RESEARCH REPORT

NO. 2
MAY 1992

NON-MEMBER EQUITY INSTRUMENTS FOR CONSUMER AND WORKER COOPERATIVES

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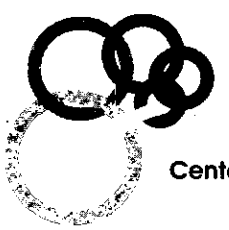

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PROBLEM

Capitalizing Privately Owned Businesses

Businesses are capitalized through two basic types of financial instruments: debt and equity. Debts are loans that the business has a contractual obligation to repay on a fixed schedule, with interest. Debt investors generally make loans only when there is a reasonable certainty of repayment, either from business cash flow or from collateral.

Equity is ownership capital: equity investors own an interest in the business. Equity is also risk capital: if the business is successful, the equity investor is rewarded financially; if it is not successful, the investor risks losing some or all of the investment. Equity usually is also patient capital, which is important for new or growing businesses. Whereas lenders require that interest and usually principal payments begin immediately, equity returns are usually not expected until the business is profitable or until the equity is sold.

All businesses need equity for seed capital, for expansion and for leveraging debt. Lenders require businesses to have equity capital to provide the down payment or "risk" portion of assets financed by debt and to absorb potential losses and protect their loans.

Although there are a wide variety of equity instruments in investor-owned businesses, they generally share the following features:

- financial return tied to the success of the business through sharing the profits and losses and/or through increased or decreased value of the equity
- no collateral
- some form of voting rights in the business
- expected return on investment proportionate to the level of risk assumed
- investment redeemed through
  - public stock offering
  - sale of business
  - sale of investment to new investor

  or
- repurchase by the company using a predetermined formula

In practice, many financial instruments cannot be strictly classified as debt or equity; they have features of both and fall on a continuum between the two extremes. Such instruments are sometimes referred to as "hybrid" instruments.

CAPITALIZING CONSUMER AND WORKER COOPERATIVES

Typical Capitalization

Virtually all consumer and worker cooperatives raise equity by requiring members to pay a membership fee or buy membership shares. Member equity is intended to help capitalize the cooperative and to demonstrate member commitment. Although many coops distribute a portion of any annual surplus as patronage refunds, member equity is not intended to be a profit-oriented investment. Coop membership shares have the following features that tend to distinguish them from shares in investor-owned businesses:

- voting is based on one member, one vote, not on shares owned
- shares are valued at book value or a formula value, not market value
- surplus is retained in the coop and/or distributed according to patronage (measured by purchases in a consumer coop, wages or hours in a worker coop), not according to shares owned
- shares are usually not transferable; they are repurchased by the coop when a member leaves for any reason
- for cooperatives incorporated under state cooperative statutes, return on member shares is limited, generally to 8-15% (return on shares is separate from patronage-based returns)

The amount of equity that is reasonable and affordable for coop members is often insufficient to adequately capitalize a cooperative. Additional equity capital may be obtained by retaining earnings, whether as permanent retained earnings or written notices of allocation on member shares. However, cooperative equity may also decline through losses, payment of written notices or repayment of equity to ex-members in excess of equity raised from new members. Thus, many cooperatives are undercapitalized in relation to other comparable businesses.

Although debt financing is available to cooperatives from both conventional and special lenders (e.g., the National Cooperative Bank), many cooperatives do

not qualify for loans due to lack of collateral, lack of historical profits, lack of personal guarantees or other credit problems. In addition, lenders' debt/equity requirements limit the amount of funds a business may borrow, thus compounding the undercapitalization effect of low cooperative equity.

While many investor-owned businesses suffer from the same problems of limited owner equity and inability to qualify for sufficient debt financing, they have the capacity to raise equity from outside investors. Cooperatives and potential investors have traditionally felt that non-member equity was not an option for cooperatives.

Historical Objections to Non-Member Equity

Non-member equity has rarely been pursued or even considered by most consumer and worker cooperatives, nor have most cooperative theorists and professionals addressed the issue. There are two main reasons that outside equity has not been considered as a viable capital formation strategy. First, outside equity has been viewed as conflicting with basic coop principles. Rodney S. Wead expresses the viewpoint of many cooperators when he states, "In a co-op, capital is there to be used. It is there to serve the consumer's interest, not the profit principle."[1] More specifically, some fear that outside equity necessitates control based on capital versus one member, one vote, and that it would violate the Rochdale principle of limited return on equity.

Second, many believe that coops have nothing to offer outside investors. They believe that coops cannot offer capital growth and voting control, and that without such typical rewards, investors would not be motivated to invest.

OBJECTIVES OF STUDY

This study hypothesized that the needs of consumer and worker cooperatives and the needs of outside equity investors are not necessarily incompatible. Given the extraordinary variety and flexibility of financing instruments, it should be possible to identify or design instruments that would satisfy both 1) the needs of consumer and worker cooperatives to maintain basic cooperative principles and 2) the needs of outside investors to earn a reasonable return with an investment that protects their interests as non-member capital providers.

The purpose of this study was to:

1) develop a set of criteria for non-member equity instruments that would meet the needs of consumer and worker cooperatives and of investors.
2) research existing and proposed non-member equity instruments designed for use by cooperatives and identify traditional equity instruments that could be adapted for use by cooperatives.
3) assess each instrument's ability to meet the needs of both cooperatives and outside equity investors.
4) recommend any existing instruments or propose new instruments that meet the criteria established.

It is essential to note that while this study addresses certain legal and tax issues, the author is not an attorney or an accountant. While attorneys were consulted in the preparation of this study, the discussions of legal and tax issues are not intended as legal advice or legal conclusions. It is essential that any cooperative considering outside equity consult with attorneys experienced in the field.

METHODOLOGY

Literature Search

A literature search was conducted to obtain any writings on non-member equity for cooperatives. Indexes of cooperative journals, books on cooperatives, publications lists of cooperative organizations and various indexes of business periodicals were reviewed and cooperative professionals were asked for literature references. The search did not yield a significant amount of material. Writings on cooperative finance virtually always focussed on member equity or on debt financing. Of the few writings on outside equity identified, most were either on theoretical models proposed for use by worker cooperatives or on agricultural cooperatives' use of preferred stock and subsidiary corporations.

In addition, traditional financial literature was reviewed to obtain information on traditional financing vehicles that could be used by or adapted for consumer and worker cooperatives.

Criteria Development

A preliminary list of criteria for outside equity instruments was developed, encompassing a broad range of issues that might concern a cooperative or an investor.

Experts in cooperatives and in finance were interviewed in order to learn which criteria were important to cooperatives and investors. The cooperative professionals included consumer and worker cooperative experts, both theorists and practitioners. The finance professionals included experts in the field of finance who had at least some knowledge of cooperatives, including coop lenders, socially responsible investment professionals and venture capitalists. In the many cases where interviewees had expertise in both cooperatives and finance, they were interviewed from both perspectives. A total of 27 experts were interviewed.

The cooperative expert interviews covered two basic areas: the interviewee's knowledge of any existing or proposed examples of non-member equity, and their opinion on what criteria should used in evaluating outside equity. The experts were read the preliminary list of criteria, requested to comment on each one, and asked to add any they thought had been overlooked.

The preliminary list of criteria on which coop experts provided feedback is summarized below.

- Most control should be by the members, with the possibility of some negotiated areas of investor control or participation (e.g., board seat; control in the event of bankruptcy)
- Measure of return to investor must avoid threat of earnings being diverted to coop members (i.e., worker-members absorbing income as wages or consumer-members absorbing income as discounts)
- The investors' exit strategy should not rely on sale or liquidation of the business
- High transaction costs should be avoided
- Instruments should limit the return on equity to investors in accordance with coop principles
- Instruments should permit an acceptable financial return to members
- Instruments should provide a market rate of return to investors
- Acceptable downside protection to investors should be provided
- Instruments should avoid complexity, to be accessible to less sophisticated coops and investors
- Legal conflicts with cooperative corporate statutes should be minimized
- Subchapter T tax benefits should be preserved

Financial experts were presented with the first four of the above criteria, which had been identified through the literature and interviews as issues of particular concern to cooperatives, in order to establish the basic parameters of potential equity instruments. The experts were asked to comment on these criteria from an investor's viewpoint and were asked a series of questions about criteria and issues from an investor's perspective. The finance experts were also asked for suggestions on what financing instruments might meet those criteria and what types of investors might be interested in such investments.

