be effected by the corporation. In a nonprofit corporation, the board reports to stakeholders, such as the donors and the communities which the nonprofit serves.

Major duties of board of directors

Board members have the following duties:

1. Provide continuity for the organization by setting up a corporation or legal existence and represent the organization's point of view through interpretation of its advocacy, products, and services.
2. Select and appoint a chief executive to whom responsibility for the administration of the organization is delegated, including:
    - Reviewing and evaluating the executive's performance regularly on the basis of a specific job description, including executive relations with the board, leadership in the organization, program planning and implementation, and management of the organization and its personnel,
    - Offering administrative guidance and determining whether to retain or dismiss the executive.

(continued)

What does a board do? (continued)

3. Govern the organization by broad policies and objectives formulated and agreed upon by the chief executive and employees; assign priorities and ensure the organization's capacity to carry out programs by continually reviewing its work.
4. Acquire sufficient resources for the organization's operations.
5. Account to the public for the products and services of the organization and expenditures of its funds, including:
   - providing for fiscal accountability, approving the budget, and formulating policies related to contracts from public or private resources,
   - accepting responsibility for all conditions and policies attached to new, innovative, or experimental programs.

Source: Dr. Carter McNamara, *Overview of Roles and Responsibilities of Corporate Board of Directors*, www.managementhelp.org/boards/brdrspon.htm (Adapted from Brenda Hanlon, *In Boards We Trust*).

- *How will the organization and the owners or members be taxed?* The organizational structure will determine how the income of the organization will be taxed – at the organization level, the individual level, or both. Tax rates may be different depending on the type of organization you choose.

Securities Law

As you think about what type of business organization to form, one of the first areas of law you will need to consider is securities regulation. These are federal and state laws designed to protect people who invest money or assets in certain types of businesses. Perhaps more than any other area of law covered in this book, securities law requires the help of a lawyer who specializes in this field. The following paragraphs provide only the most general information to provide an idea of what securities issues are involved in joint producer associations.

Coverage. Securities laws generally cast a wide net and cover just about anything you can think of that might be an investment vehicle – notes, stocks, bonds, profit-sharing agreements, certificates of deposit, options, and investment contracts. Securities laws may exampt many joint producer organizations, including relatively small businesses, certain types of cooperatives, businesses that issue securities only in the state they operate, businesses that offer securities under private offerings, and businesses that offer securities as part of a compensation plan. Even if the instrument is exempt, however, antifraud protections may still apply.

Restrictions and regulations. If the instrument is deemed a security, then a number of restrictions and regulations apply to anyone who provides information about the security or who wants to transfer the security. Most significantly, the person who creates or sells this interest may need to provide extensive disclosures to the prospective buyers about the nature of the business, the financial statements, and the risks involved in the investment. For larger businesses, this disclosure requirement can cost tens or even hundreds of thousands of dollars to prepare. If you ignore these requirements, you open yourself up to criminal and civil penalties, as well as the likelihood of civil litigation against those with whom you do business.

Limited liability companies and value-added cooperatives: Investment contracts as securities

Professor Carol Goforth has written an excellent article on the subject: *An Introduction to the Federal Securities Laws as They Might Apply to Agricultural Operations* (available at www.nationalaglawcenter.org/assets/articles/goforthsecurities.pdf.). The article includes extensive discussions on how securities law might apply to two of the newer forms of business organization farmers are using – LLC's and value-added coops. In some cases, the money people contribute to these businesses might be seen as an "investment contract," an instrument included under the coverage of the securities laws. The Supreme Court has said this "means a transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or third party." *SEC v. J. Howey Co.*, 328 U.S. 293 (1946). For LLC's and value-added coops, the biggest question under this test is whether the people providing the money have management authority in the business. In some LLC's, this may be the case, while in others, such as most value-added LLC's, the LLC may aggressively seek to attract capital from people who are not active in the management of the business. In the latter case, it is likely the investment will be covered by securities law. The question then becomes whether the venture might be exempt from some of the more costly registration requirements.

Agency Law

Depending on your role in the organization, you may be given the authority to enter into contracts or otherwise act on behalf of the group. This is called a principal and agent relationship. The exact nature of the relationship and the authority an agent has to act on behalf of the principal depends on the agreement between the parties. This agreement does not have to be in writing, but a written agreement can help avoid confusion. If a business person has reason to know someone else is holding themselves out as the business' agent and does not act to change this perception, then the business will be responsible for the agent's actions in the future. However, if an agent knowingly acts beyond his authority and the principal suffers losses because of the agent's actions, the agent may be liable to the principal.

In addition to the responsibility to act within the authority granted by the principal, an agent has other duties to the principal. These include duties of good faith and honesty. The agent also has a duty not to compete with the principal. For instance, if you are responsible for selling produce to institutions for your vegetable cooperative, but you take advantage of this position to sell your own goods, the cooperative could sue you for damages caused by your breach of duty.

The principal also has duties in a principal-agent relationship. These include honoring contracts the agent entered into within the scope of the relationship, as well as duties of good faith and fair dealing. This generally means a principal may not harm the agent's reputation or risk bodily harm to the agent. (Restatement Second of Agency § 435.)

Apparent agency: Who has to pay for the corn?

