

Bloomquist Lectureship Series 1998

FEATURED PRESENTER:

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March 27, 1998

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The Cooperative Advantage—Myth or Reality

I really appreciate, very much, both the opportunity and Dan McCarty's very, very fine, introduction. In fact, when he was describing it, I flashbacked to how my father would react to this. My interest in cooperatives, I think, was stimulated by my father who was a dairyman. Just prior to this meeting, I discovered that one of the participants in the roundtable discussion was from about five or ten miles from my home town. And, so we talked a little about dairy farming in that area. My father admired cooperatives a lot. He had a much less kind view of lawyers. And, you put those two together...I always had milking duty in the morning...he was a sports enthusiast, so as long as I was participating in some form of athletics I didn't have to milk cows in the evening. So you name it and I played it. But that didn't excuse me from the mornings and I still had trouble getting up in the morning. Well, I went off to the East Coast to try to get as far away from those cows as I could get...came back after four years, and—this happens to be a true story—we were sitting around the kitchen table and he had kind of a dry sense of humor anyhow and he finally said, "Well, now that you've wasted four years of your life out on the East Coast, what do you plan to do? You've seen the light? Ya going to come back and help farm?" And I said, "Well, no. I thought I was going to. I finally decided, after a lot of thought, I would go off and go to law school—on the other side of the country—and be the world's greatest lawyer." And he didn't look up from the table, he just thought awhile and finally said, "You know, when I had trouble getting you up in the morning to milk cows, I suspected that there was a flaw in your character. Now when you tell me your career plans you just confirmed it." So, maybe, Dan, some of my lifestyle is because I have that comment in the back of my mind—that co-ops are something that are important and good and lawyers are not half as impressive as they'd like to think they are. And, so I guess it's maybe—with that in mind—that we'll try to approach some of these issues.

What I thought I would do today...First of all, before we get started, I really do want to express my appreciation for this opportunity to participate in the Bloomquist Lectureship at this University, and after the discussions at noon and

following that, there's no doubt in my mind that this is a very, very distinguished University and there is no University better equipped and better formulated for exchanging ideas with respect to agriculture. North Dakota State has always been a leader in the exchange of those ideas concerning the evolving of the cooperative concept. We're at a level where we need to have some additional thoughts -- original thoughts -- to try to refine the models that we created and move forward.

In fact, as I was looking back and thinking on and researching and preparing some of the materials for this lecture, I was looking at the history of the intellectual development of cooperatives, there have been really, from my standpoint, three major events. The first one was probably the determination by the Rochdale Weaver Society in England in 1844 to finally put in writing some of the principles that are still--ironically still--quoted by some of the courts in the U.S. these days as to what it means to be a cooperative. They embodied a lot of the principles that evolved really from the time of Benjamin Franklin in the U.S. and in England up to that point. The next major event in a kind of history of cooperation occurred in the early part of the 1900s when growers and farmers started to form cooperatives. And part of it was, in my view, most successful. Cooperatives exist to fill a need. The need that was experienced at that point was the need to be able to have a bargaining position against the railroads and against some of the buyers of their products. And, cooperatives took, or farmers took, to the notion of cooperation with a good deal of fervor. If you look at some of the creameries and elevators and the sort of things that were reformed, many reformed in the 1900s, the teens and up to the 1920s. The Capper-Volstead Act was enacted in 1922. One of the sponsors of that legislation was a congressman from Granite Falls, Minnesota, Andrew Volstead. We used to say in our office he was known primarily for two pieces of legislation: one was the Capper-Volstead Act and the other was prohibition. As one of my partners said, "At least he had it half right." I won't say which one is which. But, in any event, the Capper-Volstead Act and the cooperatives that were formed in the aftermath of that were the next major wave of cooperative enterprise. And then things started to, in some ways, get a little complacent.

The third major benchmark for my perspective of cooperative formation is what is now referred to as the new value added, or new wave, or new age cooperatives. And there are lots of people that have taken credit for that, in effect, have looked at and discussed the reasons for it. From my perspective, the origin of that concept was American Crystal Sugar Company. It was uniquely American and maybe, Al, you can help me as to how it evolved. The history that I've seen on it was a situation in which the growers were looking to acquire stock--the ownership of an investor company--American Crystal Sugar Company--which was then a New Jersey business corporation. In order to secure the financing, it looked like maybe the best route to go was to form a cooperative. Out of that practical deed was born, in effect, a new concept of cooperation. Every one of the cooperatives that have been formed since then--whether in the new age or value added tradition--have been patterned after the structure and the concepts that were created by American Crystal at that point. And, one of the reasons that I am so honored to give this lecture today and to try to share and discuss some of these issues with you, is that this lectureship is sponsored by American Crystal and it honors Al Bloomquist. There were lots of people involved in that undertaking, but in all the materials that I've read in connection with that formation and from my perspective, the driving force, the one consistent driving force was the energy, the persistence, and the creativity of Al Bloomquist. Al, with that in mind, I attempt to repay some of that debt of gratitude on behalf of all of us that are involved with cooperatives. And I applaud

both this University and American Crystal for, in effect, carrying on this tradition so that we can try to take that concept and to make it go forward.