Finance experts were asked for their opinions on the following criteria and issues:

- Should instruments avoid complexity, in order to be easily understood and used by investors?
- Should a market rate of return be provided, or is less than market rate acceptable to some investors?
- In what circumstances or on what issues would investors require control or voting rights?
- Should investors be offered downside protection to compensate for potentially minimal control?
- Is it important for instruments to be marketable?
- Is there a preference among the various methods of return on investment (fixed payments, dividends based on profit, sale of investment, etc.)?
- If the investment is to be repaid by the coop, should the price be a set formula, or should it be some form of current market valuation?
- What is an acceptable time frame for payback?
- Are tax benefits important to potential investors?
- How different are these criteria from criteria for investments in conventional small businesses?

The preliminary list of criteria was then revised based on the literature and interviews.

Model Research

Existing and theoretical models of non-member equity were identified through the literature review and through calling over fifty coop and financial professionals. The features of the security and the experience of coops, if any, in using these instruments was then researched. For theoretical models, the research involved reviewing the literature and, if possible, interviewing the model's author. For existing models, an attempt was made to interview the cooperative, an outside investor in the cooperative and any outside professionals who had assisted in the financing. Offering documents were also obtained, if available.

Interviewing cooperatives and investors was often impossible, often because the coop was defunct or the

investors' names were confidential. In these cases, the examples were included in the study as long as the information was comprehensive enough to assess against the criteria.

Excluded Models

There are several examples of non-member equity where the equity holder is a foundation or a sponsoring non-profit organization. These examples have not been included, because they are intended primarily as grants rather than "true" equity. They are booked as equity to improve the coop's balance sheet. Although there may be a provision for redeeming the equity through a put or a call, the investment is not made with the expectation of a return.

The use of subsidiary corporations by cooperatives[2] was also not included as an instrument (except under leasing subsidiaries). Although creating a subsidiary does permit the coops to raise outside equity, that is not the primary purpose. The subsidiaries researched were used either to limit the coop's liability for certain business activities, to create related businesses that generate profits for the parent coop not subject to revolving or member withdrawal, and/or to create businesses that provide goods or services to multiple cooperatives. Since operating subsidiaries would not be used solely as a financing technique, they are not included here.

Assessment of Instruments

The features of each instrument, including examples of their use by coops (if any), are summarized. The instruments are then measured against each of the established criteria.

CRITERIA FOR NON-MEMBER EQUITY INSTRUMENTS

This section presents the findings from the literature review and interviews of experts. It is important to note that although the interviews were structured, they were open-ended. The interviewees often responded with multiple perspectives on an issue, or offered no opinion, or raised additional issues not covered in the criteria or questions. And as noted above, experts with experience in both areas commented from both the cooperative and the investor perspective. Thus, the following discussion of criteria is not a quantitative summary of opinions. Instead, it attempts to represent the views of a group of coop and finance experts, supplemented where possible by perspectives from the literature.

Control Issues

The issue of control rights by outside equity holders was identified as a critical issue by most coop experts. All of the interviewees recognized the potential conflicts of interest between coop members and investors, and several said that the control issue prevented true investors from investing in coops. However, only one interviewee felt that coop principles prohibited any type of voting or participation in the business by investors.

Most coop experts felt that giving minority board seats to investors was acceptable. Interviewees were divided on whether investors should be given shared control or approval rights over traditional issues such as sale or dissolution of company, sale of additional securities, acquisitions, change in management and assumption of new debt. But some pointed out that coops were accustomed to giving lenders approval rights in certain areas to protect their loans. Participation by investors may be more problematic for worker coops than for consumer coops, because worker coop members are usually much more involved in governance and management of the business.

Several interviewees felt that outside board participation was, in fact, a positive benefit of outside equity, particularly for low-income and less sophisticated cooperatives that could benefit from business and financial expertise. Others pointed out that shared control involved a conflict of cultures, which was generally expressed as profit motive versus member service goals.

Most finance experts interviewed did not believe, as some coops fear, that investors require a significant amount of control. Most felt that investors would want approval rights for the traditional major issues, particularly those involving change in corporate structure (e.g., dissolution, sale of new stock).

Several interviewees felt that investors only require control rights if the cooperative does not meet performance goals such as sales and profitability levels, current payment of debt and productivity measures.[3] One expert with experience in financing worker cooperatives felt that majority investors should have the right to take control of the business if there were any action that the investor believed fundamentally jeopardized the nature or long-term viability of the cooperative. This expert also felt that cooperatives were hurting themselves by not granting such control options. He commented, "A conventional small business would bristle at this much outside control demanded, but if it

were desperate for money, it would accept the terms and see the covenants as an incentive to repay the money more quickly, whereas a coop would rather fail than accept those terms."

Overall, a limited amount of control by investors, particularly on major corporate changes, appears to be acceptable to both cooperatives and investors.

Return on Investment

Historical coop principles call for limited return on equity capital. However, the Rochdale founders did not contemplate the use of non-member equity. Most coop experts felt that the principle of limited return did not necessarily apply to outside equity, but some acknowledged that it was a philosophical issue that each coop had to resolve.

State cooperative statutes generally have limits on the rate of return that may be paid on equity; 8% is typical. Again, it is not clear whether this extends to non-member equity, and cooperatives incorporated under conventional business statutes would not need to be concerned about legal limits. (The IRS explicitly limits farmers cooperatives to 8% dividends on non-member stock; there is no corresponding IRS limit for other cooperatives.) Even if the limit were considered applicable, it apparently refers to an annual stated dividend. Several coop experts pointed out that other methods of providing return on equity, such as profit sharing or redemption premiums, would not be subject to any legal limits.

Most coop experts felt that cooperatives should be prepared to pay close to market rate returns to investors. As one expert said, "limited return is a nice goal but you've got to pay whatever money costs or you can't do the deal." Most interviewees agreed that the "market rate" depended on the individual circumstances of the business, the instrument used and the investor. Several experts felt that a return of 8-10% was reasonable, but those with experience in financing deals mentioned ranges of 20-30%. Even those rates were acknowledged to be less than true market, but investors were assumed to be interested in social returns as well.

Most finance experts agreed that equity investors required market rates of return, although many added that market rate was not easily definable and that investors in coops were likely to accept somewhat below market. The appropriate rate would depend on the riskiness of the business and the features of the particular instrument. The experts' estimates of market rate for coops varied widely, from 10% to 40%. One expert who had experience in both finance and cooperatives felt strongly about the need to pay market rate returns: "The hard sell is getting capital at any price. Cost of capital isn't the main issue; availability is. Coops should pay market rate rather than risk losing investors by quibbling over price."

Coop experts were also asked how important it was for coop members to get a return on their patronage. They felt that most consumer coop members did not expect a patronage refund; often, any surplus is reinvested rather than distributed. Worker coop members, on the other hand, usually have more money invested in their coop and rely on patronage refunds as part of their total income. Several interviewees pointed out that this gives worker cooperatives more of a profit motive, and that it is in the investor's interest to keep workers motivated by patronage dividends. Similarly, retaining some earnings was viewed as being in everyone's interest.

Many experts were skeptical of the ability of most coops to pay anywhere near a market rate of return, whether or not the coops were philosophically in favor of doing so. Several experts felt that the biggest obstacle for coops in raising outside equity was the low profitability of coops in general.

Methods of Return on Investment

Equity investors typically realize a return on their investment through appreciated value of their investment and/or through receiving regular payments (e.g., dividends). When outside investors purchase equity in a conventional privately-held corporation, the most common expectation is that they will recapture the value of their investment through the business going public or being acquired by another business. Venture capitalists, in particular, rely on initial public offerings and acquisitions. These investment exit strategies clearly are not viable for cooperatives, because providing benefits to members through continued cooperative ownership is considered fundamental.

Another option is for the investor to sell the equity to a new investor at a negotiated price. However, new investors still need to get their money out eventually, and securities regulations often inhibit transferability of securities. In addition, the coop would want approval of new investors if ownership of the security involved participation of any kind (board seats, etc.).

Finally, the business itself may redeem the investment, either through regular payments (e.g., dividends),

repurchase of the equity, or some combination that has the potential to produce the expected returns.

As discussed above, while some cooperators believe that sharing coop surplus with anyone besides members violates coop principles, most of the coop experts interviewed did not object to sharing profits with outside investors as a method of providing returns. One felt that coops would prefer to offer a percentage of profits rather than a fixed dividend.

