
Starting a Value-Added Agribusiness: *The Legal Perspective*



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Disclaimer

This report was prepared for general information purposes only and was not intended and should not be construed to be legal advice on any matter or for any project or entity.

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Introduction

The surge of farmer-owned value-added processing businesses which mushroomed in Minnesota and North Dakota during the past five to ten years has been rapidly developing elsewhere as well. Producers of various commodities have begun to increase investment in their farming ventures, not by the traditional method of expanding production, but rather through investment in initial or first stage processing of their agricultural commodities and through the second stage marketing of their commodities. To some extent, further marketing and processing have been driven by low commodity prices, but, in general, these trends reflect the philosophy of a growing number of producers that producer-owned markets, whether for processing or otherwise, are essential for farmers' continued existence in agricultural production.

Many types of value-added agribusinesses have been formed to further process raw agricultural commodities. Examples of such value-added agribusinesses include processing corn into sweeteners and ethanol; processing corn or soybeans into feed for hog production, fish production, and chicken and egg production; processing soybeans into structural board products; extruding oil and other related products from soybeans; processing hogs and marketing meat products; processing cattle and marketing beef products; and a number of other ventures (Campbell 1995). The capitalization of these individual ventures has ranged from \$500,000 to \$200 million, with most projects costing from \$3 million to \$10 million.

Other businesses, which are primarily cooperatives, have formed to market raw agricultural commodities. These businesses usually focus on quality characteristics of a specific commodity or commodities for which there is a limited or nonexistent market. For example, farmers have formed marketing cooperatives in which members produce specific varieties of high oil corn as well as corn and soybeans with specific genetic traits. The marketing cooperatives enter contracts with end users for these identity-preserved commodities. Other commodities, such as specialty crops and fruits and vegetables, have also been marketed in this manner.

One of the most important reasons why these businesses are being formed is to return profits to the farmer producers who provide the investment. Secondary benefits include the association of a number of independent farmers into a common enterprise, as well as the creation of businesses with stable and long-term ties to the local communities.¹

¹Because many projects are based on a commodity, they require the delivery of a locally owned commodity, and the owners of land in an area where the commodity is grown typically comprise the largest number of investors.

In turn, profits from these businesses are returned to owners who most typically are members of the community as opposed to investment groups living far away from the community.² Anyone who has visited Renville, Minnesota, has noticed the bustling downtown business district as well as the newly constructed community center that serves as a meeting hall for various cooperatives and their members. The City of Renville has also started an industrial development park that is intended to attract agribusinesses, rather than trying to lure high-technology or medical device industries. Currently, Golden Oval Eggs, an egg production cooperative and MinAqua, a tilapia fish production cooperative are located in the city's industrial park and together they employ almost 100 people. As a rural economic development tool, locally owned value-added agribusinesses should be one of the top attractions for rural communities.

The Business Plan—How Good Must It Be To Start?

Identify Potential Market, Project Costs, and Quantify Revenue

During the life of an agribusiness project, a business plan takes many different shapes and forms. In their most basic form, business plans may start on a napkin that reflects a discussion among local producers at a local café as to additional margins that can be received on a specific project, the estimated costs of the project, and the likely capital cost per producer. The napkin business plan captures the basic premises—project costs, profit potential, and the capital contribution required for investor or per unit commodity contributed to the project—on which a successful business can be built. The napkin business plan created at the coffee shop is often the basis from which a more formal business plan is developed.

The further development of a business plan typically involves verifying assumptions on which the business idea is based. The potential market for the products and the anticipated project costs are usually examined on a more detailed basis by using consultants who outline the project in a more detailed manner and verify specific costs. Costs typically include land, buildings, and equipment costs; organizational costs; consultant and legal costs; and regulatory costs necessary to start and operate a project. In

²The City of Renville, Minnesota, which has a population of about 1,300, boasts that it is the “cooperative capital of the country” due to it being the home of ten cooperatives, which include value-added agribusiness cooperatives: Golden Oval Eggs, an egg production cooperative; ValAdCo, a swine breeding and swine production cooperative; Southern Minnesota Beet Sugar, a beet sugar production cooperative; United Mills, a federated feed mill for ValAdCo, Golden Oval Eggs, and Coop Country Farmers Elevator; and MinAqua, a tilapia fish production cooperative.

addition to the initial cost of establishing the venture, it is important to further quantify the profit potential by identifying operational costs of the venture such as labor, utilities, inputs, debt financing, and other ongoing operational costs.

Revenue assumptions about the project must also be quantified and verified. An assessment of market or sales price paid for the commodity must be made. Frequently, this investigation takes two steps: (1) identification of pricing that is commonly paid and (2) determination of whether the market for the pricing being used is actually available for the products of the agribusiness venture. For example, a business plan for a bean processing facility would need to identify the price being paid for the processed beans and determine the potential for the markets to purchase as much processed bean products as will be produced and sold by the venture.

Formulate Debt and Equity Strategy

If the business plan has an acceptable profit potential, a debt and equity strategy must be developed. In general, a start-up project should assume that 40-50 percent investor equity will be required, but specific projects may require more equity. In evaluating the success of a project, an anticipated return on equity should also be determined. Minimum returns over a five-year period are typically 10-15 percent for value-added agriculture projects.

The entity providing the debt financing will likely influence the amount of the equity investment. Although many forms of debt financing are available (e.g., commercial loans, cooperative bank loans,³ corporate bonds,⁴ tax increment financing, government loan, and loan guarantee programs), an initial evaluation should be undertaken using conventional debt financing at current interest rates. Some projects also utilize hybrid forms of debt and equity such as subordinated debt, equipment financing, or preferred stock with special buy-sell provisions. These hybrid forms should be evaluated as part of the *final* project financing.

Most groups that develop a business plan including debt and equity financing, available profit potential, and investment requirements proceed to the next stage—developing a project time line and organizing the business structure to further proceed with the project. The project time line identifies critical events that must happen in order for the business to become a reality and the timing of debt and equity financing, construction, and other events necessary to be accomplished before the project can be started.

³CoBank, Farm Credit Services, and the National Cooperative Bank all provide debt financing for cooperative projects.

⁴Various investment bankers can assist in this type of financing. For example, U.S. Bancorp Piper Jaffray, Inc. has an agricultural products division that has worked with agribusinesses and cooperatives, including ethanol projects, egg production projects, and soybean processing projects.