What I thought I would do today to try to explore this—and I know to talk for an hour, lecture for an hour—can put a lot of you to sleep. So, I thought it might be of more interest to take some categories. What I am going to try to explore is this notion of cooperation: the perception as opposed to the reality. And if you go back, and if you ever talk to my father, he would say cooperation was almost a quasi-religion to him. It was a concept that always worked and was so important. Then when you look and talk to some of the people that resisted and are concerned about what they perceive to be the values and special benefits that cooperatives have, they paint a picture that is entirely different. And what I'd like to do today is to spend the hour or so that we have to kind of walk through on a simple matrix, the various categories that distinguish the cooperative form of doing business, compare it to other forms of doing business and see how it relates. And hopefully, when we get through this, we'll have a better understanding as to what it means to be a cooperative, identify some of the issues that need to be addressed as we, as I said, go forward, and see whether we have the beginnings of any solutions. And so, if you can put in your mind this simple matrix: the advantages of being a cooperative, that of an LLC and a C Corps. There are other types of business activity that obviously could be included. We could talk about proprietorships, we could talk about partnerships and S Corporations, but for simplicity's purposes we'll stick to these three types of businesses. And we'll keep referring to this and do a running total as we go through and try to add up the score at the end of the afternoon as to whether or which form of economic enterprise has a true advantage.

Start with PACS. This description that I've just put on the overhead is a response letter to the editor of *Forbes Magazine* that followed an article that touted the development of cooperatives...in fact referred to "The North Dakota Fever"—the formation of cooperatives. And what the writer of this letter to the editor says: "My father, a Kansas grain dealer, competed with co-op grain elevators all through the '50s, '60s, '70s. He paid big taxes all those years while the co-op grain dealers around him were tax exempt. I think you owe it to the readers of *Forbes* to look into this report and give the rest of the story." There is a perception on the part of a lot of folks, a lot of people, particularly fueled a number of years ago by the National Tax Equality Program, that cooperatives had an unfair advantage, that cooperatives simply did not pay taxes, period. What we're going to do is to try and take look at what the real tax situation is for cooperatives. And, as you might suspect, cooperatives do pay taxes. They, of course, pay real estate taxes, franchise taxes, sales and use taxes, any type of tax that a normal corporation pays. They also pay—are subject to federal income tax—with respect to their earnings. The portion of the Internal Revenue code that deals directly with cooperatives is found in subchapter T. By the way, I have kind of a lengthy published presentation that will, I assume, be printed at some point. But rather than just kind of reading it and following what I am trying to do, in interest of time, is just to cover some of the highlights and go through the overheads. But, when it comes to taxation of cooperatives, you are subject, as I said, to the regular corporate income tax rules. What happens is that you are able to avoid paying tax at the corporate level, but only if you jump through all the hoops found in subchapter T. Now this is with the standard co-op—other than rural electrics. Some of you may know rural electrics. I think rural electrics and telephones had a better lobby back in 1962, when subchapter T was adopted and they are exempt from some of the provisions of subchapter T. But any agricultural cooperative that will compete with the Kansas Grain Co-op that's referred to in the letter to the editor, they are subject to these same rules. And, if you miss any of those rules, it means:

Twenty percent of the earnings have to be paid in cash:

- the patron needs to consent to the inclusion of that income in their personal income tax; and,
- the non-patronage source earnings, that is earnings from interest and rental and non-co-op type earnings will be subject to tax like anyone else.

And when you compare that to an LLC, what you find is that an LLC is, in many ways, better from a tax standpoint than a co-op. LLCs don't have a 20 percent cash requirement; they don't have the need to have the patron consent - it's automatic; they don't have to distinguish between patronage source income and non-patronage source income. The earnings or losses are simply attributed based on the percentage participation in the LLC. So, if we're going back to our matrix and making a determination as to which entity has the best tax treatment, the way I would grade the two or three is, I would give first place to the LLC... (I was going to write on here, but...) second place to the co-op, and third place to the C Corp... if you were picking a form of doing business strictly based on the impact of income tax.

Some of the value added co-ops start to run into issues as to whether they are truly doing business on a cooperative basis with growers who might deliver product. They may wish to look at being an LLC. Now there are some serious other issues related to conversion to an LLC: once you have been up and operating, you need to be careful when the timing occurs. But, if the grain or the corn is not originated and it's not producer corn and there's no patronage relationship that goes to that venture and you wish to have co-op treatment, in other words, single tax treatment on those earnings, you may find that—when you're audited—the revenue agent will raise questions as to whether there is the requisite preexisting legal obligation; whether there is a requisite tie between the patron and the co-op. And if it's not, then you may have been better off looking at an LLC. An LLC has the same single tax treatment, the earnings drop down based on the unit of participation rather than the delivery of the corn or the patronage relationship or whatever the unit of economic activity or product that is delivered.