According to one coop expert, the limited exit options coops can offer are a major reason why potential investors avoid coops. Other coop experts felt that equity redemption by the cooperative was reasonable, perhaps by establishing a sinking fund. However, two interviewees warned against deferring investor payments. As one put it, "Deferring shareholder payments really only makes sense for companies that are raising equity for major growth or expansion which will increase the company's ability to pay later. That argument doesn't hold for coops and may create additional cash management problems."

The financial experts agreed that investors had no preferred method of return, but that having some kind of exit feature is important. Most noted that investors in privately held companies tend to expect their return from capital appreciation rather than from dividends. The interviewees did not feel that marketability of the instrument was important if a credible redemption plan existed.

Some experts said that if the coop redeems the equity, investors would expect a fair market valuation. One felt that a predetermined formula would be acceptable, such as a multiple of the original investment repaid in a set time period.

Several finance experts mentioned that tax benefits would be attractive to some investors, although the availability of tax losses on passive investments is now quite limited.

When asked about an acceptable time period for investors to get their investment out, all interviewees gave a range, with a low range of 2 - 5 years and a high range of 5 - 10 years. The average length of time suggested was 5 years.

Overall, it appears that while there is no preferred method of return on investment, it is critical that the method of payment and exit strategy for investors is clear and credible. Furthermore, most cooperatives are not likely to be philosophically opposed to sharing profits with investors.

Downside Protection

Debt investors are typically offered collateral or similar guarantees of repayment if the borrower is unable to repay the debt through business cash flow. Because equity investors are given upside potential, they are rarely offered that level of downside protection against losing their investment. The coop experts felt that offering collateral to outside investors was not appropriate, but most felt that giving outside investors preference over members in liquidation or bankruptcy was acceptable. Several also said that offering investors more control if performance goals are not met would provide some downside protection.

A serious problem with cooperative equity (with or without outside investors) is that if a coop declines financially, the decline is often tied to reduced membership in consumer coops or layoffs in worker coops. As members leave, their equity is returned to them, eroding the equity base at a time when it is most needed. While some coops have discretion over repayment of member equity, others must repay it according to their bylaws unless solvency is threatened. To protect against holding the equity of last resort, non-member equity holders may require that member equity not be redeemed before non-member equity unless the coop is meeting certain benchmarks. This parallels a common debt covenant for coops.

The finance experts agreed that investors are not accustomed to receiving downside protection other than preference in liquidation and the limited control rights discussed earlier.

Earnings Diversion

The return on many equity instruments depends at least in part on the profitability of the business. Dividends are often calculated as a percentage of profits, and equity valuations often are based on profitability. This may pose a special problem for outside investors in cooperatives.

In worker cooperatives, there is the potential for worker-owners to increase their own wages and thus divert potential profits from investors. As one expert said, "It's hard to provide upside potential when members can always raid the treasury and absorb profits." In consumer coops, it is more difficult to manipulate earnings to benefit the members rather than the investors. However, the coop could offer member discounts sufficient to capture the profits for the members.

Some coop experts felt this was an inherent obstacle to financing cooperatives. Setting wages (or

member discounts) as part of the investment agreement was generally viewed as an unworkable solution. But some experts felt that while there may be some risk, any business has a concern for preserving its reputation and for treating its investors fairly so that it can attract future investors.

Several experts objected to citing earnings diversion as a special problem for cooperatives. They pointed out that skimming of profits by management is always a concern for investors in small businesses, not just cooperatives. Venture capitalist Arthur Lipper, who invests in traditional small companies, is strongly opposed to profit-based returns to investors. He writes,

I have two reasons for my aversion to profit-related inducements to invest in private companies. First, the reported net profit of a privately owned company is highly controllable by the management. It also may well be in the best interests of the company, or its managers, to take actions which reduce current profits for the sake of either increased future profit or for other reasons. Second, I see no virtue in any investment structure which unnecessarily places the company management in the position of having to report for tax purposes the highest amount possible.[4]

In general, the risk of earnings diversion was considered an important issue, although not always because of the special nature of cooperatives.

Complexity

Equity instruments can sometimes be quite complex, with dividend and redemption formulas, multiple corporate entities, etc. While simple instruments are generally preferable, finance experts felt that investors can be expected to be comfortable with complex deals. Similarly, most coop interviewees felt that complexity was not an obstacle in designing outside equity instruments. They felt that coop managers and boards either were capable of dealing with complex financial issues or needed to "bite the bullet and get people trained." However, one interviewee felt that when corporate or financial structures are too complex, coop members can lose the sense of being in control of their coop. Coop members do need to be educated about such transactions, which may be a challenging task.

While complexity may not be a major concern by itself, it is often correlated with transaction costs, discussed below.

Transaction Costs

There are a variety of direct costs involved in raising outside equity. Legal and accounting fees can be high, and commissions must be paid on equity raised from investors brought in through investment professionals. In addition, there are indirect costs of managers' time in structuring and raising the equity. Costs vary depending on the complexity of the transaction and on the experience and fee structures of the professionals involved. Except for commissions, which are a percentage of the investment (typically 5-10%), most of the costs are fixed, regardless of the size of the transaction. This means that smaller transactions can be prohibitively expensive in relation to the amount of capital raised. It was suggested that coops can keep costs down by keeping transactions simple, doing some of the work in-house and locating their own investors.

Legal Issues

State and federal securities regulations must be observed when issuing securities of any kind. Cooperatives are subject to the same securities regulations as all businesses. Any cooperative issuing securities needs to obtain legal advice on structuring the investment, complying with anti-fraud disclosure requirements, preparing the documents and promoting and selling the investment. (Debt is also considered a security; thus, securities regulations also apply to the hybrid instruments discussed later.)

The relevant legal issues also depend in part on the corporate structure of the cooperative; some cooperatives are incorporated as cooperative corporations while others, particularly worker cooperatives, have chosen to incorporate as conventional corporations. Generally speaking, state statutes for conventional corporations permit great flexibility in structuring corporate finance instruments. In contrast, state cooperative statutes may limit opportunities for issuing equity-like instruments. Or, the application of various provisions in the statutes to situations involving non-member equity may be unclear. For example, the Consumer Cooperative Corporations Section of the California Corporations Code makes no provision for issuance of shares, and the Code may limit a cooperative's ability to distribute profits to non-patrons.[5]

In general, coops would have more flexibility in issuing non-member equity if they incorporate under conventional businesss corporation laws. If incorporated as consumer cooperative corporations, coops would probably be more prudent to use the non-stock equity instruments described later.

Tax Issues

Tax issues related to securities and cooperatives are very complex and subject to change. This study covers only very basic tax issues. Expert tax advice should be obtained by any cooperative seeking to raise outside equity.

Many consumer and worker cooperatives use Subchapter T when filing federal income taxes. Although there is some ambiguity on the effect of outside equity on Subchapter T eligibility, it appears that patronage dividends would still be deductible as long as the majority of voting stock is held by members and earnings are allocated to members on the basis of patronage. The IRS has ruled that a corporation whose voting stock was 25% owned by non-member investors still qualified as doing business on a cooperative basis.[6] The Industrial Cooperative Association has researched this issue and concluded that Subchapter T would still be available to cooperatives with non-member equity, to a degree, on allocation of patronage dividends to the members. Any dividends paid on non-member equity would not be tax deductible to the cooperative. Interest payments to investors on instruments classified as debt would be deductible; IRS regulations on the classification of debt versus equity instruments should be consulted in determining whether payments on "hybrid" instruments may be deductible.

Potential Investors

The experts interviewed agreed that potential investors in consumer and worker cooperatives were limited to those who share the social concerns of cooperatives. This would include socially responsible investors, foundations and churches. In addition, coop members are a likely source of "outside" capital for both their own and other cooperatives. Customers and suppliers are other potential investors who may be interested in supporting the coop.

Summary

Based on the research and interviews, the preliminary list of criteria was revised to include those criteria and issues identified as important by many (not necessarily all) of the interviewees. It is clear that the importance of various criteria depends on the individual preferences and values of each cooperative and investor. Therefore, it cannot be assumed that each of these criteria is important to every coop and investor, or that certain criteria not included (e.g., limited return on equity) are not critical to some coops.

The following criteria were deemed to be the most significant for non-member equity instruments:

Limited Control: The instrument does not interfere with basic control of coop by coop members, but provides investors with voting participation and/or control rights in limited circumstances

Moderate Rate of Return on Investment: The instrument provides the opportunity for investors to receive a rate of return that helps compensate for the risk of the investment, but may be below "true" market rate.