The Organizational Structure

Most business ventures need an organizational structure. The choice of structure is generally determined by the owner's desires with respect to capital structure, tax considerations, and governance considerations.

Basic Business Considerations

The selection of the best organization for any business venture involves an analysis of many practical and legal considerations. The major considerations in determining which type of organization suits a given business venture include the cost and formality of organization, the ability of owners to insulate their personal assets from the claims of the business's creditors, management and control, and the manner in which the owners participate in profits. In addition, an important consideration is the taxation of the business enterprise.

In deciding on a structure, owners may consider limited liability companies (LLCs), sole proprietorships, Subchapter C corporations (C corporations),⁵ Subchapter S corporations (S corporations),⁶ cooperatives, general partnerships, limited partnerships, business trusts, or limited liability partnerships. The following discussion reviews some of the more frequently used structures and discusses the key legal and tax characteristics of LLCs, C corporations, S corporations, cooperatives, and partnerships.

Ownership. The ownership of an organization focuses on two questions: (1) Who can participate as an owner of the business? and (2) What is the nature of the ownership interest? In general, LLCs, C corporations, S corporations, cooperatives, and partnerships, do not restrict the maximum number of shareholders, partners, or members. All of the entities may have different classes of ownership and voting rights. Cooperatives, however, usually restrict the eligibility of members and generally restrict voting to a one-member, one-vote basis, subject to certain exceptions provided by state law. All of the entities generally have a perpetual existence unless limited in the organizational articles or documents; however, a general partnership is terminated by agreement of the partners, upon a partner's death, through bankruptcy, through dissolution or other disaffiliation, or by court order.

Liability of Owners. The liability of owners who are part of an organization is a significant consideration in establishing a separate business structure. The general rule is that the shareholders or members of an LLC, a C corporation, S corporation, cooperative,

⁵Subchapter C corporations are corporations that are taxed under Subchapter C of the Internal Revenue Code.

⁶Subchapter S corporations are corporations that meet certain owner and other limitations and are taxed under Subchapter S of the Internal Revenue Code.

or partnerships are not liable for the debts and obligations of the entity merely on account of their status as a shareholder or member. (In some limited circumstances, the courts may “pierce the corporate veil” and find the shareholder or member personally liable.)

A shareholder or member is always liable to the entity for any amount of unpaid subscriptions for stock or interests in the entity. In addition, contractual obligations between the entity and the shareholder or member for delivery of crops or livestock may also incur liability to the member or shareholder. As a general matter, the risk of the shareholder or member is limited to its investment in the shares or his or her interest plus any contractual liability.

Transferability of Interests. Transferability of interests in an entity is restricted by the type of entity and the availability of eligible purchasers to purchase the interest and may also be restricted by state or federal securities laws. In both a C corporation and an S corporation, ownership interests are transferable by assignment unless restricted by the shareholders. In a cooperative, shares of stock or membership interests are transferable only with the consent of the board of directors. In addition, some cooperatives require offering a right of first refusal to all members prior to transferring the stock or membership interests to nonmembers.

In partnerships, ownership interests may be transferred subject to the requirements of a partnership agreement. The complete transfer of a partnership interest will result in the termination of one partnership and the creation of a new partnership. In a limited partnership, the addition of a new partner or the transfer of a general partner’s governance interest often requires the consent of other partners. LLC and limited partnership interests can be transferred, but transfers are often restricted due to tax classification and ownership concerns. In addition, many state statutes restrict the transfer of voting rights of LLC interests unless otherwise modified by the agreement of members.

Management Responsibility. The management responsibility in an entity relates to what degree the owner of an interest has control in the entity. C corporations and S corporations are managed by a board of directors. Shareholders may participate in management to the extent of voting on issues as a shareholder group and voting for different directors. Cooperatives are also governed by a board of directors; however, only members of the cooperative or their representatives are typically eligible for election to the board of directors. Each partner shares equally in management of a general partnership unless otherwise agreed to by the partners.

In a limited partnership, all of the general partners participate in management and share that responsibility equally unless the partnership agreement provides otherwise. Limited partners, however, cannot participate in management, or they will lose their limited partner status. LLCs may be managed by members or managed by appointed representatives of members, usually designated as a management committee or board of governors. In some states, the default rule is management by a board of governors,

subject to the provisions of a member control agreement and management actions taken by a member vote. Members of an LLC may participate in management without risking the benefits of limited liability.

State Business Structure Restrictions. Many states have laws that restrict or prohibit certain organizational structures from owning agricultural land or engaging in various forms of production agriculture. These state laws typically have numerous exemptions for particular types of entities or industries.

Many states also restrict foreign citizens or entities in their ownership of land or participation in certain agricultural industries. A proposed agricultural business that has foreign entity involvement or investment should review state law restrictions prior to proceeding.

Basic Tax Considerations

The basic tax considerations associated with various organizations focus on the tax treatment of income and losses, distributions to owners, consequences of liquidating the business, and the tax consequences of selling ownership interests.

General Partnership. A partnership itself pays no federal income tax. Partnership income is taxable to the partners, however, regardless of whether it is actually distributed or retained by the business, and the partners report their distributive share of partnership income, deductions, and credits on their individual income tax returns. Therefore, a share of partnership income is taxed at the individual income tax rate applicable to the partner's tax bracket. A partnership's profits earned during the year are included in the individual incomes of the partners whether such profits have been distributed or not. Losses from the business, as they are allocated to the partners, may be offset against other personal income, subject to limitations for passive activities and other rules.

Limited Liability Partnership. Despite the limited liability provided to partners, LLPs are treated like general partnerships for tax purposes.

Limited Partnership. Limited partnerships are also treated like general partnerships for tax purposes.

Corporations. In general, a corporation is subject to separate tax procedures and rates imposed by state and federal tax laws. Unlike a partnership, in which income passes through to the individual partners, a corporation is separately taxed on its own income. Corporate taxation may result in "double taxation" since income received by the corporation is taxed at the corporate level, and any profits remaining after taxes are then available to be distributed as dividends, which are taxed again as personal income to the shareholders. This double taxation can be a distinct disadvantage of the corporate form, as compared with other forms of business enterprises. Larger corporations with many shareholders simply accept the disadvantages, but in smaller, closely-held corporations,

double taxation can be minimized. There are several planning possibilities that can minimize such double taxation:

Salaries. Whenever shareholders are officers or employees of the corporation, they may be paid salaries that are deductible as a corporate expense and thereby be compensated by means other than dividend distributions. Salaries are deductible only to the extent that they are reasonable and necessary.