So from a standpoint of income tax, when you hear the investor owned competitor saying that as a co-op you have an unfair advantage, because you don't pay taxes, that's not quite accurate. You do have an advantage, but that advantage is no different from an LLC. It's no different from a partnership and, in fact, it may be less advantageous, because you are going to pay tax on the non-cash portion of that patronage dividend. What I sometimes explore with people who come and look at what type of organization they should follow, I describe these different types of taxation and point out that the cooperative may not be the best vehicle, but it is a good vehicle because it gives you the option of having single tax treatment on the patronage source corn or the patronage source product that comes in or the patronage source transaction gives you the option of doing business on a regular corporate basis with respect to all other business. So you have the ability to pick and choose as to whether you want to pay tax, keep the earnings as unallocated earnings in your surplus account thereby enhancing the balance sheet and taking some pressure off of the revolvement. So, again, when it comes just to that one issue of tax, there are a number of considerations. It is not accurate to say that all cooperatives are tax exempt, as some people say. You pay a fair share of taxes and you are, in many cases, subject to greater taxation than other forms, such as an LLC. I think it's important that we understand that. When we, as we go through these and there are a number of these categories that we'll be going through, maybe what we could do, just to kind of, with the relatively small size of the group here, that if there

are questions, if any of you have questions on this tax issue, and we could come back to them later too, but if you have questions that are fresh in your mind now, why, I'll just take questions on this issue, and then go on to the next category.

Does anyone have a question or a comment or a thought on the tax consequence or the tax treatment of cooperatives and the perception versus reality? OK. If not, we'll just turn to the next category which is corporate and finance.

What's reality and what's perception? In this case, what I think I would do is give the number one ranking to co-ops. And the reason that I would do that here is that the cooperative statutes tend to be flexible in the sense that they are designed to deal with issues that relate to the formation of the cooperative. They are less costly in terms of the filing fees; they are easier to, in effect, comply with; they give you the opportunity to be either stock or non-stock; they give you the potential of, in effect, following rules and amendments to the statutes that have been designed specifically for cooperatives and built up over a whole series or history of time. And, in most of the state statutes, what's happened in recent times is that there is also a provision that says to the extent that the statute is inconsistent or, or I should say, not inconsistent with the provision of the general corporate law, the general corporate law features will also apply to the cooperative. So you have, in effect, the benefit of both. Where there can be some difficulties is with respect to this tension of the amount of earnings that can be paid on investment. When you go back and look at some of the fundamentals of operating on a cooperative basis virtually every statute will have something that ties or limits the amount of return that can be paid on investment. And, if you are a value added cooperative that's looking at adding different categories of equity, you may find that you have limitations on the amount of dividends or the amount of return that you can pay on the invested capital as opposed to the patronage dividend.

The other element of the, in effect, the corporate side, is from the standpoint of the value of being a cooperative or using the cooperative form, from my perspective, is the financing side. We'll get into the equity issues later and some of the difficulties that relate to raising equity in a cooperative. But, from the financing standpoint, many of the newly developed cooperatives in some ways owe their existence to the ability to do the financing with the farm credit system. The St. Paul Bank for Cooperatives, a co-bank, and its predecessors have been very willing to make advances. In fact, we were talking at the lunch break about the involvement of the St. Paul Bank for Cooperatives with American Crystal and one of your former graduate students at North Dakota State who went on to the farm credit system and helped deal with some of the sugar issues. I recall the discussion was somewhat tongue-in-cheek, but one point that they should - when they build the new office building for the St. Paul Bank -- they should build it in the form of a sugar beet in part because of the amount of loans that were outstanding. The lending abilities and the background and knowledge of that farm credit system is very helpful in the development of new cooperatives. Now, as cooperatives increase in size, they experience limitations in terms of the loan limitations that are available under the charters of the banks and they are increasingly forced to look elsewhere. But in general, the ability to look to a source of debt financing for newly emerging, starting or beginning cooperatives is a real advantage to being a cooperative. There are also other federally chartered entities such as The Cooperative Finance, CFC for Rural Electrics Cooperative Finance Corporation in Washington, and the National Cooperative Bank that are designed to cover the gap between ags and other types of cooperatives. I probably have an average of a call a week or a call every two weeks of ventures that are looking at exploring the

possibility of forming a cooperative. Many of them are not in the agricultural area. But when you look and explore the different ways in which you can form a business that you can organize—the ability to attract a loan, a base, or a loan portfolio, is obviously an important element in forming those ventures. So, when you compare and when you decide whether you're going to be an LLC or a co-op, and what the perception is in terms of the ability to raise funds, I think a clear check on this box, or in this category should go to cooperatives. Investor owned companies have other sources. There's some of the small business loans that are available and, of course, the access to other types of funding on a national scope. One of the issues that's has plagued some of the larger cooperatives until recent times has been a lack of understanding of cooperatives. When you go to Wall Street and start talking about cooperatives, you get a strange reaction. They think that there's not much protection there for the equity holder and they have questions as to how and why and the way in which they should participate. Now that's been changing, I think, in part because of the background, because of the better understanding and because of the success of cooperatives like American Crystal in recent times. Any questions on the corporate or finance side? If not, well, why don't we move then to the next category—antitrust.

This is an area that I think is probably, along with the tax side, the most misunderstood. There are a lot of cooperatives that just assume because they are formed on a cooperative basis that they are totally exempt from antitrust rules and that they can do anything they please. That is not the case.