Defined Exit Strategy: The instrument provides a clear way for investors to get their investment back.

Limited Downside Protection: The instrument only offers some downside protection to investors if it is needed to compensate for a less equity-like instrument (i.e., lower return, less control).

Protection from Earnings Diversion: The financial return on the instrument is calculated in a way that avoids the risk of earnings being diverted to members as wages or discounts.

Acceptable Complexity: The instrument is not significantly complicated to structure, manage and communicate.

Reasonable Transaction Costs: The transaction costs are reasonable relative to the expected small size of investments in coops.

Minimal Non-member Equity Legal Complications: The instrument avoids possible conflicts and ambiguities for coops that are incorporated under state cooperative statutes.

Maximum Tax Opportunities: The instrument preserves the application of Subchapter T to patronage dividends, involves payments to investors that are tax deductible for the coop and/or provides tax benefits to investors.

INSTRUMENTS

Limited Partnerships (Whole Business)

Features

A limited partnership is a business structure that can be used to structure and finance a business or a particular project or asset. In the past, businesses often used limited partnerships to finance R & D, new ventures and purchases of real estate and major equipment. In a 1983 paper, Katharine Pillsbury recommended the use of limited partnerships by cooperatives.[7] However, the 1986 tax reform act severely

curtailed the tax benefits available to limited partners. Since then, use of limited partnerships as a financing tool has been much less popular. However, they are still of potential interest if the financial return is sufficient without tax benefits or if particular investors are able to take advantage of passive losses.

This model will address the use of limited partnerships to finance and operate a business. The use of partnerships to finance specific assets is discussed below under "Leasing Partnerships and Subsidiaries."

A limited partnership has the following features:

- The partnership has a general partner who actively manages the partnership; typically, the general partner is the developer or beneficiary of the partnership (in this case, the cooperative). Although the general partner has authority for the partnership, the general partner has a fiduciary responsibility to act in the best interests of all the partners. If the general partner is a corporation (including a cooperative corporation) the IRS may require it to have a certain level of net worth relative to the amount of partnership capital.
- The limited partners are the investors. They invest most of the funds and are not permitted to participate in the management of the partnership. However, the agreement may permit limited partners to remove a general partner and to approve amending the partnership agreement, terminating the partnership and issues where there is a conflict of interest.
- A partnership typically has a predetermined life, either a fixed date of dissolution or dissolution upon an event (such as sale of the business).
- Unlike a corporation, a partnership is not a taxable entity; instead, profits and losses are passed through to the partners. This avoids the problem of double taxation of dividends paid by corporations. However, partners pay current income tax on allocations of profits even if they do not receive cash distributions. Also, limited partners can only deduct their losses against passive income or against future partnership gains; hence, the limited tax advantages.
- The allocation of profits, losses and gain on sale are specified in the partnership agreement and can change over time or with specified events. (Typically, the limited partners get a lower allocation of profit and gain after they have received an amount equal to their capital contribution.) Distributions of available cash may be made to partners irrespective of profits and are treated as a reduction of the basis of the investment.

Example

The only example identified of a cooperative using a limited partnership to finance the operating entity is from the early 1980's, before the tax benefits of losses from passive investments were curtailed. The partnership structure probably would not have been considered without the anticipated tax benefits.

1. California Worker Cooperative

A newly formed worker cooperative created a limited partnership to operate and finance the business as a whole. The coop raised over $100,000 from a single limited partner. The following summarizes the major terms of the partnership agreement:

- A limited partnership was created between the new coop as general partner and the investor as limited partner. The partnership was the operating entity; the coop provided "worker services" to the partnership.
- The limited partner contributed 99% of partnership capital and the coop contributed 1%. Additional funds from member equity were loaned to the partnership by the coop.
- Profits and loss were allocated between the partners according to capital contributions.
- Cash distributions to the limited partner were to be at least half of, but no more than, the limited partner's profit allocation, and were only to be made if the partnership had adequate capital, thus protecting the partnership from obligated cash payments. The general partner's cash distribution was limited to a pro rata percentage of the limited partner's, giving the limited partner a preference in cash distributions.
- The coop was allowed to make additional capital contributions up to a limit of 75% of total capitalization in order to increase its profit allocation.
- The coop had the option to buy out the limited partner after three years. The buyout price would be based on the limited partners' share of the fair market value determined by an outside appraiser. In addition, the limited partner had the option to require the coop to buy out its interests after 5 years. In this case, the limited partner would

receive the prorated fair market value plus a 50% premium. This gave the coop an incentive to buy out the limited partner before five years. Up to 75% of the purchase price could be paid in a secured promissory note at prime plus three; this meant that the coop did not have to come up with the full price in cash, yet the high interest rate gave the coop an incentive to obtain bank financing for the buyout.

- The partnership agreement was quite complex; in addition, separate legal documents had to be prepared to create appropriate legal relationships between the parties. Transaction costs were very high relative to the amount of capital raised.

The partnership was successful in attracting an investor who was looking for a near-market return and was socially motivated. Unfortunately, the business failed within a year and was unable to repay any capital to the investor.

Fit with Criteria

Limited Control

The limited partnership structure offers investors no voting or management participation in the business. However, it could allow for limited partners to remove and replace the general partner and to approve amendment of the partnership agreement, sale of the business or assets and issues involving a conflict of interest. It probably would be impractical to remove the coop as general partner; however, threat of removal could be used as leverage for management changes.

The type of control by limited partners intrinsic to the instrument fits well with the established criteria, although some investors would want more control. Additional control may be available through the limited partnership or outside agreements, but the characterization of the venture as a limited partnership (versus a corporation) for tax purposes may be jeopardized (see IRS regulations on partnerships and corporations).

Moderate Rate of Return on Investment

Limited partnerships permit flexibility in allocating distributions and gains to limited partners. If the business has profit potential, there is the potential for the investors to receive market rate returns. Tax benefits may add to the expected return in certain situations. At the same time, if the coop wants to limit return on equity, the partnership agreement can be written to limit the upside potential.

Defined Exit Strategy

The partnership agreement specifies the methods of return on the investment. Return can be achieved through current distributions, redemption by the general partner and/or gain on sale of the business. Thus, limited partnerships do offer investors predefined exit strategies, which can be tailored to the particular situation.

Limited Downside Protection

The partnership agreement can allow limited partners to be paid agreed upon distributions or sale proceeds before the general partner (coop) receives any.

Protection from Earnings Diversion

Return will depend on profitability, thus subjecting the investors to potential earnings diversion. If the limited partners are given the right to approve actions involving a conflict of interest, that may offer some protection, but conflicts may be difficult to anticipate or prove.

Acceptable Complexity

A limited partnership to operate the whole business is extremely cumbersome. The ownership structure of the business would be convoluted and difficult to convey to coop members and even to potential investors. Although complexity is not a major criterion, the intricacy of a partnership to operate the business would probably be too complex to be worthwhile for most coops.

Reasonable Transaction Costs

Transaction costs would be high due to the complexity of limited partnerships and the relevant IRS regulations.

Minimal Non-Member Equity Legal Complications

Because limited partners do not have direct ownership of the cooperative, legal problems associated with non-member owners are avoided.

Maximum Tax Opportunities

Income from the business flows directly to the partners, avoiding double taxation for investors (and providing limited tax benefits).

It is uncertain whether the return to the general partner can be distributed to members as patronage refunds. The complexity of multiple entities may raise questions about the cooperative's purpose and benefits and thus about Sub-chapter T eligibility.

Leasing Partnerships and Subsidiaries

Features

Limited partnerships that own and lease specific assets to a business are simpler and more standardized structures than the limited partnerships described above. The general partner could be the cooperative, or the partnership could be completely investor-owned. The partnership would purchase assets which would be leased to the coop at a fair market rate, and then sold after a period of years (to the coop or a third party) at a fair market value.

A leasing partnership is similar to a debt instrument, except that the investor benefits by retaining title to the asset and receiving tax benefits such as depreciation. The coop typically receives a higher loan to value ratio than a bank will tolerate. The coop's payments are higher but are usually tax deductible (IRS regulations on leasing should be consulted).

The return to investors can be made more equity-like by having a lease formula that includes a percentage of profits or sales of the cooperative.

It is also possible to create a subsidiary corporation, rather than a limited partnership, to acquire and lease assets to a cooperative. The subsidiary would be a stock corporation whose stock would be owned by investors and the cooperative.