Loans. A small corporation may be structured so that a significant portion of its capital comes from loans to the business rather than investments made by shareholders. Having established sufficient equity capital, the remaining funds needed for the business may be raised through interest-bearing loans, and such interest is deductible to the corporation as an expense. The interest paid to the creditor is individual income to him or her and is not subject to double taxation.

S Election. A small business corporation may elect not to be taxed at the corporate level, but to have its income (whether distributed or not) passed through and taxed pro rata to its shareholders. An S election can also permit shareholders to take advantage of losses in the early stages of the business. In general, the following five requirements must be met for a corporation to qualify as an S corporation: (1) there may be no more than 75 shareholders, (2) shareholders must be natural persons, and cannot be another corporation or partnership, (3) the corporation may have only one class of stock, (4) the corporation cannot have a nonresident alien as a shareholder, and (5) the corporation's foreign income and passive investment income may not exceed certain limitations. All shareholders must consent to the S election by signing a statement of consent that is submitted to the Internal Revenue Service.

Like a partnership, an S corporation is a conduit through which the firm's income and deductions pass through to the shareholders. Income items and deductions generally retain their character when passed through to shareholders, although special reporting rules apply, and the opportunity to fully claim a share of the S corporation's losses may be limited. Unlike a partnership, allocations to S corporation shareholders must be in proportion to their ownership of the corporation's stock. A shareholder's *pro rata* share of an S corporation's income and deductions is combined with income and losses from other sources and reported on the shareholder's individual income tax return. As in a partnership, a shareholder's use of any losses is subject to limitations imposed on passive activities and other rules.

Limited Liability Company (LLC). A properly structured LLC may be reasonably certain that it will be taxed as a partnership for federal income tax purposes. If an LLC is treated like a partnership, the members are required to declare their share of the LLC's income or loss on their individual income tax returns. Profits earned by an LLC are included in the individual incomes of the members whether such profits have been distributed or not, and the losses from the business, as they are allocated to the members,

may offset a member's other personal income, subject to limitations for passive activities and other rules.

Cooperatives. Both exempt and nonexempt cooperatives may reduce or eliminate federal income tax on patronage source earnings at the entity level by distributing income to patrons on the basis of patronage (rather than investment). In this way, cooperatives may achieve a single level taxation (at the patron level) similar to partnerships. Exempt cooperatives may also reduce federal taxable income by distributing nonpatronage sourced income to patrons. Distributions may be in cash or noncash form but must be at least 20 percent cash in order to reduce the taxable income of the cooperative. Normally, patrons must include in income any amount of cash and noncash patronage dividends distributed. Losses (and tax credits) are generally deductible (or usable) only at the cooperative level.

In partnerships and LLCs, income is determined at the entity level and is passed through to partners/members regardless of distribution. Special allocations are permitted. Losses also pass through to partners/members and are deductible to the extent of basis, subject to at-risk rules and passive loss limitations (indefinite carryover).

Fringe Benefits

Fringe benefits include items such as accident and health insurance, group term life insurance, salary continuation plans, dental insurance, death benefits, day care programs, and supplemental unemployment benefits. The following discussion analyzes the tax treatment of providing fringe benefits to owners of the business. The cost of providing fringe benefits to employees generally will be a deductible business expense if reasonable in amount and in compliance with state and federal law. In some cases, the benefits may be taxable to the employee and subject to income tax withholding.

General Partnership, Limited Liability Partnership, and Limited Partnership. Working partners of a partnership are considered self-employed individuals and generally may not deduct as a business expense the cost of obtaining fringe benefit items for themselves, although items such as day care for the partners' children may be eligible for a tax credit if such payments otherwise meet Internal Revenue Service requirements.

C Corporation and Cooperatives. A C corporation or cooperative may deduct the cost of providing fringe benefits to all employees, including shareholder employees. To be deductible, the fringe benefit plan must meet the requirements of the state and federal law, including nondiscrimination in favor of executive or highly compensated employees.

S Corporation. In general, an S corporation may deduct as a business expense only those amounts for fringe benefits that it pays to shareholder employees who own 2 percent or less of its stock. Shareholder employees who own more than 2 percent of the stock are treated in the same manner as partners in a partnership; therefore, the cost of providing fringe benefits to such shareholder employees is not deductible by an S corporation.

Limited Liability Company. LLC members are treated in the same manner as partners in a partnership. Accordingly, members of an LLC generally may not deduct the cost of obtaining fringe benefit items as a business expense.

Distributions to Owners

Distributions of cash or property from the business organization may have different tax characteristics. Distributions of cash from a C corporation are taxed as ordinary income to the extent of earnings and profits. A corporation generally recognizes gain and pays tax on distributions of appreciated property, which is also taxable to shareholders as either a dividend or capital gain. Distributions of cash from an S corporation are generally taxed to the extent that they exceed a shareholder basis in the S corporation stock. An S corporation generally recognizes gain on distribution of appreciated property that is passed through and taxed only to shareholders (if the built-in gain rules do not apply). Fair market value of distributed property is treated like a cash distribution to a shareholder.

A cooperative generally distributes patronage dividends as cash, capital, stock credits, allocated patronage equities, revolving fund certificates, or other written evidence of allocation. The cooperative receives a patronage dividend deduction while patrons must take patronage dividends into income in the year received, even if not paid in cash, in many circumstances. Exempt cooperatives may also deduct dividends paid on capital stock to a limited basis.

LLCs and partnerships may distribute cash to their members. Such distributions are taxed to the member to the extent that they exceed the partner's or member's basis in the partner's or member's interest in the entity. The entity does not recognize gain or loss upon the distribution of appreciated property. No gain or loss is recognized by a partner or member unless money is distributed with the property. An adjustment of the "inside basis" of the entity's property may be elected.

Upon liquidation of the business entity, there are also two different tax treatments. For C corporations, any gain is taxed at the corporate level and again at the shareholder level. For LLCs, S corporations, cooperatives, and partnerships, there is generally no tax at the entity level, but there is tax on any gain which is either passed through or returned to the patron on the basis of prior patronage.