Cooperatives, like any other venture, are normally subjected to antitrust rules. The carve outs that exist are those that Congress adopted as part of the Clayton Act, section six of the Clayton Act, and that's one of the reasons that a number of cooperatives, particularly on the marketing side, have chosen to operate on a non-stock basis. Section six of the Clayton Act, which, in some ways is even a little broader than the Capper-Volstead Act, applies only to non-stock entities. And, in fact, when the Capper-Volstead Act was adopted in 1922, it was because of the fact that stock cooperatives were not covered by the exception of section six of the Clayton Act. And so the Capper-Volstead Act (put the elements of the Capper-Volstead Act up on the overhead) permits farmers to act together in associations with or without capital stock and that was one of the key fundamentals. You have to be operating for the mutual benefit of the members and here are some of the restrictions: either limit your voting rights to one vote per member, or limit the payment of dividends on stock membership to eight percent, and then not deal in the products of non-members in an amount greater than the value that the association handles for members. That gives the authority for farmers to get together and market. One of the reasons that I think that the antitrust rules and particularly the Capper-Volstead Act creates, for some reason as I said, probably one of the most misunderstood and maybe one of the most underutilized advantages of being a cooperative. There are a lot of people in the investor world, when they're told that you can get together with your competitor and literally, horizontally fix the price that you're selling the product at, they'd say "I'd kill to be able to do that". Co-ops can. The antitrust rules the cases that have gone to the various levels of the courts have said—even in the case of the cranberry growers in Massachusetts—that you literally can get to 100 percent of the market in a particular commodity if it's done voluntarily and if it's controlled by producers.

Cooperatives, for some reason, have had difficulty achieving that. Even here, in our beloved Red River Valley, I think it took me eight years, Al, to get three sugar beet grower groups together to form United Sugars. And there were always other issues that kind of got in the way. I suspect now that even though there may still be some issues in between, most people believe that that was a beneficial step. And

when the cane growers in Florida saw the opportunity to become part of United Sugars, they were very receptive. They jumped at the opportunity to become part of that group. It is an advantage that growers have, a tool that growers have to enhance the return for their product that has rarely been used. In fact, to give you an example of how little used it's been since 1922, there's a second section of the Capper-Volstead Act that most people never think about or refer to. And that provides that the United States Department of Agriculture has the right to intervene and literally enjoin the operation of a Capper-Volstead Co-op if there is any evidence that the organization is unduly enhancing prices. Now, maybe it's the bias of the USDA, but not once since 1922 has the USDA ever found that there's been any undue enhancement of prices for products...for farm products. And, so if that gives you some indication that maybe farmers could be a little bit more aggressive in trying to form Capper-Volstead common marketing agencies to do a better job to compete in the marketplace and to get their products sold over the years—they could be right.

Capper-Volstead, as I said, is a very important tool. It is one that, I believe, has been underutilized by cooperatives over the years but it's also—the perception again on the part of some people—is that cooperatives have a total exemption. And that's not true, either. The Capper-Volstead Act permits the farmers to get together to market the product. It does not permit farmers to use that position, or growers to use that position to abuse a competitor. And there have been a number of cases where the courts have dealt with it. Maryland/Virginia Milk Producers was a case where, the milk producers in that Washington D.C. area, in effect, conspired to drive a competitive bottling plant out of business. They used a whole assortment of dirty tricks and the courts said, "No, that's not permitted." The market position that you develop cannot be used to abuse that position. What it means is that you can get together to sell the product, in effect, at the same price. It also doesn't mean that it's there forever. Just because you call yourself a cooperative doesn't mean that you have that protection. In Case-Swayne case, Sunkist growers lost their Capper-Volstead status when they had a non-producer in their membership. And, in the case of the National Broilers Association, there are serious questions as to what is really meant by a cooperative, by a producer. And, in fact, that is one of the issues that needs to have some work done. There is no uniform definition of producer and when you read the National Broiler case—there was a lot of debate on it. There was not only a majority opinion, but a concurring opinion and a dissenters' opinion. And the majority opinion, written by Justice Blackman, who was at one point a lawyer in Rochester, Minnesota, and you can just—when you read the opinion—you can kind of sense what Justice Blackman was doing when he was writing it. You can see him looking out the window and saying—when he's examining whether Ralston-Purina was a producer because they were bearing -- the judicial definition is when you bear risk of gain or loss to be a producer. And he's looking out the window saying, "I may not be able to define a producer, but Ralston-Purina sure doesn't look like and seem like a producer to me." From my perspective, as someone who spent most of their life in Rochester, Minnesota, I can look out the window and say, I can't—like Justice Potter Stuart said in defining or rather in his inability to define pornography." I can't define it, but I know it when I see it." In this case, I think Blackman was saying I can't define a producer, but I know one when I see one and Ralston-Purina doesn't look like a producer to me. And so, in effect, he says they are not a producer. That issue has a lot of substance for questions relating to the value added cooperatives. There is really, I think, in some ways a whole kind of cottage industry that's developed in the Red River Valley of creative lawyers and accountants trying to find ways to keep their clients producers, even though they may have retired and moved to Arizona. Kind of keeping this notion that they are bearing the risk of gain or loss. And that is a real issue. It's one that boards of a lot

cooperatives struggle with as to who is a producer and the debate goes back and forth. No definition, in effect, says that you have to log a certain number of hours in the tractor seat to be a producer. But, you do have to have and withstand the test of a legitimate definition of bearing risk of gain or loss. And the consequences are significant. If you are effective in forming a Capper-Volstead organization—that means that you are doing something to push the price to the level that you are going to enhance or return a better price to the grower, to the participant. That's the reason you are doing this, to have a better, stronger bargaining position against your buyer. But that protection, and that exemption is limited to producers. And so, if you go beyond that definition, as Sunkist discovered, you will lose that status. There can be some consequences, because then the antitrust laws affect you.

