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Considerations for Membership/Investment in a Processing Cooperative

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Considerations for Membership/Investment in a Processing Cooperative

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Introduction

The "Tennessee Processing Cooperative Law"[1] provides new opportunities for Tennessee farmers. These include new market opportunities for farm commodities and the opportunity for investment in a value-added processing business. The new law is intended to encourage business formations that will add value to farm commodities and agricultural resources in Tennessee.

A thorough introduction and overview of Tennessee's processing cooperative law is available in UT Extension PB1748, "Commentary and Overview for the Tennessee Processing Cooperative Law." Basically, the new law provides for the establishment of a new business structure specifically for businesses that will add value by processing or marketing agricultural commodities. The new business structure can be described as a hybrid between a traditional cooperative and a Limited Liability Company (LLC). A business formed under the law will follow traditional cooperative organization principles and will be exempt from state franchise and excise taxes, similar to traditional cooperatives, but will accommodate both patron and non-patron membership.

A business organized under the new law can raise start-up capital from farmers (patrons) **and** investors (non-patrons) with **both** having membership rights in the cooperative. Patron members are those who "conduct business" with the cooperative by delivering a predefined quantity of raw input commodities to the business for processing. So, a patron member of a "processing cooperative" has potential benefits from selling commodities to the business plus possible financial returns on investment in the business from the value of the processed product. Non-patron members do not have an obligation to deliver commodities for processing. Non-patron members seek to benefit from their capital investment through dividends and appreciated stock value. Non-patron membership is not restricted to non-farmers. Non-patron members may be retired farmers, venture capitalists, current farmers or any other individual interested in an investment position without the commitment of delivery or input commodity for processing.

The initial start-up costs for many large-volume agriculture processing businesses often exceed the investment capacity for even a large number of cooperating farmers. The new law provides a legal business structure that allows farmers to cooperate with each other to obtain the required quantities of agricultural commodities for a processing operation and to supplement their capital investment with capital from outside investors. The start-up costs associated with many large value-added processing businesses are often very high. Under the new law, a "processing cooperative" can raise start-up capital from both farmer and non-farmer members.

It is important for farmers who are considering membership/investment in a new processing cooperative to understand that their involvement will be from three different perspectives: member, capital investor and obligated supplier of commodities for processing. Patron membership brings with it various responsibilities and opportunities for leadership, direction and decision making in the business. Patron members are also capital investors, having invested financial capital in the business. Additionally, patron members become commodity investors because they must commit a specified amount of their annual commodity production as raw input for processing by the business.

Chicken or the Egg?

Successful processing cooperatives in Tennessee will likely result from business ideas that are well-formulated, planned, organized and led. Because a processing cooperative has similar organizational characteristics to traditional farmer cooperatives, strong farmer leadership in the business is essential. In fact, most processing cooperatives may only achieve success if they are farmer-driven from the beginning. However, since a processing cooperative can have both patron and non-patron investors, some processing cooperatives may be initiated by investor leadership. Because the processing cooperative law requires that patron members retain some majority voting rights and because patron members have both a cash investment in the start-up costs and an obligation to deliver a specified amount of raw commodity for processing, strong patron-member leadership is suggested.

Preparing Against Possible Conflicting Objectives

The most likely projects to use the new processing cooperative structure would be ones that require a large amount of equity investment, have an attractive rate of return and are in a business area attrac-

[1] The law can be accessed on the Web at:
<http://www.state.tn.us/sos/acts/103/pub/pc0534.pdf>

tive to general investors. In addition, projects that need a consistent source of an agricultural input commodity from farmer members may also be a potential processing cooperative. Projects that may be acceptable to producer members, because they provide additional commodity market outlets, may not automatically be attractive to investor members.

During the feasibility and planning phases, the project's leadership should carefully evaluate membership structure relative to farmer and investor members. If the group is considering substantial investor funds, it would be important to involve representative potential investors as part of the project steering committee. Investors and farmers often think differently, so it may be difficult to bring in investors to a project designed solely by producers.

Issues involving commodity purchases are likely to be a significant source of possible controversy. Farmer members may be motivated to pressure the cooperative to purchase commodities at above-market prices and therefore increase the rate of return on their production efforts. Conversely, investor members would have an incentive to push for a lower commodity purchase price. The cooperative may want to consider a clear formula for commodity pricing prior to starting operations. Another potential conflict would occur if the business finds it can purchase the commodity cheaper from another region. Farmer members will be concerned with a market outlet for their crop, while investor owners may prefer to use the least-cost commodity source to maximize returns.

Likely Patron Members

The results of some interesting research by North Dakota State University and Kansas State University help identify some common characteristics of farmers who may be more likely to become members/ investors of new cooperative ventures.