In a South Carolina case involving the sale of six rail cars of corn, a lender provided a farm manager with $85,000 to buy the corn. At the time the two parties entered into the lending agreement, the lender did not know the farm manager worked for another person named Serbin. Subsequently, the lender became aware the farm manager and Serbin had a farm management agreement spelling out the farm manager's duties for Serbin. The agreement clearly stated that the farm manager was an independent contractor and not an agent of Serbin, and if the farm manager wanted to incur expenses for the farm, he had to get written approval from Serbin.

The lender sued both the farm manager and Serbin for repayment of the $85,000. Part of the suit argued Serbin was the principal of the farm manager and thus was responsible for the farm manager's debts. The court found Serbin did not have to pay because the agreement made it clear the farm manager could not act as an agent for Serbin. The lender pointed out that even if there was not a formal "principal-agent" relationship, Serbin could still be liable if there was an apparent agency relationship. But the court ruled that three things must have been in place for an apparent agency relationship to be found: 1) the farm manager would have had to consciously or impliedly represented to the lender he was an agent; 2) the lender would have had to rely upon the apparent agency relationship; and 3) the lender was harmed because of the reliance. The court then determined the lender did not know of any relationship between Serbin and the farm manager at the time the lender and manager entered into the loan agreement, so the lender could not have relied on any apparent relationship.

Graves v. Serbin Farms, Inc., 306 S.E.2d 769 (S.C. 1991).

Articles of incorporation, bylaws, and operating agreements

Some of the basic legal documents joint producer organizations businesses need to create include the articles of incorporation, bylaws and operating agreements. Articles of incorporation are created by the organizers of the group and are filed with a state office to gain recognition as a legal business entity. The appendix to this book includes the contact information for the appropriate state office to file the articles of incorporation in each state. State law generally dictates what information to include in the articles and typically requires information such as the business' name, place of business, purpose, and names of the organizers or original directors.

Bylaws (or operating agreements as they are known in LLC's) are created by the members to set the rules on how the business will actually operate. The bylaws can both grant and restrict the authority of different people involved with the organization. Typical issues addressed in bylaws include membership rights and responsibilities, the procedure for the election of directors, and duties of officers. Most state laws are fairly permissive in what a group may decide to include in the bylaws.

For more information on articles of incorporation, bylaws, and other legal documents, see Donald A. Fredrick, *Sample Legal Documents for Cooperatives*, USDA Cooperative Information Report 40. www.rurdev.usda.gov/rbs/pub/cir40/cir40rpt.htm#Articles%20of%20Incorporation.

The creation of bylaws or the operating agreement. One goal of most producers who form a joint producer association is to create a fair and flexible way of structuring the business which preserves the reasons it was created. Most groups start out as informal associations of people with similar ideas who share their energy and expertise – the "soft capital" of the business. One challenge for any successful business is how to preserve the original purpose of its creation while dealing with issues such as control and ownership.

How this objective is approached can mean the difference between the success or failure of the original vision of the founders.

Some factors an organization should consider include:

- Treating people equitably and respectfully;
- Acknowledging important contributions regardless of size;
- Respecting each member's unique knowledge;
- Preserving the communication and mutual support that was the basis for the project in the first place;
- Providing a fair and equitable means of adding new people to the group;
- Providing a reasonable method of achieving a valuation of the enterprise members can live with; and
- Providing a flexible means of management to adapt to changing market conditions.

Some of the major features of governance for a small enterprise might include:

- Limiting non-producer voting members on the board of directors. For example, producers shall always hold a certain majority (for example 51%, 67%, or 75%) of voting seats;
- Limiting members' ability to withdraw support from the enterprise in its formative period;
- Allowing any producer regardless of size to sit on the board of directors;
- Having a semi-independent marketing and operations arm; and
- Creating an informal dispute resolution mechanism.

All of these features can be included in the bylaws or operating agreement. Although it is not easy, the process of creating an operating agreement provides an opportunity for sharing knowledge, building mutual respect, and discussing different points of view. At the end of the process, the finished product will represent a real consensus, and each member who was part of the process will have an ownership stake in it and will understand exactly what it means.

Types of Business Organizations

The rest of this chapter examines different types of business organizations, ranging from sole proprietorships to corporations and cooperatives.

1. **Sole proprietorship**. This is the model most people have experience with because it is the simplest. Although by definition this type of business does not include a group of people, it is the proper place to start when comparing different forms of business organizations. It involves one person doing business alone with no legal organization to represent the business. The example is when a farmer wants to market pork and decides to raise hogs outdoors with no antibiotics. He pays someone to process the meat and then sells the pork to people in a neighboring community.

    - Ownership and control. In a sole proprietorship, ownership and control are held by one person. In our example, the farmer provides all of the capital and assets needed to run the farm, including the land, feed, equipment and costs related to marketing, and he receives all of the income and losses. He also makes all of the decisions related to the business, such as what breed to use, whether to hire help, and where to market the product.

    - Liability. In a sole proprietorship, the owner is personally liable for all of the debts of the business. This means if he owes the hardware store $100 for equipment, or owes someone who was injured on the farm $100,000, he will have to pay it either out of the cash and assets of the business or out of his own personal assets. In a sole proprietorship, there is no formal distinction between the individual and the business.