So getting back to our matrix. Again, when it comes to the advantages—and I'm trying to—well, I'll go through and in the written material that's published there's probably a summary of some of these issues. But again, I think, on the antitrust side, there isn't much question which box you check and put in first place. The cooperative concept and the cooperative way of doing business does work.

Are there any questions on the antitrust issue or these producer issues? Dale?

"Mr. Morris, do you think we are more of a threat within the cooperative in the community than outside of it — probably two examples that came to mind as you were speaking of Ralston-Purina is the entity that I would consider somewhat outside this on the debate, held back by the 'LLC' farmers in the system which are valid reasons for debate. You talked about growers...cottage industry...using that example farmers themselves are concerned with valid debate on these issues. It is the outside of the people that are looking, like me, at cooperatives as large enough to be recognized would target us. It seems to me that we've got so much turmoil going inside...that it worries me."

Well, it is an issue. I'm not sure if you're referring to the hog feedlot situation...When it's a debate internally within cooperatives. As we get down the list and talk a little bit about governance and the advantages of being a cooperative and some of the burdens, I think that's one of the issues. Last week, maybe what Dale was referring to, there was a bill introduced in the Minnesota Legislature by Representative Winter, who is I think, the House Majority Leader, in effect says that no cooperative shall be engaged in any form of business activity that competes with any of its members. Well, that's a pretty broad brush. I mean, literally it could prevent Land O'Lakes from operating their milk processing plants because some of their members are other co-ops that are involved in processing. But what it was designed to do was to prohibit Land O'Lakes from financing an industrial size hog operation in Nobles County, Minnesota, in Southern Minnesota. Land O'Lakes does not, would not own the land or own the animals, but would provide the financing and the consulting services to enable a group of hog producers who wanted to form a commercial unit of hog production to be involved in production agriculture. And so the question becomes, and it runs into the anti-corporation farming laws as well, at what point should a cooperative be permitted to be involved in production agriculture? And does it matter whether the members of that cooperative have blessed the activity or involvement? And that is a debate. And that's one of the issues. But I think one of the consequences of being involved in cooperative activity is that you have this member obligation. Earlier today -- and Gerald Custer is here—Mike Toley, board members of Harvest States and Cenex, and one of the Twin Cities' newspapers commented of the story of the member meetings. They were talking about if this were a merger of two investor owned companies they'd probably have one meeting—they'd go to

Wall Street and discuss the terms. Because it's Harvest States and Cenex, two cooperatives, they ended up with 27 or 28 member meetings to, in effect, communicate the story of the merger. And that is just inherent in being a cooperative. You need to have that discussion, you need to have that participation. Yes, it's a burden, but perhaps it can turn into a benefit at some point, too, if you're successful in that description. But it does make it different in being a cooperative—whether it's right or not—cooperatives do have some burdens. Land O' Lakes is probably paying a little bit of a public relations price for that activity. And the question is: Where is it going to end? One of the problems that have prevented cooperatives from being more effective, from the marketing standpoint, is that farmers are very independent. And they do have very deep seated differences of opinion as to the best way in which to market. And there isn't any question in my mind that the Minn-Dak growers and the American Crystal growers all wanted to get a better price for their product. It's just that they couldn't quite come to terms...eventually they did, but it took a while...to come to terms as to the way in which you can effectively do that in the formation of United Sugars. Intelligent people, with the same kinds of principles at stake, have different ways of approaching it and farmers are very independent. It's one reason that, I think, cooperatives generally have been attractive to farmers. They are able to maintain their independence and participate in these ventures and still have some degree of group buying or group marketing.

So, again we get back to this, to this matrix. The antitrust benefit of being a cooperative is significant, from my perspective. Any other questions or comments on, on the antitrust issues? And joint ventures...there was a question earlier on, before the meeting started, on joint ventures. And those do raise an interesting question as to how you apply participation in an LLC? And the short answer is that the LLC itself is not protected under the Capper-Volstead Act, or some of these exceptions, from the antitrust rules. You still need to have the grower involvement. And it can be processing or it can simply be joining together in marketing. There is a case in Oregon or Idaho involving two potato bargaining associations. And one simply called up the other bargaining association and said, "What are you going to charge Simplot for potatoes this year?" And the other one said, "Well, I plan to charge this." And they agreed as to what each was going to charge and it was going to be the same price. And Simplot sued them saying that was not protected—pure price fixing—not protected by the Capper-Volstead Act. The Circuit Court of Appeals for the Tenth Circuit, in effect, said it is protected as long as you are grower controlled...grower owned and controlled. Again, it's a strong tool that, from my perspective, has not been fully utilized by growers over time. It is also, when it is used, sometimes misunderstood because the perception is that cooperatives are totally exempt. I mean, just because they are a cooperative. That's not the case either. But there is still a strong value and virtue in being that cooperative.