The North Dakota study found that members of new-generation cooperatives were younger than non-members and tended to have higher levels of education. Members also farmed more acres, had more net income from farming and had a stronger financial condition (debt-to-asset ratio) than non-members. Members felt more strongly than non-members that their role in the agriculture industry extends beyond production agriculture and into the food processing and distribution businesses.

The Kansas State study looked into the factors underlying a producer's decision to invest a portion of his or her production in a closed-membership, food-processing cooperative. The study found that producers require detailed information about the risks and potential returns for the commodity that they would commit to a processing cooperative. In addition, the relative perishability of the commodity and the end food product has a significant impact on the amount of production that an individual producer will invest in the cooperative. That is, as the perishability of the commodity or end product increases, the portion of the farm-produced commodity committed to the business decreases.

Organizing Steps

Most cooperative processing ventures will encounter a variety of phases and organizational steps. Despite the many developmental and implementation steps and phases that successful cooperative processing ventures may take, three key components must be present early: good ideas, appropriate leadership and sufficient start-up capital.

An idea that blossoms into a successful business often addresses an unmet need, provides a competitive advantage and addresses an economic need that might be fulfilled by a cooperative effort. Successful business ventures also are well-rooted in strong leadership. Leadership for successful agricultural cooperatives should demonstrate a confident balance of expertise, vision, dedication and commitment to the project.

While the following is not a complete or comprehensive description of every phase that will be encountered in the development of a new cooperative processing venture, the listing should help provide a guide to a successful effort. In many cases, the development phases of a cooperative processing business can be categorized as follows:

I. Exploration and assessment
II. Feasibility analysis
III. Planning
IV. Implementation
V. Operation

Some of the steps that organizing leaders should address include:

1. Organize and develop the business idea and the leadership team.
2. Conduct exploratory meetings with potential member-users.

3. Survey prospective members to determine potential and capability of delivery.
4. Discuss survey results at a general meeting and decide whether to proceed.
5. Identify a steering committee.
6. Open an escrow account – an account used to deposit funds until the time they are used for a specified purpose.
7. Raise seed capital – funds contributed at the early stages of a new venture.
8. Conduct a needs-and-costs analysis.
9. Conduct a feasibility study.
10. Develop a business plan.
11. Contract for legal and accounting services.
12. Prepare articles of incorporation, charter, bylaws and legal papers for business organization.
13. Elect a board of directors.
14. Organize and conduct a membership drive.
15. Conduct an equity drive – a targeted effort to raise capital.
16. Hire a manager.
17. Acquire facilities.
18. Begin operations.

Collecting Initial Operating Funds

The primary organizers behind a processing cooperative venture often seek funds to assist in the initial consideration and organizational phases of a project. Sometimes this initial money will be used to help finance technical assistance, feasibility analysis and organizational functions. This type of money is often referred to as "at-risk" funds and should be considered more as a contribution or a donation than an investment. Initial funds are normally used for operational expenses rather than investment in real property. Contributions to the initial pool of money may or may not be tied to any stock investment. Any unused initial money may or may not be returned to the contributors if the project is discontinued. These details will be subject to specific state statutes and policies regarding the offering of securities.

The need for initial operating money during the analysis and evaluation phases is practically unavoidable, so project organizers are likely to have to solicit these types of funds. Soliciting and contributing initial operating money can be a difficult task for some organizers. Potential contributors should be well-informed on how the funds will be deposited, how they will be managed and how/why they will be used. Potential contributors should also be well-informed whether initial operating money will relate in some way to stock allocations. Potential contributors must fully understand how the initial operating money will be used, and they should understand that these funds are at risk and may not be returned.

The solicitation of initial operating money may be a very formal process involving escrow accounts and detailed, contract-like procedures that describe its need, use and handling. However, the seeking of initial operating money is often a very informal process concentrating on verbal communications and possibly the use of personal bank accounts. Either of these scenarios can work, as long as all individuals involved are informed and comfortable. However, the process for seeking and contributing initial operating money is normally handled differently from the equity drive.

Equity Drive[2]

A significant amount of work must be done prior to discussing and soliciting equity investments. The steering committee should work with legal and accounting professionals in the preparation of a business prospectus prior to receiving any investment funds or discussing investment opportunities. In fact, anyone considering starting a processing cooperative should retain and adhere to the guidance provided by qualified professional legal counsel throughout all phases of the business development process. There are significant federal and state regulations of equity investments. Violating these regulations can result in significant civil and/or criminal liability. Therefore, it is important for the steering committee to use the well-developed prospectus to guide informational meetings involving the equity drive. There are state and federal restrictions on making public comments about a project before the prospectus is in the hands of potential investors.