When owners of a business entity sell their ownership interest, the proceeds from the sale of the interest usually result in a capital gain for C corporations, S corporations, and cooperatives. For LLCs or partnerships, the gain may be part capital gain and part

ordinary income. There is usually an election available to adjust the tax basis of the entity's assets for the purchaser.⁷

Basic Securities Considerations

Subject to some very limited exceptions, the offer and sale of an equity interest in a business enterprise will generally be considered the offer and sale of a “security” requiring compliance with applicable state and federal securities laws. The basic requirement under the securities law is that offers and sales of securities must be registered with the applicable regulatory authority or completed in compliance with an exemption from registration provided by the applicable statute or the regulations adopted under that statute. The availability of one or more of those exemptions will depend on the type of entity involved in the venture and the number and nature of the prospective investors. The following summary of the registration process and certain state and federal exemptions from registration is provided for reference purposes only. The specific state and federal regulations must be reviewed and carefully analyzed for any given project.

Registration of Securities. The registration of an offering under the state and federal securities laws requires the preparation and filing of a detailed registration statement. The registration statement includes the prospectus that is actually to be distributed to prospective investors and also includes other information that will become publicly available following the filing with the applicable regulatory authority.

Preparation of the registration statement for an equity offering requires extensive effort on the part of the business enterprise. Preparation for filing typically takes at least 30 days and many times it takes substantially longer. Once the registration statement is completed to the satisfaction of the business entity and its advisors, the registration statement is filed at the federal level with the Securities and Exchange Commission (SEC) and the appropriate state authorities. The SEC staff and the state agencies then review the document and provide a series of comments regarding the registration statement. The comments are usually received in a letter provided by the SEC staff roughly 30 days after the initial filing.

Upon receipt of the staff comments, the enterprise must respond to the comments, usually through the preparation and filing of one or more amendments to the registration statement. Only after the SEC staff is satisfied that adequate responses have been provided for all of its comments will the registration statement be declared “effective.” It

⁷The foregoing tax discussion mainly focused on the federal tax issues. Local and state taxation may also be an important consideration in selecting the appropriate entity. For example, most states follow the federal income tax classification of LLCs either as partnerships or corporations. Some states, however, treat all LLCs as partnerships, and a few tax all LLCs as corporations or impose a franchise tax on LLCs.

is only at that point in time that the business enterprise can begin accepting subscriptions for the sale of its securities. State securities laws generally include procedures similar to the federal procedures followed by the SEC, although some state regulators may have the authority to review the merits of the proposed venture, as well as commenting on the adequacy of the disclosure contained in the registration statement.

In addition to the significant amount of time involved in completing a securities registration, the process can be expensive. The registration process requires the effort of attorneys and accountants, as well as printing expenses and payment of filing fees. The total cost of a securities registration at the state and federal levels for a relatively new venture frequently ranges from \$75,000 to \$150,000. Depending on the complexity of the issues presented, the costs can exceed that amount significantly. (Additional offerings or offerings by an entity with a proven track record may be less expensive than the first registration prepared by a development stage entity.)

Given the time and expense involved in a securities registration, most value-added agricultural ventures attempt to structure their efforts to obtain the benefits of an exemption from registration. As indicated above, the availability of exemptions from both state and federal securities registrations depends on the nature of the business enterprise and the number and nature of the investors who will be approached to participate in the venture.

General Exemptions from Registration. On the federal level, there are four primary types of exemptions that may be of interest in a value-added project: (1) the private offering exemptions; (2) the small offering exemptions, including Regulation A; (3) the “intrastate” offering exemption; and (4) the cooperative exemption.

Private Offering Exemptions. Congress has enacted and the SEC has adopted “private offering exemptions” to allow entities seeking investment from a very small number of individuals to obtain that investment without the cost and expense involved in a registration. In addition to the statutory exemption for a transaction not involving a public offering, the SEC has adopted a variety of safe harbor exemptions from registration. Although generally not limited by dollar amount, the private offering exemptions are premised on private contact between the issuer and a relatively small number of prospective investors.

Subject to a variety of other technical requirements, most of the private offering exemptions indicate an exemption from registration that will be available in situations in which the securities in question are sold to no more than 35 unaccredited investors. It is also possible to sell securities in such a placement to an unlimited number of accredited investors. Accredited investors are individuals with a net worth in excess of \$1 million or an annual income in excess of \$200,000 or corporate entities which have total assets in excess of \$5 million. In situations involving offers to nonaccredited investors, the applicable safe harbor regulations specify the form of disclosure to be made to prospective investors.

Small Offering Exemption. The counterparts of the private offering exemption described above are exemptions from registration for certain “small offerings.” The private offering exemptions focus on the number of participants and, with one exception, do not contain dollar limitations on the amounts of investment that may be obtained. There are two basic small offering exemptions contained in the Securities Act of 1933 and the related regulations. The first exemption is found in Rule 504, which provides an exemption from the registration of offers and sales of securities for which the dollar amount invested is less than \$1 million in a 12-month period. That exemption does not require a specified form of disclosure to the investors and also, as indicated previously, does not limit the number of investors who may participate.

“Mini-Registrations” — Regulation A Exemption. The second “small limited offering” exemption provided by the Securities Act and its associated regulations is found in Regulation A. This regulation provides an exemption for the offer and sale of securities for which the total dollar amount sought is less than \$5 million in a 12-month period; however, the procedure for claiming a Regulation A exemption is more cumbersome than the procedure for claiming the other exemptions discussed in these materials.

To claim the benefits of the Regulation A exemption, an issuer must complete a process that can be thought of as a “mini-registration.” In that process, the issuer prepares an informational statement and files that material with the SEC. The SEC staff reviews the draft materials, in a process not unlike that involved in the full registration described previously. The disclosure standards for the Regulation A offering are not as exhaustive as those imposed in a full registration of the securities, however. After the SEC staff has reviewed the information statement, the staff will provide comments which the entity must respond to by preparing and filing amendments to the information statement. Once the SEC staff is satisfied that all regulatory requirements have been met, the information statement is deemed to be “qualified,” and the issuer can begin the process of accepting subscriptions for the securities to be offered in the Regulation A offering.