Ok. The next category relates to securities law. And in the securities questions, a lot of people have assumed again, that cooperatives are not subject to the securities laws and so there is no need for them to do any filings of any type. And that is often the case, but it varies depending on the type of paper that's issued. The test that's been enunciated in the *Howie Case*, which is the primary description of the standards for being a security, is: whether there is an investment contract; whether there is an investment of money; whether there is a commitment in a common enterprise that is based on the activities of the managers that the entity hires. Well, from the perspective of the cooperative, you'd say, "Yeah, that should cover it." And there were some early indications and issues suggesting that cooperatives were covered. That case led to a United States Supreme Court decision often referred to

as the Foreman Case. In the Foreman Case, the United States Supreme Court outlined five factors. Those factors are:

- the right to receive dividends contingent on the apportionment of profits;
- negotiability, or the ability to transfer the shares;
- an ability of the stockholder to pledge the shares as part of a bank loan;
- conferring the voting rights in proportion to the number of shares owned;
- capacity of the shares to appreciate in value.

This excludes the typical non-cash portion of a patronage equity. So, the traditional cooperative should not have any concern about registering the equities that were issued as part of the transaction of doing business on a cooperative basis. Where it raises questions is in the new value added cooperatives. The difference is—those of you that have been fortunate enough to hold American Crystal Sugar shares from the time that Al and his colleague started it and paid a hundred dollars an acre for the right to grow sugar beets—now if you'd like to grow sugar beets the price is considerably higher. What that tells you, of course, is that there has been some enhancement in the value of those shares. It also, in the case of Crystal, voting is on the democratic basis—it's one member, one vote. You are able to pledge the shares, though, and they are transferrable. So, when you look at these five tests in the case of the American Crystal Sugar Company, on the first flush you have failed two of the tests in terms of being exempt from the securities filing.

Arguments can be made, as we have done from time to time, with the Securities and Exchange Commission as to whether they should be registered or not. American Crystal and Minn-Dak have both taken what I think is the correct—conservative—but the correct position and that is to go forward and to eliminate any doubt and to do the filing. There are a number of other value added cooperatives that have not done so. In part, they are relying either on the view that these five steps—these five tests have been met. Or they are taking the position that they have some other exemption. And, there are some exemptions. There is an intra-state exemption, that says if you issue shares only to residents of one state you can avoid doing a federal registration. There is also a small issuance—it's not an exemption, but it's a different procedure that permits you to avoid a full scale registration. But the consequences of the securities laws...they said the perception has always been that cooperatives are not subject to it. And so a lot of cooperatives have just sort of ignored it. There have been a few that have had some inquiries raised and the consequences—should the venture fail—if you have not complied the securities laws are, of course, substantial. Most newly formed cooperatives use what is called a value added arena and again the benefit when we go back to our matrix is a benefit of being a cooperative—as opposed to an LLC or a C Corp—is that if you are forming a new venture value added cooperative and if you can fall within one of these exceptions, you can avoid having to do the federal registration. We talked about the intra-state, the one-state transaction. The one that has been used most commonly is obtaining a section 521 letter. What section 521 means is that it is a section of the Internal Revenue Code. It may not make a lot of sense to say that if you comply with the section of the Internal Revenue Code you're able to get an exemption from the securities law, but that's the way the securities law reads. But, to qualify for 521 status, you have to be producer only, you have to limit the membership and the ownership of shares to producers. So again, it puts to a strong test whether the individuals that are holding the shares are really producers. If they are and if you've made application for a 521 letter and you've received it, you then have an exemption from the registration of the filing for Federal

Securities Laws purposes. Again, that is a benefit that applies only to cooperatives—not to LLCs, not to C Corps. So, there is a benefit, from my perspective, under the securities laws as well.

So, we go back to our matrix...what I would say is that in the securities law issue, there is a benefit to being a co-op. On the LLC side, there is some question—most instances you have to file. The problem is that in an LLC, there is even some difficulty in creating a market for those shares and so the securities laws are probably more complicated and there are some questions as to how they apply. So, what I would say here is that in a C Corp, there's certainty and in an LLC there's not. So there's some disadvantages from a securities law standpoint in formation of the LLC if you have multiple units or multiple participants. Any questions on the securities issues? If not, we will move to the next subject which is the equity section.