    - Financing. The farmer will need to finance the operation with loans from a financial institution and by using his own income or assets. The sole proprietorship does not have the ability to sell an interest in the business to raise funds.

    - Taxes. Because the law looks on the business and the person as the same entity, the farmer will include the income and losses from the farm in his personal income taxes.

    - Securities law. Because the sole proprietorship does not sell or transfer an interest in the business there are no securities involved. Sole proprietors do not have to be concerned with securities law.

Who's who in the organization?

The different types of business organizations have different terms for the people who have an ownership interest in the business.

Partnerships = general partners or limited partners.
Limited liability companies = members.
Corporations = shareholders.
Cooperatives = patrons, members, or shareholders.

2. **General partnership**. When two or more people enter into business together they may be entering into a partnership. By doing so, the law prescribes a number of things about the legal relationship between them and how the business relates to others. The partners may be able to modify these legal assumptions in law with their own partnership agreement. Unlike most other joint producer ventures, such as limited liability partnerships and corporations, a general partnership does not have to file any papers with the Secretary of State in order to be legally recognized. The example we will use here is where two farmers, Brian and Rita, decide to raise pasture-raised hogs, have them processed, and sell the meat at the local farmers' market. Rita owns most of the facilities while Brian wants to manage the business and has a lot of the know-how it will take to be successful. They decide to buy the hogs together.

   - Ownership and control. In a partnership, unless the partnership agreement provides otherwise, all of the partners have equal rights to the profits and each owner has an equal say in the management decisions. In the example, Rita and Brian could agree that Rita will get 2/3 of the profits from the business but will not get any salary. Brian will a receive a small salary and 1/3 of the profits. If the partnership agreement does not address control issues, it is assumed both parties have equal rights to control the business. Each partner has the ability to enter into agreements with other parties that will bind both partners.

   - Liability. In a general partnership, as opposed to a limited liability partnership, each partner is personally liable for the debts of the business. In the example, if Rita borrows $10,000 to purchase feed for the business and neither the partnership nor Rita is able to pay the debt, Brian will be personally liable.

   - Financing. The partnership provides more options for financing than the sole proprietorship, but not as many options as LLC's or corporations. The sole proprietorship generally has to rely on debt financing or personal assets. The partnership also has these options, but it can also seek to join other people as partners who will provide financing. In the example, Brian originally had the experience and desire to raise hogs, but he did not have the facilities. To gain access to facilities, Brian approached Rita to become a partner in the new business. Rita contributed facilities and gained a right to a part of the profits.

   - Taxes. Tax laws treat partnerships as a mere conduit for income and losses, and thus the partnership itself is not taxed. The default rule is the partners will share in the income and losses to the extent of the partner's interest in the partnership, generally

> A partnership is a voluntary association of two or more persons who jointly own and carry on a business for profit. Black's Law Dictionary (8th ed. 2004).

assumed to be equal, although partnership agreements often change this assumption. In our example, Rita and Brian agree their tax responsibilities should match their share in the profits, so Rita takes 2/3 of the profits and losses and Brian is allocated 1/3. This means if the partnership has an income of $30,000 this year, then Rita will need to claim $20,000 income for her personal income.

- Securities law. As a general rule, partners in a general partnership do not have to worry about securities law because the investment a partner contributes to the business is coupled with management responsibilities. This means the general partner's interest is not a security.

3. **Limited partnership**. A variation on general partnerships is the limited partnership (LP). A limited partner is someone who agrees not to be involved in the management of the business in return for limiting potential liability to the value the limited partner invests. The trade-off is giving up control in return for limited exposure to liability. An LP must have at least one general partner and one limited partner. For an LP to be recognized, the business must register with the appropriate state official, usually with the Secretary of State. In our example, Brian and Rita have the ongoing partnership with their hog farm, while they are seeking more investment for expansion. Loran has agreed to join as a limited partner and has provided $25,000 to the business. The business has filed LP papers with the state. Beyond registration, the LP usually has an LP agrement setting out many of operational details of the business.

- Ownership and control. The owners of an LP are split into two classes: general partners and limited partners. General partners have the right to manage and control the business, while limited partners have a very limited role in the controlling the business and may only participate in some major decisions, such as dissolution. If a limited partner becomes active in managing the business, the person could lose the status as a limited partner. In the example, Brian and Rita are general partners so they each have the right to make decisions about how many hogs to raise, what to feed them, where to have the farm, and how to market the meat. As a limited partner, Loran cannot participate in these decisions. But because he contributed money to the LP, he has the right to claim a percentage of the income.

- Liability. The LP treats the two classes of partners differently in terms of liability. General partners are still personally liable for the debts of the partnership, while limited partners are only liable for the amount they have put into the partnership. In the example, assume the LP owes the local implement dealer $80,000 for a new tractor and feed mixer. When the debt is due, the LP only has $30,000 available to pay the debt. In this case, Brian and Rita will have to dip into their own personal finances to pay the remaining $50,000, but Loran will not have to pay any losses beyond the $25,000 he originally put into the LP.

- Financing. LP's open another avenue of financing beyond general partnerships. Some people who want to provide money to a partnership may not be willing to expose themselves to losses beyond the contribution. A general partnership cannot provide this type of protection, while the LP does have this feature, as long as the limited partner is willing to give up most control of the LP.