Examples

No consumer or worker cooperatives are known to have used leasing as an equity financing tool. The examples that follow are from agricultural cooperatives.[8]

1. Pacific Coast Producers

Pacific Coast Producers is a large agricultural cooperative that needed to raise capital in its early years. The coop formed four limited partnerships (before the tax law changes) in order to build or purchase major assets such as warehouses, which were then leased to the cooperative. The limited partners were coop members and employees rather than true outside investors. The partners received periodic distributions from the asset leases. The limited partners had no voting rights. Two of the partnerships terminated when the cooperative purchased the assets at market value from the partnership in accordance with the partnership agreement (two partnerships are still operating). The investments were very profitable for the limited partners; however, this caused considerable conflict between those members who had invested and the other members.

2. Sapiro Model[9]

In the 1920's, coop attorney Aaron Sapiro devised a model for agricultural cooperatives to form subsidiaries to finance new plants. The cooperative held the subsidiary's common stock and raised outside equity through selling nonvoting preferred stock. Bank loans were also obtained to finance the assets. The coop gradually bought out the investors through repurchasing the preferred stock. Although many coops used this model in the 1920's, few had the ability to service the debt on the facilities, let alone pay back the investors.

3. Shereff Model

A third model is proposed in a paper by Henry Shereff, et. al.[10] The model involves forming an investor-owned corporation or partnership to build a processing plant and lease it to the cooperative. The lease rate would be equal to the debt service on the property plus 50% of the available cash flow of the facility. The suggested formula for determining available cash flow is the profit remaining after deducting 1) all costs of operating the facility, 2) a reserve for repairs and new capital investments and 3) advance payment for crops. (This last deduction could be reconfigured as a working capital formula.) A management agreement between the coop and the leasing entity would govern the relationship.

Fit with Criteria

Limited Control

The amount of control held by investors would vary depending on whether the leasing entity is a partnership or a corporation, and whether the cooperative is a general partner or common stock holder. However, because the investors own the assets, and not the business, control issues are much less relevant. The major opportunity for exercising control would be through lease covenants.

Moderate Rate of Return on Investment

If the assets purchased offer capital gain potential (e.g., real estate) or high lease rates, there is the opportunity for the investors to receive market rate returns. Tax benefits may add to the expected return in certain situations. The addition of a percentage of profits or sales can provide upside potential. Expected returns should be lower than typical equity instruments because of the increased downside protection.

Defined Exit Strategy

Investors would typically get their investment out by selling the assets, most likely back to the coop but

possibly to an outside buyer. The investment may be partially redeemed through lease payments that include performance-based returns. The partnership and/or lease agreement would clearly define the exit method.

Limited Downside Protection

This structure offers more downside protection than most equity-like instruments, because the investors own specific assets that may be liquidated if the coop defaults on lease payments.

Protection from Earnings Diversion

Because the investors' return is through lease payments and capital gains, the problem of earnings diversion is largely avoided. Lease payment formulas that include a share of the profits may risk earnings diversion, but formulas can be created that avoid the problem (see "Participating Debt" and "Royalties", below).

Acceptable Complexity

Because investors do not have ownership of the cooperative, this structure avoids the ownership and control issues that lead to problems in structuring most non-member equity. Although limited partnerships are complex, this type of partnership is very common; existing models can be fairly easily adapted. Subsidiaries for this purpose are less common and may be complicated to structure. Adding a performance-based return would add another level of complexity, as would a lease agreement that includes non-standard clauses.

Reasonable Transaction Costs

Transaction costs would probably be reasonable assuming the deal is for the purchase of a building or major assets.

Minimal Non-Member Equity Legal Complications

Because investors would not have direct ownership of the cooperative, legal problems associated with non-member owners are avoided.

Maximum Tax Opportunities

A leasing arrangement typically allows the coop to make tax deductible payments to the investors in the form of lease payments. The owners of the asset can take advantage of depreciation. If the leasing entity is a limited partnership, investors may also receive benefits from passive losses associated with ownership. The deductibility of patronage dividends would not be affected. Thus, this structure clearly maximizes tax opportunities for the coop and the investors.

Preferred Stock

Features

Preferred stock is a class of stock frequently used in venture financing. "Preferred" means that the stock is senior to common stock in terms of claim on assets and usually in dividend rights. (In a coop, membership shares are the equivalent of common stock.)

The terms of preferred stock are flexible and can be tailored to a particular situation.[11] There are two typical variations on basic preferred stock: participating preferred and convertible preferred. Participating preferred means the stock participates in profit sharing with the common stock. Convertible preferred means the stock may be converted to other instruments: common stock, another class of preferred stock or debt. The option to convert to common stock is used in situations where the business is expected to go public and thus is not relevant to coops.

The basic features of preferred stock are as follows:

- Dividend provisions may include the following variations:
  - no fixed dividends; payment of dividends at discretion of board, but typically paid before dividends to common stock/member equity (most typical provision)
  - fixed dividends, paid before any dividends on common stock/member equity
  - dividends payable whether or not earned (payment may be restricted by state laws concerning legally available funds), or dividends declared only as earned or after a certain number of years
  - "participating dividends" in which preferred stock participates with the common/member equity in any dividends in excess of the stated dividend
  - no stated dividend; participate on the same basis as the common/member equity
  - cumulative dividends (i.e., declared or owed but not paid until earned or until cash is available; accumulated dividends must be paid before any distributions to common stock) or noncumulative dividends
  - cumulative dividends only to the extent earned
  - dividends paid in preferred stock
  - increase in stated dividend if dividends are earned but not paid

- Dividends on preferred stock are not tax deductible.
- Preferred stock has a claim on assets in liquidation senior to common stock/member equity and junior to creditors. With regular preferred, shareholders would have a claim on assets up to the purchase price of the stock plus any accumulated dividends. With participating preferred, the shareholders share with the common stock holders (members) any proceeds in excess of that amount. Preferred shareholders may be offered a premium upon voluntary liquidation (i.e., sale of the company). Approval rights or performance benchmarks may also be required before the company can redeem common stock (member equity).
- Preferred stock typically lacks voting rights, although state law (including California) generally requires that stockholders must approve any action that differentially affects their class of stock. In addition, minority board seats and voting on major issues such as liquidation are commonly included. (On occasion, preferred shareholders are instead given the right to appoint nonvoting or "advisory" directors.) Preferred stockholders may also be given voting rights or voting control if dividend payments are missed or if stated covenants are violated. In addition, payment of common stock dividends/patronage dividends may be restricted unless the company meets certain financial ratios.
- Preferred stock may or may not have a redemption date. Preferred shareholders may be given the option to sell their shares to the company after a certain time at a specified price or formula, or redemption may be at the option of the company. Preferred stock may also have preference in redemption over common, which would mean member shares could not be redeemed without at least pro rata redemption of preferred stock.

Many agricultural cooperatives issue preferred stock, but the preferred stock is usually issued to represent retained patronage dividends. Some agricultural coops have sold preferred stock, mostly to members or member cooperatives, but always with a fixed dividend of no more than 8% (to comply with IRS regulations pertaining specifically to farmers' cooperatives) and no appreciation potential.[13] (One agricultural coop, Farmland Industries, gave member coops that purchased preferred stock the right to receive up to 50% more than the usual 20% of patronage dividends in cash, up to the par value of the stock, as an added incentive to purchase the stock.)[14]

Examples

1. Omega Press

Omega Press was a worker-owned printing company structured as a stock cooperative, with 15 members and revenues of close to $1 million. With over $200,000 in loans and leases and no historical profits, the Press was unable to obtain new loans. They had already raised almost $50,000 through selling preferred stock to several employees. In 1988, with legal help, they structured a new class of preferred stock aimed at socially motivated investors who did not require high returns. The documents took one year to prepare; transaction costs were about $8,000. $45,000 was raised from 5 investors. The stock had the following features:

- Cumulative stated dividend of 7.5%, paid before any patronage dividends
- Redemption was at the discretion of the coop, but was intended to be at the initial purchase price
- 10% of profits after stated dividend payments on preferred were to be set aside to buy out preferred shareholders who requested redemption (however, members could amend this bylaw provision without approval of preferred shareholders)
- Preferred stock holders were given no voting right other than those required by law

In 1991, the business failed. No proceeds are expected to be available to preferred shareholders.