And again, we look at the advantages or disadvantages of being a cooperative. Probably most commentators would identify the inability to raise equity as the biggest impediment to being a cooperative. The reason for it, of course, is that there is restriction, under most cooperative statutes, on the return on the investment. As we found earlier, if you are a Minnesota cooperative, you can't pay more than eight percent of the face amount of the equity as a dividend. The fundamental notion of being a cooperative is that you exist for the benefit of the patrons, not for the equity holders. And so, if you're an equity holder, or you're an investor, why would you invest in a cooperative? What that means that most of the investors are going to be producers that are having some relationship with the cooperative? It's a market for their product, it's a way in which they can deliver their shares or have an extension of the farm gate. In the case of beets, of course, beets aren't worth much unless you have a processing plant. We discovered that. We used to—my grandfather used to—raise beets for American Crystal's Chaska plant and when that closed, it pretty well dried up our market. Beets aren't worth anything unless you have that processing. And that's the case of a number of these types of facilities. How do you generate the equity? Well, if it's important enough to you—like it was in the sugar beet instance—you make the up-front investment. But when you get to the next level, where do you cap equity? And, as the holders of those equity units age, as they retire and move to Arizona, is there a market? In the case of Crystal and Minn-Dak, the values have been strong, but if you're a participant in some of the other value added cooperatives, do you have a liquid enough market for those units? If you're a holder of units in the corn plant in Marshall, Minnesota, and you'd like to dispose of those shares, is there a market for those shares? And, at what level? And, as more and more types of value added cooperatives are developed, where is the market? Are you, in effect, so restricted in terms of the potential holders that you have put a kind of a lid on the value of those equity units? In the case of a traditional cooperative, it's even a little worse. Gerald Custer will tell you that some of the Harvest States' members keep asking, "What's your revolvement program? Can you do better? Can you revolve your equity?" If you are a traditional cooperative and the pressure is to revolve equity and you're trying to compete with an ADM or Cargill that has no requirement to revolve equity over a period of time, are you at a significant disadvantage? Most commentators would say yes. One of the strongest impediments in the development of cooperatives—expansion of cooperatives—is the inability to tap sources of equity. And so that's one of the challenges.

I think, when we look back then at our matrix, we are going to have to say that C Corps are in first place—they have the ability to attract equity. LLCs—it's an emerging type of entity. There's a lot of

confusion as to what they are and what they mean and what types of equity, but they're still probably ahead of co-ops. And that's one of the challenges.

Again, is perception accurate? The perception is that co-ops simply can't expand because they can't raise equity. I think some of you in this room have proven that's not quite the case. American Crystal has had a number of additional stock offerings that have raised equity. There have been other examples...Dakota Pasta, Dakota Growers raised significant amounts of equity. Harvest States has raised some in their defined investment program- I think they—Gerald would probably prefer to do better, but there is an ability and there are ways in which you can raise equity. It's just that it's not as available as some of the other sources. The question then becomes, and I think this is a challenge, the perception is pretty accurate. Co-ops do have a problem. It's not without other solutions. Perhaps, again, this type of discussion, and as the Burdick Center identifies issues to kind of expand the model of cooperation—the ways in which you raise equity has to be, I submit, at the top of the list. And, there are different alternatives. Some are already emerging as Wall Street gets to better understand cooperatives. There are also other ways that you can do it. Pro Gold is maybe an example of a model that can be used in structure. Even though American Crystal and Minn-Dak have participated in Pro Gold—they were cooperatives—they were not participating as cooperatives, they were participating as investors in an LLC. ADM is participating in the corn wetmill plant in Marshall as a passive investor. There are other sources of passive investment that could be used by cooperatives and LLCs. The challenge is going to be to find ways in which the growers keep control. If you have an ability, to control the governance of the entity and still raise those types of equity...and one way to do that, I think, is through as I said, the LLC model—there are other types of programs—QUIPS and MIPS and the Merrill Lynch programs of equity formations that are kind of borderline between debt and equity, but the accountants will let you treat as equity because the term of the loan may be 30 years. Those are kinds of sources of equity that cooperatives are probably going to have to look to if they wish to expand their processing. Any questions on equity? If not, the final category is that of governance.

And this is another area that most cooperatives are viewed by the outside commentators as being at a significant disadvantage. We reference the fact that in the Harvest States/Cenex merger there had to be 27 grower meetings or member meetings instead of the one decision being made by the investor, by Wall Street or someone who, in effect, accepts the method in which you are proposing to finance the merger. And you can't have proxies. You can't, under Minnesota and North Dakota cooperative law, come to the meeting carrying 70 percent of the votes of the cooperative, because you've gone out and solicited proxies by management. There is this democratic control concept that even where you have multiple votes based on patronage or something of that sort, those multiple votes still rarely account for any significant percentage of the total voting power of the cooperative. So you need to do precisely what Harvest States and Cenex did and that is to go to 27-28 grower meetings - member meetings to describe the process. Is that a disadvantage? Everyone says it is. But if you read the articles in the Harvard Business Review and listen to some of the management gurus these days, the notion is and the concept is and the hot topic is relationship building. If you listen to Cargill and ADM, they will tell you how important it is to keep the relationship with the growers and how important it will be to build and develop those relationships. Mark, they didn't want to disband Golden Growers—they wanted to see Golden Growers continue and participate, as you know. I think perhaps if you listen to what your investor owned competitors are saying, it's that relationships with the suppliers or the growers are pretty important. It may be a burden and it may be a pain, but at the end of the day, it's going to make

the organization much more effective if you continue that level of communication. The commitment to cooperative enterprise is different today from what it was in my father's generation. It's not this notion of having social overtones, a commitment—blind commitment almost—to the concept. Most growers and producers these days look to the cooperative only if the cooperative can be effective. The view is much shorter term. It's one where the cooperative enterprise, to be successful like any other business venture, needs to spend time with those members and with those growers and needs to have a plan of communication. It used to be called cooperative education. Today, I think it should be called building relationships with the supplier. Cooperatives are forced to do it and they sometimes resist that notion. It's usually given as an example of why cooperatives can't function very smoothly because of the burdens of the governance procedures. I guess, what I am submitting, in the interest of—and maybe I'm biased—but in the interest of promoting the use of the cooperative concept, is that in the long term, that is going to be beneficial to you. And with that, I think I'll conclude some of these comments. We can complete our tally here. I'm not sure where we put governance. Maybe I should ask you.