Depending on specific organizational principles and details, equity investment in the business may be exempt from both state and federal security exchange regulations. However, it is important to fully understand state and federal securities issues and to apply for possible exemptions (if applicable) prior to the equity drive. Again, qualified professional legal counsel should be involved during this phase.

[2] Information in the "Equity Drive" section was based on information provided by Dr. Philip Kenkel, Chair of the Bill Fitzwater Cooperative Center at Oklahoma State University, compiled from various sources.

Depending on the type of security exchange exemption or registration used, a specific format for the disclosure material may be required. Regardless of the legal requirements, the value-added project should disclose all information that might be relevant to an investor's decision to participate. Well-written and comprehensive disclosure documents assist potential investors and help protect the entity, the directors, organizational committee and the manager from legal claims from disgruntled investors. The purpose of the disclosure statement is to inform potential investors about the risks, rewards, legal terms, conditions of membership, delivery obligation and other information material to the decision to participate.

Members of the steering committee should avoid talking to potential investors until information is available to answer most questions. Being in this position will require a thorough understanding of the feasibility study and business plan. However, the business plan should always be considered a working document because market prices, costs, interest rates and other factors will fluctuate. In addition, many parts of the business plan may not be complete at the time of the equity drive. The organizers must be careful not to misrepresent the potential risks of the project or make definite statements about some issues.

Organizers should be particularly careful in making statements concerning the projected return on investment (ROI). ROI questions can best be addressed by discussing the range of returns identified in the feasibility study and sensitivity analysis and by discussing which factors will have the most critical impact on ROI.

A well-defined goal for the equity drive should be in place before the equity drive begins. It is important to meet the equity drive goal and get the project started with sufficient capital. Under-capitalization is a primary reason for many business failures, and it is one of the most difficult hurdles to overcome. If the equity drive goal is not met, the project should be carefully reconsidered before proceeding.

It is often suggested that the time period from initial informational meetings to the close of the equity drive should be kept as short as possible, because enthusiasm for a project may wane. However, the time frame often needs to include separate informational meetings for lenders, managers of existing cooperatives and others. Many producers will also need time to discuss the proposed equity investment, both within their operations and with their lenders.

A general rule of thumb is that about 10 percent of the producers who attend an informational meeting will eventually invest in the business. Successful equity drives often require multiple meetings at given locations, which may include both short informational meetings and more in-depth follow-up and one-on-one meetings.

Another rule of thumb is that simplicity helps support a successful equity drive. Specifying numerous classes of stock or different alternatives, depending on the number of shares of stock, often makes sales more difficult and extends the time frame of the equity drive.

A Checklist for Potential Patron Members

People contribute and/or invest in business ventures for different reasons and with different objectives in mind. The following questions should assist individuals considering patron membership in their evaluation of possible investment. Answers to these issues will vary. No specific pattern of responses necessarily indicates a decision to invest or not invest. However, consideration of these issues should assist potential investors in assessing their awareness, comfort and capabilities.

1. Do you have a good understanding of the business venture proposed?

2. Are the objectives of the proposed business consistent with the goals and mission of your farm operation?

3. Does the business venture have valuable and respected farmer leadership involved?

4. What advantages/disadvantages do the non-patron members provide?

5. Has the project been well studied and planned?

6. Do you have a good understanding of why the requested funds are needed and how the requested funds will be used?

7. Will the requested funds be used for initial operating purposes or do they represent an equity investment?

8. If the requested funds are for operating purposes, does the contribution create some type of priority or advantage for later capital investment?

9. How will the requested funds be deposited?

10. Have potential conflicts between patron and non-patron members been identified and addressed?

11. Who will have oversight and authority for the use of the requested funds?

12. What will happen to the requested funds if the business idea is abandoned?

13. What are the potential returns from the invested funds?

14. What are the potential returns from cooperative membership?

15. What risks are the cooperative business exposed to?

16. How will membership/investment in the cooperative influence your farm operation?

17. How will cooperative membership impact your personal and business goals?

Summary

The "Tennessee Processing Cooperative" law creates a new business structure that combines some characteristics of traditional cooperatives with some characteristics of a limited liability company. This new business structure is for ventures that add value to agriculture commodities by processing or marketing them. A business formed under the law will follow traditional cooperative organization principles and will be exempt from state franchise and excise taxes, similar to traditional cooperatives, but will accommodate both patron and non-patron membership. Patron membership will involve both capital investment and a pre-defined delivery commitment of commodities to the business for processing. Non-patron membership includes only capital investment. Membership and investment in a processing cooperative should be carefully considered and evaluated. Anyone considering starting a processing cooperative should retain and adhere to the guidance provided by qualified professional legal counsel.

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