2. Equal Exchange

Equal Exchange is a worker-owned business founded in 1986 that sells coffee from Third World farmer cooperatives and governments. Employees own all of the voting stock. At the time of the company's founding, nonvoting common stock was sold to employees and outside shareholders at $25 per share, raising $100,000. The stock was converted in 1989 to Class B nonvoting preferred stock. The face value of the stock at that time was increased by 10% to $27.50. Dividends were declared for the first time in 1989. The coop is currently selling additional shares of Class B preferred stock at $27.50 per share to investors who share their social goals. No direct underwriting costs

were incurred.

The stock has the following features:

- 5% noncumulative dividend when the dividends are earned (i.e., paid only out of profits)
- Dividends may, at the board's discretion, be allocated to the basis of the preferred stock, which would increase the basis for calculating future dividends
- Shareholders may sell their stock back to the coop after the sixth year at 80% of face value, after the seventh year at 90% and after the eighth year at 100%. The coop may redeem the stock at any time at 100% of face value by converting it to an 8% promissory note.
- Stock may only be transferred with the company's approval.
- Stock is nonvoting, but employees elect a shareholders' representative to the board of directors

Fit with Criteria

Limited Control

Because voting and control rights of preferred stock are very flexible, they can, within the limits of applicable state law, be structured to fit the needs of a particular coop and its potential investors. Investors can be given no voting rights but approval rights on major corporate transactions. This was acceptable to most coop experts. In particular, control rights can be structured to take effect only when the investment is threatened. The only difficulty may be defining what constitutes a threat, or, according to many state securities laws, a differential threat to the preferred stock.

Moderate Rate of Return on Investment

A high return on preferred stock would normally be expected due to the limited control and downside protection. Preferred stock with a fixed dividend combined with redemption at face value would not provide a sufficient return on investment to most investors (especially if the dividend is limited by state statute). However, the two worker cooperatives described above did succeed in selling preferred stock on this basis.

Participatory preferred or a redemption formula that permits redemption at a price higher than the original investment could provide higher returns.

Defined Exit Strategy

Preferred stock with no redemption plan would not appeal to most investors, although the Omega Press succeeding in raising capital with only the expressed intent to redeem preferred shares. Shares that give the investor the option to sell the shares back to the coop at a fixed price or based on a market valuation would fit most investors' criteria, particularly if a sinking fund or staged redemption plan is established.

Limited Downside Protection

Preferred stock gives investors some downside protection in the event of liquidation, in that their claim is senior to member equity. However, proceeds in liquidation are usually insufficient to pay off both creditors and equity holders. Voting control rights triggered by performance criteria can also provide some downside protection. In addition, the stock agreement can prevent the coop from redeeming member equity prior to redeeming preferred stock or unless certain benchmarks are met.

Protection from Earnings Diversion

Cumulative fixed dividends, declared irrespective of earnings, would avoid earnings diversion, as would redemption formulas that are based on factors other than earnings (e.g., sales, multiple of investment). Fixed dividends, if declared only as earned, would not fully protect investors against earnings diversion; nor would participatory preferred.

Acceptable Complexity

Preferred stock is fairly straightforward, although performance criteria and redemption formulas can make it complex. Securities laws must always be observed.

Reasonable Transaction Costs

Transaction costs for structuring and selling preferred stock are probably about average for issuing securities.

Minimal Non-Member Equity Legal Complications

In California and possibly other states, preferred stock issued to non-members, especially participating preferred, may potentially conflict with the consumer cooperative corporation statute. Coops organized as conventional business corporations should not have a problem.

Maximum Tax Opportunities

Dividends to investors would not be tax deductible, and investors would receive no special tax benefits from owning preferred stock.

If members hold the majority of stock and the majority of profits distributed are done so according to patronage, the ownership of preferred stock by non-

members probably would not affect the use of Subchapter T for patronage dividends. A fixed dividend would probably not be considered a distribution of profit.

Non-voting Common Stock

Features

Non-voting common stock is very similar to preferred stock, except that it is on par with rather than senior to voting common stock (member equity) for dividend payments and in liquidation. It would more typically be appraised at fair market value at redemption and would rarely have a fixed or cumulative dividend feature.

Example

In 1983, Economic Development, Inc. (EDI) was founded as a venture capital fund to finance worker-owned businesses. The fund invested in several Mississippi woodcutters cooperatives through non-voting common stock. EDI invested from $25,000 to $50,000 in each of three cooperatives. The financial objective was to obtain a 20% after-tax rate of return on investments.

The non-voting common stock had the following features:

- No voting control, but the fund could assume complete control of the coop if certain performance criteria were not met. In addition, control could be assumed if the employees took any action that the fund felt fundamentally jeopardized the nature, structure or long-term viability of the business. Performance criteria included:o productivity levelso regular, current payment of debto minimum cords of woods producedo adherence to approved budget
- Surplus cash was to be placed in reserve for stock redemption.
- No dividends were anticipated; redemption was to be at a formula price based on earnings.

The woodcutters cooperatives ultimately failed and EDI lost its investments.

Fit with Criteria

The fit of non-voting common stock with the established criteria is only analyzed below as it differs from the discussion of preferred stock, above.

Moderate Rate of Return on Investment

Common stock holders typically bear the most risk and therefore demand the highest return. However, common stock has less potential than preferred for regular dividends, since it would probably not offer a fixed or cumulative dividend and is not senior to member equity. The return on investment would be dependent on profitability. A redemption formula with premium potential could also offer a potential return on investment.

Limited Downside Protection

Common stock offers no downside protection to investors, but the stock agreement can include a transfer of control to investors if the coop becomes financially troubled.

Protection from Earnings Diversion

Common stock dividends would be subject to potential earnings diversion, as would a redemption formula based on profits. However, other redemption formulas are feasible.

Participating Debt

Features

Participating debt refers to a hybrid debt/equity instrument that is characterized as debt on the balance sheet but has some equity-like features. It has many similarities to preferred stock, but if characterized as a debt instrument, it may avoid the problem of outside ownership of a coop and the legal issues may be much more straightforward. It is also similar to an income bond[15], but with a variable interest payment.

Participating debt would include the following features:

- Subordination to all other debt and typically uncollateralized; as a debt instrument, it would be on par with other unsecured creditors in the event of liquidation
- Interest payments that may be cumulative in early or unprofitable years
- Variable interest feature tied to performance of the business (profits or other measures); may be a fixed premium payment triggered by performance (e.g., interest rate increases with increased revenues) or a fixed share of a performance-based measure (e.g., 20% of profits)
- Redemption at specified date or at option of company
- Redemption at face value (plus cumulative interest and dividends, if any), or redemption formula based on performance

Example

No consumer or worker cooperatives are known to have used participating debt, but cooperative theorists have designed such instruments for use by coops. Richard Cornwall[16], Jaroslav Vanek[17], Roger McCain[18], David Ellerman[19] and others have proposed variations on participating debt securities to be used by worker cooperatives to raise outside financing. These instruments were explicitly designed to avoid the perceived risk of workers increasing their wages and benefits and undermining profit-based returns to investors. Only Ellerman's proposed instrument will be described here, as it is the clearest example of a participating debt security for coops.

1. David Ellerman's Participating Debt Security

Ellerman's security was structured to:

- Circumvent potential earnings diversion
- Provide investors with a share in the upside potential of the coop
- Protect the coop against high interest payments in poor years and against giving investors high profits in very good years
- Provide the coop with tax deductions from interest payments

This instrument's special feature that avoids the siphoning of profits by workers is a variable interest payment tied not to profits but to the value-added by the workers, with value-added defined as total labor costs plus profits. This means that it doesn't matter if members leave profits as profits or take them as wages, because the investor's return is based on the total of labor costs and profits. The instrument designed by Ellerman has the following features:

- Fixed face value
- Fixed interest rate, below prime and payable semiannually or annually
- Regular variable interest payment geared to the value-added by labor; value-added would be calculated as revenues minus all non-labor operating costs including fixed interest on all capital. Possible formula:
- Variable payment equal to the value added by labor for that period that is in excess of a minimum value added, calculated as average value-added per member on the security issue date times the number of members on the payment date. The variable payment would cap at a percentage of the investment. The result is that the equivalent of any wage or benefit increases and any increased profit per worker are paid to the investor, up to a certain cap; the excess above the cap would go to the members.
- Variable interest may be cumulative or noncumulative
- Secured only by general credit of the corporation
- Fixed maturity or perpetual, perhaps with a call feature
- No voting rights

Although Ellerman and other proponents of participating debt had worker cooperatives in mind, a similar security could be structured for consumer cooperatives. In this case, the variable portion of the return would be based on profits plus discounts to members. (Of course, if the consumer coop has the flexibility to lower prices to members rather than offer discounts, it would be nearly impossible to protect against diversion of earnings.)