Like the registration process, it is possible for an issuer to distribute a preliminary information statement prior to the time that the Regulation A disclosure statement has been declared qualified by the SEC staff; however, it is not possible to accept subscriptions prior to the completion of the SEC process.

“Intrastate” Exemption. In addition to the private offering and small offering exemptions, the Securities Act of 1933 and the associated regulations contain an exemption from the registration for transactions considered to be “local” in nature. In general terms if all the investors in an offering are located in one state, the proceeds of the offering will be used to fund a business located within that state, and if the business is headquartered in that state, it is possible to claim the “intrastate” exemption from federal securities registration. This exemption also requires that steps be taken to prevent the shares sold from being transferred outside the state in question for a period of nine months following completion of the offering.

The intrastate exemption does not require a specified form of disclosure in order to claim the benefits of the exemption and, subject to the requirement that all of the investors must be residents of the state in question, does not contain limits on the number of prospective investors who may be approached to participate in the offering.

Section 3(a)(5) Cooperative Exemption. The Securities Act of 1933 also contains an exemption from registration for securities issued by cooperatives classified as exempt cooperatives under Section 521 of the Internal Revenue Code. Because of the language in the Internal Revenue Code and the associated tax relations and Section 3(a)(5) of the Securities Act, this exemption is not available until the cooperative has applied for and obtained a determination letter from the Internal Revenue Service indicating that the cooperative is tax exempt. Like the intrastate offering, no specified form of disclosure is required and there is no limit on the number of investors who may participate in the offering.

State Law Exemptions. State securities laws provide a variety of exemptions from state registration that may be of use to a value-added venture. Many states have an exemption for any securities issued by a cooperative, especially one organized in that state. In addition, state law also generally includes a limited offering exemption for entities formed under the laws of that state in which the aggregate number of sales is limited within a 12-month or other period.

Disclosure Regardless of Exemption. Regardless of the registration or exemption of a specific securities offering, it is advisable to provide detailed disclosure materials to prospective investors. While some exemptions (and the registration process) specify the form in which the disclosure must be provided, other exemptions do not specify a particular form of disclosure. Regardless of the form, however, the value-added entity should disclose all information that is material to an investor's decision to participate in a particular venture. Not only will such disclosure assist the investors in making reasonable choices regarding their participation in the value-added venture, it will also help protect the entity and its officers, directors, and agents from legal claims for disgruntled investors.

Broker Dealer Requirements. Most states require securities to be offered through registered brokers or dealers. Brokers or dealers will provide their services at varying costs. Some states provide exemptions from the broker-dealer requirements if the offering is exempt from registration; however, such exemptions may require the persons offering the securities to register as "agents." As most value-added ventures will offer and sell their securities through the efforts of officers and directors of the entity, it may be necessary for some of the entity's officers and directors to register as "agents." The necessity of registration will vary under the broker-dealer requirements, depending on the activities of the officer or director and the nature of the exemption from registration that is used with respect to the offer and sale of the securities themselves.

The Value-Added Cooperative Model

The Basic Cooperative Structure

The cooperative has been used as an agribusiness structure for more than 80 years in American agriculture. More recently, in the last 20 to 30 years, the Value-Added Cooperative Model has been developed. This model has basic differences from the traditional cooperative model. The equity structure of the value-added cooperative is capitalized by members making a cash investment in stock or other equity of the cooperative.

A traditional cooperative is usually capitalized through retained earnings from profits at the end of the year, commonly called “retained patronage,” or through retaining a portion of the price to be paid to the producer upon delivery of the commodity to the cooperative, commonly called “unit retains.” Retained patronage or unit retains can also be used to provide supplemental capitalization for a value-added cooperative (Costello 1996); however, the primary capitalization most often occurs by means of a direct investment through the purchase of stock or other equities of the cooperative.

All cooperatives operate on a cooperative basis. Although not completely defined by statute or by tax law, operating on a cooperative basis generally means adhering to the following three principles: (1) democratic control—one-member, one-vote or at least voting not based upon capital investment; (2) subordination of capital, generally meaning that profits of the cooperative are not paid back based on the amount of investment but rather on the amount of patronage or business done for or with the cooperative; and (3) preferences in liquidation based on patronage rather than investment.

Traditional cooperatives are commonly called open cooperatives, as any producer can join simply by bringing their product to be processed, marketed, or handled by the cooperative. There is generally no up-front investment other than a nominal membership fee. There is also typically no further commitment to further patronize the cooperative.

Value-added cooperatives, especially processing cooperatives, are typically financed based on maximizing the capacity of the processing facility. Accordingly, membership is generally restricted to the members who purchase stock and acquire the coinciding delivery rights. In other words, if an alfalfa processing cooperative is organized to process 100,000 tons of alfalfa, members would typically purchase stock and acquire coinciding delivery rights for 100,000 tons of alfalfa to be delivered to the cooperative.

If the cooperative was profitable and a nonmember producer who did not participate in the cooperative’s offering wanted to deliver his or her commodity to the cooperative, that nonmember producer would not be allowed to deliver to the cooperative unless that producer purchased equity and delivery rights from an existing member. The reason for this structure is twofold: (1) the cooperative can assure that it will have a fixed supply of the commodities which is the basis of the cooperative’s business allowing it to operate at

100 percent capacity, and (2) members who desire to leave the cooperative will have the opportunity to sell their equity and delivery rights to other producers. This is in contrast to the traditional cooperative model, in which there is no incentive to purchase a member's equity in the cooperative because a new member can typically participate in business with the cooperative without an equity investment.

Retirement of equity or “cashing out” in a value-added cooperative is generally accomplished by the member selling his or her delivery and equity rights to another producer at the market price for those rights. For many successful value-added cooperatives, the value of the equity and delivery rights increased significantly in value. Businesses that have not been successful have suffered decreased equity values. In a traditional cooperative, equity at the face dollar value of the date of allocation is returned to the member either after a period of years or at a certain age, typically over 65 years of age.

The value-added cooperative is structured to be capitalized by investment from producers. Value-added cooperatives are also structured to pay out earnings annually, rather than retain earnings for many years or to a particular age of the investor.

Tax and Securities Advantages of Cooperatives

Many value-added businesses select the cooperative model because of the tax and securities advantages over other entities.