- Taxes. LP's are generally taxed in the same way as the general partnership so all of the partners, both general and limited, will include a portion of the income or losses of the LP in their own personal income. One variation is limited partners usually do not have to include their LP income for purposes of self-employment taxes, whereas general partners usually do. In the example, assume the LP has an income of $60,000. The LP agreement states Brian, Rita, and Loran each have the right to 1/3 of the income. Brian and Rita will include the income as personal income, including for purposes of self employment taxes. Loran will include $20,000 in his personal income, but will not have to include that amount for purposes of self-employment taxes.

- Securities law. Securities law treats general and limited partners differently. The interests held by general partners are generally not deemed to be securities because the financial interest is coupled with the general partner's personal efforts. On the other hand, limited partners gain their profits as a result of other people's efforts, thus they are generally deemed a security. The question then becomes whether the law provides an exemption from the securities law requirements. In the example the LP will need to examine securities laws regulation to determine how the law will treat Loran's interest in the LP. Even though the general partners' interest is probably not regulated by securities law, the LP interest may be defined as a security. If it is, the question then becomes whether the security is exempt from certain regulations.

4. **Limited liability partnerships**. Another variation on general partnerships is the limited liability partnership (LLP). This type of entity blends elements of the general partnership and the LP. It is difficult to generalize about LLP's because their details vary considerably from state to state, but some helpful distinctions from other business organizations can be made. For an LLP to attain legal recognition, it must register with the state.

    - Ownership and control. Like a general partnership, an LLP only has one class of partners. All of these partners contribute to the LLP and have a right of control. In the example, Brian, Rita, and Terry decide to form an LLP as the business organization for a hog farm. Brian contributes much of the labor and know-how, Rita contributes the facilities, and Terry contributes cash. According to the LLP agreement they have executed, each of the limited liability partners have a right to 1/3 of the income and have an equal say in the management of the business.

- Liability. As the name implies, the major difference between a general partnership and a limited liability partnership is the amount of liability to which the partners are exposed. Professor Carol Goforth provides a very helpful discussion of LLP's in *An Overview of Organizational and Ownership Options for Agricultural Enterprises, Part I* (available at www.nationalaglawcenter.org/research/#ownership). Professor Goforth explains that the primary benefit of an LLP is it shields partners from certain debts of the LLP. In general terms, partners of an LLP will not be personally liable for damages caused by the misconduct of others, but will be liable for their own misconduct. In some states, limited liability partners may not be personally liable for debts incurred in the regular course of business. In the example, if Brian causes a car accident while hauling hogs on the highway, Brian could be personally liable for the injury, but Rita and Terry will not be.

- Financing. LLP's share many of the same financing considerations with LP's, that is they may be able to attract people who are willing to contribute to the partnership but who are not willing to be personally liable for some of the debts of the LLP.

- Taxes. LLP's are taxed much like general partnerships. So the income and losses will be attributed to the limited liability partners.

- Securities law. Because the limited liability partners participate in the business, it is unlikely their interest in the business would be deemed a security.

5. **Limited liability company**. Recently people have shown considerable interest in a new type of business organization, the limited liability company (LLC). LLC's share some of the characteristics of general partnerships, LP's and corporations. One of the most striking features of the LLC is its flexibility. LLC's must register with the state and most state statutes require the LLC to register for a limited number of years. In the example, we will again look to Brian, Rita, and Terry who create an LLC for their hog and pork operation.

- Ownership and control. LLC's provide members flexibility to be involved in management, much like how partners have control of a general partnership. Members, however, can choose to appoint managers, more like a corporation or coop. Even when managers are appointed, most statutes provide that all members have the right to participate in certain major decisions, such as whether to admit new members or whether to terminate the LLC. Most state statutes also assume the profits and losses will be shared equally, but the statutes allow the LLC agreement to provide for the profit sharing to be modified. In the example, our three LLC members decide to appoint Brian as manager of the business. The LLC articles provide the LLC will attribute 50% of profits and losses to Brian, with Rita and Terry each receiving 25%.

- Liability. Members of the LLC are generally shielded from personal liability beyond the amount contributed to the LLC. If as manager of the LLC, Brian purchases a new refrigeration truck that costs $60,000 and the LLC is unable to pay for the truck, the seller of the truck will only be able to look to the assets of the LLC for payment of the debt. None of the members, not even Brian who is the manager and actually entered into the deal, will be personally liable.

- Financing. The financing options for an LLC are much like those for an LP or an LLP. The LLC can attract people who are willing to contribute to the LLC but unwilling to be personally liable for the debts of the business.

- Taxes. In general, LLC's will be taxed as partnerships where the profits and losses will be allocated to the members. LLC's that become very large (500 or more members) may be taxed as a corporation. The inherent flexibility of LLC's raises the possibility of more complicated tax issues. Professor Goforth points out in her article, depending on how the LLC is organized, it may need to address issues of timing, allocation and valuation of the contributions. One thorny issue that has yet to be clearly determined is when the income of the LLC needs to be included in the calculation of self-employment taxes.