Fit with Criteria

Limited Control

One of the major advantages of debt securities to coops, and a likely disadvantage to investors, is the absence of voting or control rights. However, participating debt could have positive and negative covenants similar to conventional debt, and board seats could be negotiated.

Moderate Rate of Return on Investment

Because some upside potential exists with the variable portion of the return, there is the potential for investors to realize a higher return than on straight debt. The amount of upside potential would be less if there were a cap such as Ellerman recommends. One potential problem with the variable return as structured by Ellerman is that if it is earned based on wage increases rather than on profits, the cash available to pay the return may be decreased.

From the coop's perspective, the fixed interest portion of the debt would be an obligated payment, even in unprofitable years; however, it would typically be lower than a normal debt rate. The variable portion should be affordable, since it depends on the coop's performance (or in Ellerman's model, wage increases plus profits). A cumulative feature could make the payments more manageable. A moderate rate of return would be expected, since a portion of the return is fixed and the instrument offers higher preference in bankruptcy than preferred stock.

Defined Exit Strategy

If the security has a maturity date, that would

constitute a defined exit strategy. A sinking fund or a plan for staged principal payments would make the exit more feasible.

Limited Downside Protection

The fixed interest offers some downside protection. In addition, if the covenants are not met, the debt would be callable; however, this offers little protection since the coop would be unlikely to be in a position to repay the principal. It is possible to collateralize participating debt, but most coops pledge all available collateral to conventional debt.

Protection from Earnings Diversion

Ellerman's model is designed to eliminate the risk of earnings diversion by worker cooperatives. Other measures of return that are based on performance measures such as sales or production would also solve the problem.

Acceptable Complexity

Debt is generally much simpler to structure and understand than equity. A participating debt security can be structured in a fairly simple manner, although the variable return has the potential for complex formulas.

Reasonable Transaction Costs

Because it is a debt instrument, which has fairly standardized documentation, participating debt could be expected to have lower transaction costs.

Minimal Non-Member Equity Legal Complications

As a debt instrument, participating debt should avoid any legal problems of having non-member equity holders. However, depending on the features of the instrument, the IRS may characterize it as equity.

Maximum Tax Opportunities

Because interest payments are tax deductible, this instrument clearly has tax advantages for coops. The variable return should also be tax deductible if it is an obligated payment of the coop. However, care must be taken in structuring the instrument to ensure that the IRS will recognize it as debt and allow payments to be deductible.

Royalties

Features

A royalty agreement is a type of instrument typically associated with product development, but it can be adapted for any kind of business or project. The distinguishing feature of royalty agreements is that payments to the investor are based on sales, not profits, of the company.

Royalty agreements are neither debt nor equity; the instrument does not appear on a company's balance sheet. With a pure royalty agreement, the company would recognize the investment as revenue, which is a disadvantage because it potentially creates taxable income to the company. However, royalty agreements are typically used in combination with other investments. They can be combined with subordinated debt, where the royalty agreement serves as a type of "equity kicker". They are frequently used in combination with limited partnerships, where the investment is made in a partnership that has a royalty agreement with the company, which maximizes potential tax advantages.

Venture capitalist Arthur Lipper[20] advocates royalty agreements, which he terms revenue participation certificates, as the instrument of choice for investors in private companies. He prefers to combine revenue participation certificates with loan guarantees, in which the investor guarantees a bank loan in exchange for a revenue participation certificate. Royalty or revenue participation agreements are of particular interest to cooperatives.

Typical characteristics of royalty agreements are as follows:

- Royalty payments are made based on revenues, not profits. The agreement can be for total sales or sales of a particular product or department. Variations on structuring royalty payments include:
  - payments of a percentage of sales
  - payments of a fixed amount per unit sold
  - percentage of sales that increases (or decreases) over time or upon performance benchmarks such as sales levels
  - no payments or deferred payments until certain time or sales level
  - limited time period or payments in perpetuity
  - floor or cap on total payments, possibly varying depending on time period
- No voting power, although investor may have rights or impose covenants through separate instruments or agreements
- No collateral; however, investor may be given collateral rights to proprietary products or processes in R & D deals
- No residual interest in liquidation, except for any royalty payments owed (unless combined

with debt or equity)
- Payments are tax deductible to the company and taxable to the investor
- Royalty payments are assignable to third parties
- Unexpired royalty agreements may be subject to a call by the company at a predetermined price or may be convertible to some form of stock

Fit with Criteria

Limited Control

Royalty agreements have no inherent voting or control rights; however, there is nothing that prevents the parties from including covenants or board seats in the agreement. If the royalty agreement is combined with debt or equity it would contain the control provisions associated with those instruments.

Moderate Rate of Return on Investment

Because returns are tied to sales, the rate of return to investors is not affected by the frequently lower net margins of coops. Royalty formulas including floors and adjustments based on performance can further insure a targeted rate of return. When the agreement is combined with a limited partnership, tax benefits can add to the investors' return. When combined with debt, the investor would also receive interest payments.

From the coop's perspective, the fact that royalty payments are tax deductible makes them more affordable. On the other hand, because payments are made based on total revenue, the viability of the business may be jeopardized because the margins would be automatically lower than competitors' margins. Deferring payments until certain targets are met can mitigate this risk to the business. Royalty agreements probably would not be feasible for businesses selling commodity products or those with low gross margins.

Defined Exit Strategy

Royalty agreements have a variety of defined exit strategies. A pure royalty agreement may be self-liquidating, in that the investor receives back the investment plus return through the stream of royalty payments. Alternatively, the business may have a call on the instrument, which gives the business the opportunity to buy out its obligation to pay future royalties by paying the investor a predetermined price. (Typically, royalty agreements would have a call but not a put; however, a put would be an optional strategy.) A royalty agreement combined with a limited partnership would have the same exit options as a pure royalty agreement.

If the agreement is combined with debt, the loan would be repaid through amortization or a balloon payment, as specified in the loan agreement.

Limited Downside Protection

A pure royalty agreement has no downside protection except possibly collateral rights associated with proprietary technology. Combining the agreement with a loan or guarantee would provide investors with more downside protection; however, a loan of this type would typically be subordinated to other loans.

Protection from Earnings Diversion

Because returns are based on sales, earnings diversion is of no concern to investors.

Acceptable Complexity

A royalty agreement, even combined with a loan, can be a very simple instrument. The possibilities for complexity arise when it is combined with a limited partnership agreement.

Reasonable Transaction Costs

Transaction costs should be relatively low, unless the agreement involves a limited partnership.

Minimal Non-Member Equity Legal Complications

Royalty agreements, whether by themselves or in combination with a loan or limited partnership, avoid any legal problems associated with having non-member equity holders in a cooperative.

Maximum Tax Opportunities

Royalty agreements and loans with royalty agreements permit tax deductible payments to investors and tax deductible patronage dividends to members. In addition, limited partnerships with royalty agreements may offer tax benefits to investors. Thus, royalty agreements can provide significant opportunities to realize tax advantages. However, if the royalty agreement is not combined with another instrument, it could create taxable income for the coop, which would be a major disadvantage.

CONCLUSION

Comparison of Instruments

The following matrix summarizes how each instrument described above fits the established criteria. "Yes" means the feature is inherent in the basic instrument. "Possible" means it is possible to meet the criteria through structuring the instrument appropriately or through related agreements (e.g., the lease in a leasing partnership). "No" means the basic structure of the instrument does not meet the criteria.

CRITERIA	Preferred Stock	Nonvoting Common Stock	Ltd Partnership: Whole Business	Leasing Partnership	Participating Debt	Royalty Agreement
Limited Control	Yes	Possible	Possible	Possible	Possible	Possible
Moderate Rate of Return on Investment	Possible	Possible	Possible	Possible	Possible	Possible
Defined Exit Strategy	Possible	Possible	Yes	Yes	Yes	Possible
Limited Downside Protection	Yes	No	Possible	Yes	Yes	Possible
Protection from Earnings Diversion	Possible	Possible	No	Yes	Yes	Yes
Acceptable Complexity	Yes	Yes	No	Yes	Possible	Yes
Reasonable Transaction Costs	Possible	Possible	No	Possible	Possible	Possible
Minimal Legal Complications	No	No	Yes	Yes	Yes	Yes
Maximum Tax Opportunities	No	No	Yes	Yes	Possible	Possible

The analysis suggests that only two of the instruments do not meet sufficient criteria: non-voting common stock and limited partnerships that operate the business as a whole. Non-voting common stock is difficult to protect from earnings diversion, offers no downside protection and involves direct ownership of the cooperative by investors. Limited partnerships involving the business as a whole are much too complex and expensive to set up, are subject to earnings diversion and may offer too little control to investors.