Tax Advantages. The partnership tax model, which is the basic model for the LLCs and S corporations, generally does not tax income at the entity level. Rather, income is passed through and is taxable at the owner (partner, shareholder, or member) level. Cooperatives are unique from other business structures in that a cooperative can, at its election, be taxed at the entity level or pass patronage-based earnings to its members or shareholders without tax at the entity level.

Securities Advantages. Cooperatives also have advantages in issuing securities to their members. While most entities involving more than 35 investors would be required to register with state and federal authorities, cooperatives can be exempt from registration both on the state and federal levels. On the federal level, a cooperative offering in a single state will typically avail itself of the intrastate exemption from registration of its securities; if the offering is to be made in a number of states, a cooperative can be exempt from registration if it is a Section 521 certified cooperative. The registration exemptions typically allow cooperatives to offer their securities more expediently and at a lesser cost than entities that do not have registration exemptions.

Section 521 Certification for Cooperatives

Many value-added cooperatives apply to the Internal Revenue Service to be certified as a “Section 521 Cooperative.” The certification as a Section 521 Cooperative is available to cooperatives composed of farmers and fruit growers who meet certain requirements under Section 521 and Subchapter T of the Internal Revenue Code. These restrictions generally require that all of the member/investors of the cooperative be producers. The term “producer” is defined as a person at risk in the production of agricultural products, including owners of land who receive rent on shares and, therefore, share in the risk of production.

In addition, a cooperative certified as a Section 521 Cooperative must generally only deal with producers in its patronage transactions. For example, if a cooperative is engaged in processing corn and does not have enough corn, usually the cooperative will be required to purchase additional corn from producers rather than purchasing from a nonmember producer. When additional corn is purchased from one or more producers, the cooperative is obligated to pay patronage to those producers in the same amount that it pays to its member producers. If a Section 521 Cooperative, does need more corn, it will likely turn to its member-producers to acquire the corn in light of those member-producers’ initial investment rather than paying patronage to nonmember producers.

Certification from the Internal Revenue Service requires preparation of a lengthy application form, complete with actual or projected financial information and the description of the business that the entity desires to include with its tax-exempt operations. This is often a key element in the application. Patronage and nonpatronage sourced activities, upon certification, can be exempt from taxation at the entity level, which means that profits from these activities can be passed on to the member investors without tax at the cooperative level if paid to patrons on the basis of patronage.

Obtaining a Section 521 certification and maintaining that status allows the cooperative to eliminate the risk of having some of its business activities determined by the Internal Revenue Service to not be patronage-sourced activities and thus subject to state and federal tax at the entity level. This is no small consideration since the combined state and federal tax for net income exceeding \$300,000 is approximately 40 percent in many jurisdictions.

While the Section 521 certification restricts some of the cooperative’s operations the advantages have induced many cooperatives to seek and obtain Section 521 certification.

Financing Advantages of Cooperatives

Cooperatives are unique in that they are eligible for different forms of financing through cooperative banks and other state and federal programs that favor or specifically identify cooperatives. Cooperative banks typically involved in cooperative financing include CoBank, the Farm Credit Banks, and the National Cooperative Bank. These

entities typically restrict their financing to businesses that are cooperatives or businesses that are primarily owned by producers. The financing is typically done on a project financing basis—that is, without personal guaranties from the individual owners. In addition, many states and some federal agencies offer cooperative development services consisting of grants and other assistance for new cooperative projects.

Uniform Marketing Agreements

One of the uncertainties in any processing business is the ability to obtain an adequate quantity and quality of raw product for processing. Many states have statutes not only authorizing marketing cooperatives, but also statutes specifically covering contracts between a cooperative and its producers regarding delivery of the product to the cooperative (Hanson, Costello, and Thompson 1999).

Most value-added cooperatives acquire products from their members pursuant to uniform marketing agreements. A uniform marketing agreement is a standardized or common contract for all members to deliver a specific amount of product to the cooperative to be marketed and/or processed on a collective or cooperative basis.

Uniform marketing agreements are typically governed by statutory provisions that authorize specific performance and liquidated damages. In some states, the statutes also authorize the imposition of penalties against any person or entity who attempts to dissuade producers from delivering their product to a cooperative under the uniform marketing agreement. These statutory prohibitions against interfering with the uniform marketing agreement and sanctioning their use, enhance their utilization as a tool in structuring a value-added cooperative business. Lenders and others involved with a value-added cooperative project generally regard utilization of uniform marketing agreements as a significant measure in reducing the risk and assuring the overall success of the business.

Hybrid Cooperative Models

Although many projects use the Value-Added Cooperative Model, more and more projects require alternatives and variations of that model. Lindquist & Vennum is currently working on an equity model to allow greater flexibility for the cooperative's members to retain their investment in the cooperative. In addition, the cooperative could be structured to allow outside investors to invest in a pool that would generally benefit the cooperative in its processing operations and be conducted under the control of the cooperative.

Some cooperatives have been structured to be taxed on a partnership basis through the “check the box” provisions. While this model may have some advantages, the restrictions and liabilities of such a model must be carefully evaluated prior to adoption.

Many of the advantages of being a cooperative can be obtained without incorporating as a cooperative. For example, a corporation can be operated on a cooperative basis, and so can an LLC. While those structures should normally only be used for special situations, they are alternatives.

In working with cooperatives, there are issues not easily handled within the cooperative structure. Typically, these issues focus on outside investment and control of particular aspects of further integration of a cooperative's business. In these cases, it is not uncommon to structure a joint venture, typically as an LLC or partnership. The cooperative must carefully evaluate such a structure so that it maintains its ability to pass the profits on to its members without tax at the cooperative level. In addition to joint venture entities, contractual joint ventures may also be used.

Getting Started

Organizational Documents

One of the first steps in starting a business is to formally adopt a business structure. The business structure becomes an entity when its charter, or organizational documents, are filed with the jurisdiction where it is to be organized. Typically, this involves filing Articles of Incorporation with the Secretary of State. In general, the Articles of Incorporation are brief, describing the basic structure of the organization. Articles include provisions regarding the organization's purpose, its capital structure, membership or investor requirements, liquidation provisions, certain tax provisions, a listing of the first board of directors, and provision for amendments. If the organization is to be a tax-exempt cooperative, certain provisions must also be present in the articles which are required to meet the certification requirements of Section 521 under the Internal Revenue Code.