Dale, where would you put governance? How would you rank these three?

"I think the emerging governance that were coming through in the Harvest States and Cenex, Heartland mergers on large equity where they're concentrating on customers and attempting to give that back to the growers. That's a big plus and I'm going to give it a number one...Probably a couple of years ago, I would have given it less."

Well, I think all of these have benefits. The tendency would be to say that in investor owned, it's easy to govern because you could have proxies. You have, usually, a board that's responsive to or understands the needs of management. In an LLC, the board of governors, in effect, represents the participants. Usually it's a smaller entity and most commentators would say governance is a real negative from the cooperatives' standpoint. I think what Dale is suggesting, and what I am suggesting as well, is that governance need not be such a negative or a disadvantage in a cooperative.

Then when you summarize these and kind of add these up, the number of...as I said, maybe I'm somewhat biased... but, I think that when you do the arithmetic, the cooperative form of enterprise, the cooperative form of doing business still comes out very well when measured against the other two major forms of doing business. That's often misunderstood. The biggest impediment, I still believe, is in the form of equity. The challenge and the need for exchange of ideas in expansion and refining of the model is in ways in which to deal with that equity concept. There are other issues along the way that I think you could use to enhance the development of cooperatives. You could try to have a better understanding, both internally and to the public at large, as to how cooperatives are treated from the tax standpoint. They are not, somehow or other, pool riders or leaches on the backs of society. They do pay taxes. Any other entity can operate on the same pass-through or look-through basis like an LLC or any partnership. On the corporate finance side, a lot of people suggest that cooperatives are somewhat archaic. I guess what I am suggesting is that for most forms of business cooperatives, the corporate side, and the way in which you structure it can make sense. In fact, during the discussion—the Round Table discussion earlier today—I pointed out that when you look at the use of cooperatives in other settings...I once formed something called First Air Fleet Cooperative. It was a cooperative that had six members. The membership fee was a million dollars. That was an up-front membership fee, there were also fees along the way. The six members consisted of the First Bank System, St. Paul Companies, an

insurance company, an investor owned utility and Greentree Acceptance. And the reason the co-op ended up being dissolved is that one of the other members was Midwest Federal and they got into a little dispute with another member- Greentree—and other matters, and we decided to dissolve the co-op. But I never thought I'd ever see the day when First Bank Systems would be out peddling co-op memberships. But they were. Once they saw the notion of a cooperative and the way in which a cooperative can operate...Basically, it's cost sharing, it's group activity and, for the accountants in here—Terry—they're able to show on their balance sheet an investment in this cooperative as opposed to showing the ownership of three corporate aircraft. And there are some reasons even for the non-traditional type that would suggest that cooperatives make no sense at all. They find that the cooperative way of doing business, the cooperative concept works. And, I think as Al and his colleagues discovered, it works particularly well when modified slightly to reflect the changes that occur...And I think it works particularly well for agricultural groups. And, again, the reason for it is, in part, the independence of farmers. Farmers do have different ideas—they're reluctant to join together. That's the reason why they haven't taken full advantage of the Capper-Volstead Act, but there's still hope. We did get United Sugars formed and there may be others along the way where you can preserve your independence to the extent you want and still receive and realize the benefits of cooperation. So, hopefully we've had, what we've tried to do...and I apologize for it being a little disjointed...we've tried to cover a lot of issues and I know there's varying levels of involvement and interest in these different topics, but the message that I wanted to leave you with is that the cooperative enterprise and the cooperative way of doing business is still somewhat misunderstood. You need to use the Burdick Center and this great University to help explain, from an academic standpoint, reality and perception, and at the end of the day, the bottom line is that the cooperative form still stacks up very, very well against any other form of doing business and, if understood and utilized properly, I think can be the most effective. Thanks very much for the opportunity to discuss this with you.

Ralph Morris

Morris was raised on a farm near Dassel, Minnesota. He was a graduate of Harvard University in Cambridge, Massachusetts and Stanford University Law School, Palo Alto, California. Following graduation from law school, he returned to Minnesota and began a lifelong career of representing farmers, ranchers, and cooperatives. Although the scope of his law practice was national and increasingly international, he gained a very special relationship with cooperatives in the Red River Valley.

Morris was instrumental in the formation of United Sugars Corporation and Midwest Agri-Commodities Company, and in 1996, received the Hall of Fame Award from Minn-Dak Farmers Cooperative. He also served as corporate secretary and general counsel to American Crystal Sugar Company. Morris maintained an active interest in national agricultural policy and educational issues. He served as a director and vice chairman of the American Farmland Trust, Washington, D.C. He continued to own a farm in the Dassel-Cokato, Minnesota area.