The other four instruments are all feasible instruments for consumer and worker cooperatives, depending on how the instruments are structured and on the individual circumstances of the coop and potential investors.

Preferred stock works best when the cooperative is incorporated as a conventional business corporation or where state cooperative statutes explicitly permit nonmember classes of stock. The primary advantages are simplicity of structure, flexibility in control features and some opportunity for upside potential. The disadvantages are dividends that are generally either fixed or profit-based and are not tax deductible, and possible legal and tax concerns.

The level of control can be structured to meet particular goals. For example, the terms may include a "control flip", where investors may assume voting control if the coop violates certain covenants. The stock may be given upside potential through participating dividends or a performance based redemption formula. Cumulative fixed dividends would help avoid earnings diversion (but perhaps offer less profit potential), as would redemption formulas based on factors other than earnings (e.g., sales, multiple of invest-

ment). A put option or other mandatory redemption feature would be important, and a sinking fund would help ensure ability to redeem the shares.

A leasing partnership is useful when the coop requires fixed assets, particularly where the assets may be leveraged. The addition of a performance-based element to the lease payment offers an interesting possibility to add upside potential to the investment, particularly if the formula is not based on profits. The primary advantages of a leasing partnership are direct ownership of assets by investors (providing downside protection and avoiding direct ownership in the coop), potential tax benefits to investors, potential capital gain (if real estate), reasonably simple structure, tax deductible lease payments and avoidance of potential earnings diversion. The disadvantages include the need for current lease payments that may be unaffordable to developing coops. Thus, leasing partnerships are most appropriate for established businesses with reliable cash flow.

Participating debt is a model that has been proposed for worker coops for many years, but has never been used. This is probably due to the perceived complexity of applying a "value-added" formula. While participating debt does not offer control opportunities to investors, loan covenants and the threat of calling a loan provide some influence, and a board seat could be provided. Participating debt has the advantages of avoiding potential diversion of earnings, avoiding legal and tax problems of direct ownership, reasonable transaction costs, upside potential, possible exit through loan amortization or a balloon payment and probable deductibility of interest payments.

Royalty agreements offer interesting opportunities for cooperatives. The main advantages are no direct ownership of the coop, protection from earnings diversion, tax deductible returns, upside potential and a reasonable level of complexity and transaction costs. The disadvantages include virtually no downside protection, no control opportunities except through covenants (which may be difficult to enforce), payments that may be unaffordable to developing coops and the possibility of the coop having to recognize revenue. Deferred royalties would provide the coop some breathing room.

Combining a royalty agreement with a loan or a limited partnership would create a more attractive instrument, as downside protection, exit opportunities and control opportunities would increase, and the investment would not be characterized as revenue. The problem with this combination model is the increased complexity and transaction costs, particularly with a limited partnership.

These four types of financial instruments have the basic elements that meet the needs of consumer and worker coops and of investors. It should also be clear that the terms of a particular instrument are at least as important as the type of instrument. The choice of instrument and the particular features of an instrument will vary, depending on each coop's goals, structure and prospects and on the level of risk and type of return in which potential investors are interested.

Use of Instruments

Of the six instruments examined, four had been used by cooperatives, one (participating debt) had been adapted for use by worker cooperatives but never used and one (royalties) had not been used but is suitable for cooperatives. Three of the instruments had been used by worker cooperatives, but the study did not identify any consumer cooperatives that had used non-member equity. Of the four instruments that fit the criteria, only two—leasing partnerships and preferred stock—have been used by any type of cooperative (including agricultural).

It is unclear why consumer cooperatives have not used outside equity. It may be that they have greater access to debt due to the nature of the retail food business. Consumers also sometimes support their coops by providing loans, while worker coops have a much smaller membership to turn to and already require a significant amount of investment from members. It is also possible that consumer coops may have more of a bias against outside "ownership" than worker coops have.

Of the four worker coops profiled that used outside equity, three went out of business without returning any of the investors' capital. The fourth raised outside equity very recently and therefore does not yet have a track record of repayment.

While this is a discouraging finding, the sample size is very small, and experienced venture investors expect that a high percentage of the companies in which they invest will not succeed. On the other hand, consumer and worker coops often are in low margin industries (such as food), are small in size relative to other firms in their industry and have higher expenses due to commitments to customer and worker satisfaction and to cooperative education and decision-making. While some coops are able to turn their distinctive

features into competitive advantages that increase sales and profits, few coops can provide what most investors would consider market rate returns. Still, most coops have the potential to be financially successful and to provide socially oriented investors with at least some return on investment.

The key tasks facing consumer and worker coops interested in exploring non-member equity include:

- deciding what they can offer potential investors (e.g., rate of return, control, downside protection, etc.)
- deciding how much they can afford in transaction costs
- obtaining advice from professionals, especially attorneys, who have experience with cooperatives and with equity instruments
- educating their membership about the issues involved
- identifying potential socially motivated investors

After taking these steps, the cooperative should be able to decide whether non-member equity is appropriate and, if so, which type of instrument may work best for the coop and the potential investors.

Footnotes

[1] Wead, Rodney S. *The Neighborhood Cooperative: Economic Democracy in Low-Income Communities*. General Board of Global Ministries, The United Methodist Church, 1983; p. 41.

[2] See Shereff, Henry D., et al. "Funding Capital for Cooperatives by Joint Ventures with Non-Cooperatives", *Cooperative Accountant*, Fall 1981; pp. 40-53, and Evans, James. "Report of Subcommittee on Use of Subsidiaries by Cooperatives", *Cooperative Accountant*, Summer 1989; pp. 73-83.

[3] For a good discussion of control issues in venture capital, see Bartlett, Joseph W. *Venture Capital: Law, Business Strategies, Investment Planning*. NY: John Wiley & Sons, 1988; pp. 162-164, 204-205.

[4] Lipper, Arthur. *Venture's Financing and Investing in Private Companies*. Chicago: Probus Publishing Co., 1988.

[5] California Corporations Code, Sections 12200-12704.

[6] Legal Tax Accounting Memorandum Vol. XXVIII, No. 14, National Council of Farmer Cooperatives, December 21, 1978).

[7] Pillsbury, Katharine. "An Introduction to Limited Partnerships and Their Potential Use by Co-ops". Prepared for The Industrial Cooperative Association, May 1983 (Unpublished).

[8] See also Wanthal, Alvin E. "Report of Subcommittee on Capital Formation and Financial Structure of Cooperatives", *Cooperative Accountant*, Summer 1984; pp. 54-55.

[9] See Garoyan, Leon. "California's Contributions to Cooperation" Working Paper Series No. 1-A, Center for Cooperatives, University of California, Davis; July 1989.

[10] Shereff, Henry D. et al; op cit.

[11] For examples of preferred stock term sheets, see Bartlett, Joseph W., op cit.; pp. 179-190.

[12] In two cases in the State of Arkansas, the court found that two agricultural cooperatives had abused their discretion by failing to establish or implement adequate plans to redeem preferred shares: Driver v. Producers Co-op., 233 Ark. 334, 345, S.W.2d 16, 17 (1961); Collie v. Little River Co-op., 236 Ark. 725, 370 S.W.2d 62 (1963).

[13] See Matthews, Mary Beth. Financial Instruments Issued by Agricultural Cooperatives. USDA Agricultural Cooperative Service Research Report No. 68; March 1988.

[14] Wanthal, Alvin E., op cit.; p. 47.

[15] See Brealy, Richard & Myers, Stewart. *Principles of Corporate Finance*. New York: McGraw-Hill, 1981.

[16] Cornwall, Richard. "Sharing Risk in a Worker Cooperative". (Unpublished paper), Department of Economics, Middlebury College, 1982.

[17] Vanek, Jaroslav. *The Labor Managed Economy*. Ithaca: Cornell University Press, 1977.

[18] McCain, Roger A. "On the Optimum Financial Environment for Worker Cooperatives", Zeitschrift fur Natinalokonomie, 1977; 37(3-4): pp. 355-384.

[19] Ellerman, David. "Participating Debt Securities: A Marketable Risk-Sharing Instrument for Worker-Owned Firms." Industrial Cooperative Association, 1989.

[20] Lipper, Arthur; op cit.