LLC provides flexbility for organic dairy

When several farmers in Southwest Iowa decided they wanted to fill a niche for organic and sustainably-produced dairy products, one of the first questions they needed to answer was what business organization the dairy would adopt. On its way to becoming Naturally Iowa, LLC, the organization required flexibility so it could bring together the capital needed for the processing facility, but also to ensure a portion of the profits would go back to the farmers to help sustain rural communities. The organizers chose the LLC model because it provided the opportunity to attract capital, but also maintained control in a small group of the original organizers who wanted to maintain the goal of sharing profits with producers. Although Naturally Iowa does not have a traditional cooperative governance structure, the LLC model provides the ability to achive what otherwise looks like cooperative patronage refunds. The supply agreement between the LLC and the producers states that ten percent of after-tax profits will go back to the producers. Producers also appreciate the stable price built into the supply agreement which is generally significantly higher than the price for the non-organic milk. www.naturallyiowa.com

- Securities law. Whether a member's interest in an LLC is deemed a security will probably depend on whether the income obtained from the LLC relies on the efforts of others. Given the inherent flexibility of LLC's, the answer to this question will vary with how the management structure is set up and how much the member participates in the LLC.

6. **Corporations**. The corporate form of business is the one people usually think of for large-scale operations. In some ways the corporate form is the most formal and clear cut, but in other ways it varies as much or more than the other types of organizations discussed. Corporations can be very large, but they can also be much smaller and “closely-held” with stockholders running the business. In the example, Brian and Rita’s hog and pork business has grown and they have decided to expand to a much larger scale. For this to occur, they need large amounts of capital and a business form that provides for the efficient management of a very large business. They choose to “go public” by registering as a corporation with the state and offering to sell shares of their business to the public.

   - Ownership and control. Traditionally, ownership and control are separated in the corporate form. The owners, or shareholders, have voting rights in electing the board of directions and in some other major structural decisions, but most of the decisions are made by the board while the executives are responsible for the day-to-day decisions. Shareholders can be divided into different classes with distinctions based on voting rights, transferability, and the rate of return. In a variation from the classic corporate form, smaller, closely-held, or S-corps (discussed below) can sometimes merge the role of owners and managers, much like what occurs in partnerships or some LLC’s. The example uses the classic corporation and may involve hundreds or thousands of people owning shares in a vertically integrated meat business that raises hogs and processes pork. The shareholders elect a board that in turn hires executives to run the business. Brian and Rita may still be involved in the business as board members or shareholders, but the formal control of the business now rests with the entire board and the profits will be shared among all of the shareholders based on their investments.

   - Liability. In almost all corporations, large or small, the shareholders’ liability is limited to the amount invested in the firm.

   - Financing. One of the greatest advantages of the corporate form is the number of options available for financing. Because the ownership interests of large corporations are highly standardized and the trade of shares is highly regulated, it is relatively easy for people to invest small or large sums of money in the business. Unlike most partnerships and LLC’s, where people need to spend time and money considering their legal and financial rights in the business before investing, corporate investors, even small ones, are familiar with the corporate form and generally do not feel the need to spend resources determining their rights should they invest. When people think about investing in corporations, they are primarily concerned with whether the investment will yield a return or whether the corporation operates in a socially responsible way. Most corporate investors do not spend resources worrying about their rights and responsibilities as shareholders.

- Taxes. The primary disadvantage of the traditional corporation is that both the income at the entity (corporate) level as well as the income to the shareholders is subject to income taxes. This differs from partnerships, LLC's, and cooperatives because those entities are generally only taxed at one of the levels. A major exception to this rule is the S-Corporation (named after subchapter S of the Internal Revenue Code). S-Corps are not taxed at the business level. To be an S-Corp, however, the number of shareholders must be limited to 75 and only individuals can be shareholders. This differs from the C-corporation that has an unlimited number of shareholders and allows other corporations, LLC's, or partnerships to be shareholders.

- Securities law. Another disadvantage of the corporation is the need to abide by securities regulations. Shares in a publicly-traded corporation are the classic definition of a security. As discussed above, securities compliance can be very expensive, whichis a reason why only relatively large businesses find it financially reasonable to organize as a publicly-traded corporation.

Corporate character

In their book *Business Organization and Finance: Legal and Economic Principles*, William A. Klein and John C. Coffee, Jr. explain four characteristics that tend to set large corporations apart from pure partnerships:

- Investors limit their liability to the amount of money they have invested in the business.
- The equity investment, known as shares, can be traded easily on a secondary market (such as the New York Stock Exchange).
- Corporate law has a highly developed set of contracts and legal forms that make it easy for people to know the rights and duties of the different people involved with the corporation. This decreases costs associated with negotiating about who does what and who gets what from the business; and
- Normally the management is centralized in a board of directors, not the shareholders.

Obviously some of these characteristics are not exclusive to the corporate form; for instance LP's, LLP's, and LLC's all feature limited liability to some extent. This illustrates the fact that these business organizations are really more on a spectrum than in distinct categories.