By listing the first board of directors, the entity has a governance structure that can manage the ongoing affairs immediately after the Articles are filed. Typically, the organizational board has an initial meeting to procure state and federal tax identification numbers, approve one or more financial institutions for its banking purposes, elect officers, and resolve any other administrative duties or obligations.

The Bylaws usually govern operations of the cooperative and its members. In many states, the initial Bylaws can be adopted, and in some cases, even amended, by the board of directors. In applying for certification as a Section 521 tax-exempt cooperative, the application must include a copy of both the Articles and Bylaws. Early preparation of the Bylaws is advised in order to be prepared to apply for Section 521 certification. The Bylaws also must contain certain provisions to meet the certification requirements under Section 521 of the Internal Revenue Code as well as patronage and other tax provisions of a cooperative (Devoy 1999). Again, it is advisable to incorporate these provisions in the initial Bylaws.

The initial board also approves the membership of producers in the cooperative. This may occur immediately or after the cooperative has conducted some of its organizational activities.

Seed Money for Cooperatives

One of the first issues faced by the organizing board of directors is how to fund the activities of the business. Occasionally, development grants are available through various entities, including cooperative development services. Most grants are restricted in how they can be used, however, and the cooperative often must seek additional funds from members or potential members. To fund its initial activities, many cooperatives charge a membership fee or, depending upon the state of incorporation, issue membership stock.

In either case, the membership fee or membership stock should be structured in such a manner that the fee or stock is not a “security” for purposes of the federal securities laws. Under a ruling by the U.S. Supreme Court, membership interests that are subject to restricted transferability and cannot appreciate in value, among other characteristics, can be excluded from the definition of “security” in some circumstances. In seeking new members, the cooperative must clearly disclose the risks and rewards, if any, of membership. This is typically done through a membership agreement and summary information statement.

The membership agreement and summary information statement typically describe the general purpose of the newly formed cooperative and describe any pre-organizational activities and the cooperative’s general plans. The documents also describe the amount of the membership fee or the amount to be paid for membership stock. The membership agreement also specifically states that the amount paid for the membership fee or for the membership stock is generally nonrefundable and at risk to accomplish the initial activities of the cooperative. If voting rights are not to be obtained until further investment is made in the cooperative, this must also be fully disclosed.

Organizing Potential Members, Shareholders, and Investors

After the entity is formed, the cooperative must identify potential members, shareholders, and investors. Typically, the growers, producers, or a trade group necessary to provide products to the cooperative are identified and the cooperative holds organizational meetings to further inform the members of the purposes and goals of the cooperative and its potential benefits.

Often the cooperative also seeks to have initial members join the cooperative through entering a membership agreement and paying the initial membership fee or purchasing a share of membership stock. These initial members typically gain voting rights subject to termination if the member does not satisfy additional membership criteria, including further equity investment. Some projects have also required members to enter uniform marketing agreements which are contingent upon the project coming to fruition. These

initial activities give the cooperative credibility and provide a basis for lenders, vendors and potential joint venture partners to evaluate the strength and ability of the cooperative to complete its project.

Permitting, Licensing, and Other Approvals

After the initial organization, many cooperatives start the process of permitting. Processing many of the permits takes more than 180 days and sometimes longer. Although these contingencies should be identified in the critical time line for the project, permitting should be an initial consideration soon after the entity is formed. In addition, the entity must also review licensing and conditional use requirements associated with any specific site where the cooperative's facilities may be located.

Addressing and Minimizing Risk

Identifying Risks

One of the continuing tasks of any project is to identify the various risks to the project. Risk identification tasks must continually be evaluated by board of directors and management throughout a specific project. Many times, risks are not addressed simply because they are not identified. In developing a project, the board and management should constantly evaluate criteria to identify risks. Risks are typically characterized as events or conditions which, if they occur, will negatively impact the project or potentially change the course of the project. Although many risks to the project are identified as part of any equity offering, before, after, and during the equity offering, the board of directors and management must identify how the changing or evolving nature of the project and the business relating to the project affect the overall viability of the project.

Contractual Risks

Most projects try to reduce risk by contracting for inputs and also by having out-take agreements for the products produced or to be sold. Within any contractor agreement, there are always risks. For example, if the project is going to acquire certain commodities at a fixed price, management needs to identify how a fixed price for inputs impacts the cost of production if the sale of the processed product is not fixed.

Alternatively, if input commodities are to be acquired at a market price, management should identify how the price of the inputs vary, both historically and as projected in the future, and the point at which the project cannot afford the inputs or will have to change the pricing of the processed product that it is in turn marketing. Most contracts contain provisions on the risk of loss of the product and who bears that risk. Management must also be aware when the project has the risk of loss and whether or not those risks can be covered by insurance. The impact of an uninsured loss on the project as a whole needs to be evaluated.

Marketing Risks

Marketing risks involve the ability to sell a specific product at a profitable price in the market. The evaluation of marketing risks includes research and analysis of competitors, the marketplace, demand, industry capacity, product prices, pricing differentials for that product, and a variety of other factors. If there are substantial companies already in the market which are better capitalized, it is likely that those companies can better withstand downward price variations than, for example, a start-up venture. In a similar vein, if additional production capacity for a particular agricultural product is constructed, the project may strive to minimize risk by seeking long-term contractual sales at pricing that may sometimes be less than the market pricing but overall assure a profit.

Limitations of Insurance

Many projects seek to reduce certain risks by purchasing insurance. While insurance is available to cover many of the losses encountered in a project—in particular, casualty losses—management should be cautioned that the receipt of any significant amount of insurance proceeds may take a significant amount of time and that most losses are only partially covered. As part of management’s evaluation of risks, the levels of insurance and any gaps in coverage should be evaluated.

Equity Offering

Risks and Liability for Control Group

In conducting an equity offering, the cooperative’s management, board of directors, and their accountants and legal advisors must be aware of the special risks and potential liabilities arising from offerings of securities. State and federal law both provide that liability may be imposed on a control group for misstatements of material facts or the omission of material facts that are pertinent to making an investment decision. Consequently, disgruntled investors who are not properly informed of material facts about a project or certain risks of the project may be able to impose liability on the control group.