7. **Traditional cooperatives**. Cooperatives have a long tradition in the agricultural and food sectors. Most people are familiar with farmers using the coop model to purchase inputs or sell commodities. Coops have also been used by food retailers and consumers as a way to join together to purchase food. The main distinction between coops and other types of business organizations is coops are designed to provide benefits to the users of the coop, as opposed to the investors. Because of the focus on coop

users, some traditional coops that need a significant amount of capital have trouble attracting investors. This situation is addressed in the next section on value-added or investment friendly coops. An example of a traditional coop is where Brian, Rita, and ten other farmers form a coop as a marketing agent to sell their hogs. In this example, the farmers own and raise the hogs; the coop's function is to pool together the hogs so the group has the number of hogs to be able to be a consistent supplier to larger buyers. The coop has a staff person to deal with the day-to-day dealings with the buyers and to keep up with the trends that affect the market price of the hogs.

Cooperative principles

The following explanation of basic cooperative principles is adapted from USDA Cooperative Information Report (#55) (1997) by Donald Frederickson. www.rurdev.usda.gov/rbs/pub/cir55/cir55rpt.htm.

The User-Benefits Principle. Members unite in a cooperative to get services otherwise not available, to get quality supplies at the right time, to have access to markets or for other mutually beneficial reasons. Acting together provides members the advantage of economies of size and bargaining power. They benefit from having these services available, in proportion to the use they make of them.

Members also benefit by sharing the earnings on business conducted on a cooperative basis. When cooperatives generate margins from efficient operations and add value to products, these earnings are returned to members in proportion to their use of the cooperative. Without the cooperative, these funds would go to other middlemen or processors.

The User-Owner Principle. The people who use a cooperative own it. As they own the assets, the members have the obligation to provide financing in accordance with use to keep the cooperative in business and permit it to grow.

The User-Control Principle. As owners, a cooperative's members control its activities. This control is exercised through voting at annual and other membership meetings, and indirectly through those members elected to the board of directors. Members, in most instances, have one vote regardless of the amount of equity they own or how much they patronize the organization.

In some instances, high-volume users may receive one or more additional votes based on their patronage. Equitable voting is assured, often by limiting the number of additional votes any one member can cast. This protects the democratic control of the membership as a whole.

Only members can vote to elect directors and to approve proposed major legal and structural changes to the organization. The member-users select leaders and have the authority to make sure the cooperative provides the services they want. This keeps the cooperative focused on serving the members, rather than earning profits for outside investors or other objectives.

- Ownership and control. In the traditional coop, producers own and control the coop. Known as members, these farmers usually own at least one voting share of the coop and may own more. Traditionally, coops are democratically controlled, meaning each member has one vote on major issues, no matter how much they use the coop or how many shares in the coop they own. Depending on the size of the coop, the management structure can look much like a corporation with most of the decisions made by a board that delegates operating responsibility to managers. Because coops have more of a member focus, however, more of the decision making authority tends to be held by the members. Members receive income from the coop in proportion to the amount they use the coop (either providing products to sell or purchasing products) or in proportion to how much they have invested in the coop. Interest on coop investment is generally limited to a modest return. This reflects the fact policy makers have historically viewed coops not as an investment vehicle but as a way to help users of the coop. In our example, Brian, Rita and the other ten farmers each form the coop. Because this is a small coop, the board decides to delegate much of the day-to-day responsibilities to a manager who will do most of the marketing for the group.

- Liability. Like LP's, LLC's or corporations, coops provide members with limited liability.

- Financing. Depending on the capital needs of the coop, it may require a more substantial up front investment or sell shares in the coop. Because the return on investment is sometimes limited, and because the amount of control in the coop does not necessarily match with the amount of investment, attracting capital can be a challenge. Another way coops accumulate capital is to retain some of the earnings in the coop's coffers as opposed to distributing it to the members. Coops are also the only type of businesses that can borrow from CoBank, a Farm Credit institution that may be able to provide better loan terms than other banks.

- Taxes. A major advantage a coop has over a corporation is it may be taxed only on the entity level or the member level. Federal tax law has fairly rigorous qualifications for a coop to qualify for this treatment, but in general the law requires the firm to be operated for the benefit of the users of the coop and not investors. This approach puts coops more on par with partnerships or LLC's in terms of tax consequences. Coops can experience a myriad of special tax issues because of their ability to choose at what entity level the income is taxed as well as whether to retain the earnings of the coop.

- Securities law. Certain coops, known as section 521 coops after a section in the Internal Revenue Code, are expressly exempt from securities regulation. To qualify as a 521 coop, substantially all of the stock of the coop must be held by producers who use the coop. Otherwise, whether financial interests in

CROPP Cooperative

Most consumers are more familiar with their adopted brand name, Organic Valley Family of Farms, while farmers around its headquarters in LaFarge, Wisconsin, know the cooperative by its initials, which stand for Cooperative Regions of Organic Producer Pools. Since 1988, CROPP has grown from just seven farmers in Southwestern Wisconsin to the largest organic cooperative in North America. CROPP operates as a marketing association for its producers of milk, eggs, juice, meat, soy, and produce. All of its products are certified organic.

As a cooperative CROPP is owned and run by its producers. The producers set the price of their products, which results in fairly stable prices that do not fluctuate with the varied commodity markets. The cooperative purchases the products and then markets the products to grocery stores, institutions, and other venues. In terms of governance, farmers who produce particular products participate in separate "pools" have a say in how the coop will market the product. Producers also elect representatives from their region who have the ability, through monthly phone conferences, to voice concerns to the board and the management team.

CROPP limits the amount of "brick and mortar" investment required to process its products by entering into "co-pack" arrangements with processors around the country. This strategy allows the coop to grow without having to build processing facilities in each new region or with each new product.

CROPP has a history of paying premiums gained on the organic product soon after it receives them. This is unlike many cooperatives that retain premiums until the end of the year. The coop also generally pays interest on the equity the producers contribute to the coop.

Even though CROPP limits its capital demands, developing sophisticated marketing campaigns and distribution plans for a large business does take a significant amount of money. The coop raises capital by requiring each member to contribute equity equal to a percentage of the member's annual sales. The coop also has the option of retaining some of the profits is otherwise pledged to a member, known as "retained patronage refunds." The board has the option of distributing these patronage refunds at a later time. The coop also offers preferred stock to members and non-members with limited voting rights and a maximum of 8% annual dividend.

One of the great challenges CROPP faces, along with any growing business, is how to balance supply with demand. One tool CROPP has employed to do this is to accept new producers only as the demand can absorb the new supply. This characteristic distinguishes CROPP from many of the older traditional coops that simply marketed as much commodities product as the members delivered.

Sources: Organic Valley Website. www.organicvalley.coop/our_story/our_cooperative/index.html; University of Wisconsin Center for Cooperatives, *CROPP Cooperative: The Cooperative Regions of Organic Producer Pools: A Case Study Prepared for the North Central Initiative for Small Farm Profitability*. www.farmprofitability.org/research/cropp/cropp.htm.

a coop are securities can quickly become a complicated question. In the arena of traditional coops Professor Goforth states that "[g]enerally speaking, equity interests in traditional cooperatives will be outside the scope of the securities laws so long as the motivation behind the purchase is to enable the purchaser to use or participate in the use of the purchased item." *An Introduction to Federal Securities Laws as They Might Apply to Agricultural Operations* (2002) available at www.nationalaglawcenter.org/research/#securities. If the equity interest was invested with the intention of earning a profit, securities law may apply, an issue discussed in the next section.

Because policy makers have generally encouraged farmers to join cooperatives as a way of providing farmers a better way to market their products, there are two other legal factors for coops to consider that other types of business organizations do not need to address.

- The right to bargain collectively. Antitrust laws generally prohibit individuals who compete against each other from agreeing on or fixing prices. The Capper-Volsted Act (7 USC 291), however, provides that producers of agricultural products have the right to collectively bargain, and in essence, agree to prices among themselves, so long as the agreement does not "unduly enhance" prices. The law provides limited immunity from the antitrust laws. The trade-off is (1) the coop must operate in a democratic manner, which means one member-one vote, regardless of the amount of investment *or* (2) the return on investment is limited to 8% per year; and in any case, the majority of the coop's business must come from members. In the example, the coop wants the Capper-Volsted exemption so it can bargain for all of the members. To qualify for the exemption, the bylaws state each member only has one vote in the election of the directors and on other matters. This is the case even though Brian owns three times more stock in the coop than Rita. To qualify for the exemption, the coop also must market at least as many hogs owned by members of the coop as by non-members.

- Right to join a cooperative. The Agricultural Fair Practices Act (7 U.S.C. 2301) generally prohibits processors from discriminating against or intimidating producers who want to join or are members of a cooperative. This protection applies only to members of cooperatives that meet the definition of an association under the Capper Volsted Act. A major limiting factor in the AFPA is the "disclaimer clause." This clause states a processor can refuse to deal with a producer for any reason other than the producer's relationship to an association. This provision has greatly limited the law because processors can usually point to some other reason not to deal with a producer rather than the producer's association with the coop.

8. **Value-added coops**. In recent years, a number of producer groups have considered joining together not just to market their commodities but to actually process the product. Depending on the nature of the processing involved, these types of ventures can require substantial equity to build or buy the plant, purchase

the equipment, pay employees and purchase other inputs. Because traditional cooperatives were not designed to attract large sums of capital, some have looked at new ways of operating and financing. These cooperatives have become known as value-added coops.

- Ownership and control. Ownership is still generally vested in people who use the coop, but value-added coops generally require a greater amount of investment. To attract investment, the coop allows members to use the value-added process offered by the coop only to the degree they have invested in the venture. Shares in the coop may be transferred, but only to other producers who will also use the coop.
- Liability. Like LP's, LLC's or corporations, value-added coops provide members with limited liability.
- Financing. In general, only those who invest a significant amount in the coop may use the coop. The idea is to create a coop that includes further processing will allow farmers to capture more of the consumer food dollar. But for farmers to participate in this more attractive marketing system, they will need to contribute a significant amount of capital to finance the processing side of the business.
- Taxes. Members of a value-added cooperative risk losing the advantages of being treated as a cooperative for tax purposes. This means the income may be taxed at both the entity and individual level. Although competing approaches exist, one of the main questions a court will probably ask is whether the benefits that accrue from the entity come from the use of the coop or from the investment in the coop. If the benefits are really based on the investment, then the court would probably not consider the arrangement as a cooperative for tax purposes.
- Securities law. Whether a value-added or closed coop is exempt from securities regulation is an exceedingly complicated question that will depend on the circumstances. Groups creating these types of coops will need to tread lightly and seek the advice of lawyers familiar with this area of law. The more the membership interests or delivery rights look like simple investment vehicles, the more likely they will be regulated by federal securities law. Factors include: what type of voting rights the stock confers (democratic or based on amount of investment), whether the stock confers the right to use the coop, whether transferability is limited to other producers, and how much the value of the stock increases over time. For an excellent discussion on the possible regulatory pitfalls of value-added coops, see Christopher Kelley, *New Generation Farmer Cooperatives: The Problem of the "Just Investing" Farmer*, 77 North Dakota Law Review 185 (2001).