To minimize this liability, a disclosure statement describing the project and various risks and facts about the project must be prepared and disseminated to potential investors. It is important for all parties in the control group to review disclosure statements for their accuracy prior to the dissemination to potential investors. In addition, a subscription agreement is prepared describing the conditions of purchasing the investment. The control group must always monitor oral and written statements about the offering before and during the offering itself to protect against misstatements which may impact investor’s decisions. For example, many times news articles are written about a specific

project, and any statements or quotes from the control group about the project must be consistent with the disclosure statement and the actual offering. In addition, many entities are using websites to convey information to their existing shareholders and potential investors. These statements must also be consistent with the disclosure as well as any newsletters or other materials disseminated by the entity or the control group.

Disclosure Statements

The purpose of the disclosure statement is to inform potential investors about the project, the entity proposing the project, and the offering and to protect the control group from investors who claim that they did not receive adequate information. Items that are generally disclosed include the potential risks and rewards of the business, the market in which the business intends to compete, the products which the enterprise intends to produce, the competitors in the marketplace, management of the enterprise, and information regarding the legal terms and conditions of the membership or stock interests. In general, the goal is to provide all information which would be material to a producer's decision to participate in the enterprise.

Subscription Agreement

Subscription agreements are part of the offering materials and are the contract by which potential investors purchase shares or other units of equity being offered. The subscription agreement describes the total amount of stock being purchased and the terms of payment for the shares or other units of equity. The subscription agreement also identifies information that the control group has determined is pertinent to the offering and contains representations by the subscriber that the subscriber has received and read those materials or has had access to those materials and understands the conditions of the offering. If the purchase price can be paid over a period of time, a subscription agreement may also contain provisions for a promissory note from potential investors for the purchase of the shares described in the subscription agreement.

Practical Tips

Most successful offerings are a result of hard work by the board of directors and management prior to the offering activities. Many groups start out with informational meetings to prospective producers to inform them about the nature of the project and to gather a general sense of the interest of potential investors in the project. Prior to conducting informational meetings, the board of directors and management should develop a substantial amount of information about the project that can be disclosed to the meeting participants.

Many groups hold the first meetings about the project with area lenders. (Lenders may be important as either financial resources for the cooperative itself or as a source of financial resources for the cooperative's members). These meetings frequently give the

board of directors and management a good idea about tough questions that will be asked when meetings are held with potential investors. By informing lenders prior to holding meetings with potential investors, the lenders are usually in a much better position to positively evaluate a loan decision should a potential investor desire to borrow funds to participate as a member in the cooperative.

Most groups hold a large number of meetings with potential investors in various areas in which the project will need agricultural products. Most of the meetings consist of a presentation followed by questions and answers. Many projects have a sign up for the persons attending the meeting so they can communicate with either new information or respond to any follow-up questions that were raised at the informational meetings. Most meetings have copies of the Disclosure Statement and the Subscription Agreement available so that the potential members can take these materials with them and make an informed decision with their advisors prior to investing.

Potential investors will look to the commitment of the board of directors prior to making an investment. The boards of directors of many projects have made it very clear to the board members that they must be the first persons to invest in a successful project. Such investment shows confidence in the project.

Board of Directors' Issues

What Successful Ventures Seek in Directors

Successful ventures look for leadership and project champions in start-up value-added agriculture projects. Leadership shows the ability to attract members to a project and to reach consensus in a manner that moves the project forward. Project champions are directors who continually move forward in a positive manner through the many challenging times in a project. Successful ventures also look for a board of directors to have fiscal responsibility. This means evaluation of the costs and profit projections for a project and determination of the business opportunity in a responsible manner. Confidence in the directors is gained when the members and potential investors believe that the directors are dedicated to the project, above their personal financial interest in the project. It is important that directors avoid the appearance of improper personal gain as they act in their position as director.

Information to Members and Investors To Maintain Confidence

One of the main duties of the board of directors during the initial stages of a project is to maintain regular contact and provide information to members and investors. Regular informational meetings, as well as newsletters, must be provided to maintain member and investor confidence. The board of directors should disclose delays and setbacks, as well

as their solutions to overcome such problems. Most members and investors understand that few projects go as planned and that no projects are perfect. We believe that the better advice is to let the members know that the directors are in charge of the project and resolving issues as they arise.

Attracting and Hiring a CEO

The hiring of management is one of the most important decisions that the board of directors makes. The board of directors must carefully identify its continuing duties, even when the CEO is hired. The CEO generally holds a dual role of managing the company and providing regular information in contact with the board of directors. Some projects fail to distinguish between the position of a CEO and the position of an operations manager. Typically, the operations manager is the hands-on person who does the day-to-day management over the operations of a particular project or business. The position of CEO not only oversees operations management but also has responsibility for monitoring the cooperative's focus and interacting with the board of directors as well as with the members and investors of the company. In successful ventures, the CEO is frequently on the leading edge of discussions with the board of directors as to when the project should expand, from whom and where investment should be sought, and other strategic issues about the project. In smaller projects, for which a CEO is not hired, the position is typically carried out through an executive committee of the company. It is important in all cases that the function be filled.

For a start-up venture, the costs and ability to hire a CEO are important factors. Many companies look to other businesses and try to find a "junior executive" in the industry who is a rising star. Sometimes, the ability to lead a new business, even though it has more risks, is attractive to such a person. Compensation issues typically revolve around base compensation plus some incentive or bonus pay that is tied with the performance of the company in a manner that benefits all the members or investors. Executive compensation agreements require careful structuring to protect both the company and the CEO.

Retaining Legal, Accounting, and Consulting Services

Throughout the time line of a project, professionals are a necessary part of any business, and mistakes are costly. Accordingly, boards of directors typically must make judicious use of consultants and professionals. In selecting an accountant, the board of directors must make sure that the accountant's duties on audit will result in a report to the board of directors that fairly describes the financial position of the cooperative. Audits are often the board of directors' primary review and check of management's financial performance.

In contracting for legal services, the board of directors must make sure that services are appropriate for the given task. If the lawyers do not understand the nature of the business

or the legalities of the project, generally obtaining advice will be either costly, time consuming, or both.

Frequently, the board of directors will require consulting services to obtain information or reports about various topics concerning the company. It is important for any consulting contract that specific objectives are identified, including the anticipated scope of results. All consulting services should be retained under written contract which contains the objectives and anticipated results.

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