Income from a cooperative

When trying to determine how to treat cooperative income under the tax code, courts and experts usually cite the 1965 U.S. Tax Court case, *Puget Sound Plywood, Inc. v. C.I.R.*, 44 T.C. 305. The court said there were three guiding principles for an entity to be deemed a coop for tax purposes:

"(1) Subordination of capital, both as regards control over the cooperative undertaking, and as regards the ownership of the pecuniary benefits arising therefrom; (2) democratic control by the worker-members themselves; and (3) the vesting in and the allocation among the worker-members of all fruits and increases arising from their cooperative endeavor (i.e., the excess of the operating revenues over the costs incurred in generating those revenues), in proportion to the worker-members' active participation in the cooperative endeavor."

9. **Investor-friendly cooperatives.** Some states have considered legislation to make it more attractive for non-patrons to invest in and control cooperatives. The state laws do this by providing more rights to non-patron members of the coop. For instance, Minnesota and Iowa have passed laws that allow a cooperative to pass bylaws to provide members as little as 15% of the voting rights and 15% of the financial rights in the coop. (Minnesota Code Ch. 308B; Iowa Code Chapter 501A). If the coop is set up to include nonpatrons, the laws do provide the patrons voting rights will be voted in a block. This is an effort to unite the patron's voting rights in case the nonpatrons want to move the coop in a direction against the patron's interest. This protection, however, may not be that effective if the coop only provides the patrons 15% of the vote.

   Because these types of entities can sometimes look more like LLC's than traditional coops, investor-friendly coops may share many of the same considerations listed above for LLC's. This applies to questions of capital formation, control, taxes,

Farmers' markets join together into nonprofit corporation

As discussed in Chapter Three, farmers markets are an example of how farmers can come together to market their products. This idea can be taken a step farther by the markets themselves joining together to promote the creation and success of farmers' markets. For example, a group of farmers markets in Arkansas originally formed an informal coalition to promote farmers markets in the state. The original ad hoc group worked with University Extension and the State Plant Board to formalize the group that eventually decided to organize formally as a non-profit corporation known as the Arkansas Farmers Market Association. This status, known as a 501(c)(6) from the IRS code section that provides the tax exemption, gives the group the ability to promote their agenda in the market as well as the political arena. The IRS code allows groups such as business leagues, boards of trade, and chambers of commerce to organize to promote the common business interest of the members if it does not engage in a regular for-profit business.

and securities regulation. For an analysis of the genesis of these new forms of businesses and how they will be treated under federal law, see Doug O'Brien, *Legal and Policy Considerations of Investor-Friendly Cooperatives* on the National Agricultural Law Center website. www.nationalaglawcenter.org/assets/articles/obrien_cooperatives.pdf.

Conclusion

State laws provide groups of producers a number of ways to legally organize their producer marketing association. Determining which type of organization to use will depend on issues related to control, liability, taxes, and securities regulation. Another key consideration for groups requiring significant amounts of investment is which type of legal entity will provide access to capital. The next chapter considers some of the financing options and legal issues related to financing any joint producer initiative.

Additional Internet Resources for
Legal Business Organizations

Business Structure Basics

National Agricultural Law Center (website)

An Overview of the Organizational and Ownership Structures of Agricultural Enterprises (Goforth)

Other Resources

Alternative Financial/Organizational Structures (Purdue Extension)
Choosing Your Business Structure (Entrepreneur Magazine)
Forms of Ownership (www.business.gov)
Incorporation, Legal Structures, and Business Formation (Findlaw.com)
Legal Organizational Structure (Ag Marketing Resource Group)
Starting a Value-Added Agribusiness: The Legal Perspective (Illinois Institute for Rural Affairs)

Cooperatives

National Agricultural Law Center (website)

Cooperatives Reading Room
Legal and Policy Considerations of Investor-Friendly Cooperatives (O'Brien)

USDA Rural Development Business and Cooperative Programs (website)

Co-ops 101: An Introduction to Cooperatives (PDF)
Designing Membership Structures for Large Agricultural Cooperatives (6.3 MB)
How to Start a Cooperative (PDF)
USDA-RBS Library of Publications

Other Resources

Cooperative Development Manual (University of Wisconsin Center for Cooperatives)
New-Generation Cooperatives: An Internet Guide (PDF) (Purdue Extension)
What is a New Generation Cooperative? (Missouri Department of Agriculture)

Securities Law

National Agricultural Law Center (website)

An Introduction to Federal Securities Laws as They Might Apply to Agricultural Operations (Goforth)

Other Resources

Q & A: Small Business and the SEC (SEC)
Securities Law Issues (CCH Business Owner's Toolkit)

Compiled by Kurt Olson, National Agricultural Law Center Graduate Assistant