

“Outside” Cooperative Equity: Obligations, Tradeoffs, and Fundamental Cooperative Character

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Three forces have converged in the last quarter century to cause significant rethinking about “traditional” cooperative finance. The first has been the realization that participation in value-added activities by cooperatives on behalf of their farmer members can or must supplant a defensive devotion to commodity marketing. The second force, growing from the first, has been new demand for large amounts of capital, capital that is either beyond the means of farmer patrons to provide or available only at a cost to farmers exceeding the returns expected from their use of the cooperative. The third force has been farmers’ changing views of cooperative capitalization as evidenced by their demands for measurable return on capital and for liquidity.

The consequences have been relatively new efforts by some cooperatives to obtain “outside” equity capital. Though very limited at present, this activity has led to a much broader consideration of cooperative fundamentals because cooperative incorporation statutes are viewed by some as “impediments” to such equity plans. Actions by a relative few have carried the issue into arenas that may have significant impacts on the cooperative form of business not only for farmer cooperatives but for those creating, using, promoting, and supporting cooperatives in all sectors of the economy. The prime example, discussed at this Conference, is a revision of cooperative incorporation statutes that have typically reflected a generally understood concept of what cooperatives are and how they focus on the economic returns to their users.¹ Given that cooperative statutes do reflect principles with which “outside equity” seems to be at odds, statutes may indeed pose challenges to such equity plans.

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¹ In Minnesota, the law is CHAPTER 105-H.F.No. 984; An act relating to cooperatives; authorizing businesses to organize as cooperative associations; providing penalties; amending Minnesota Statutes 2002, sections 80A.14, subdivision 17; 80A.15, subdivision 2; 322B.70, subdivision 1; proposing coding for new law in Minnesota Statutes, chapter 322B; proposing coding for new law as Minnesota Statutes, chapter 308B. Wyoming was the first to enact such a statute. The National Conference of Commissioners on Uniform State Laws (NCCLUSA) created a Study Committee on a Business Cooperative Act to address the possibility of developing a new cooperative law for State consideration. After meetings and discussions, the Reporter prepared a draft for the annual NCCLUSL meeting July 30 - August 6, 2004. By that time the effort had narrowed to agricultural and agricultural related cooperatives in a current proposal entitled “Agricultural and Agricultural Related Cooperatives Act.”

Issues Raised

Outside equity yields three views of cooperative finance that are at odds with traditional cooperative principles. The principle that cooperatives are financed by those who use them is challenged when equity capital can be invested by those who do not patronize the cooperative. The principle that the benefits of a cooperative are devoted to and distributed to those who use the cooperative in proportion to use is challenged by the assertion that investors in a cooperative demand compensation solely for their investment. The latter view also suggests that the value of the equity can be realized by equity transfers in market-driven transactions. The principle that cooperatives are controlled by those who use them is challenged by the explicit or implicit participation in cooperative control by those whose only relationship to the cooperative is that of investors.

From a broad perspective, these challenges draw into serious question the character of an organization as a cooperative or, even more fundamentally, the very definition of a cooperative. From the member-patrons' perspective, such challenges may create conflicting obligations, motivations, and governance issues that undermine essential rationales for a cooperative's existence and farmers' membership therein. For purposes of this paper, cooperative "fundamentals" will be defined as the set of relationships established by generally accepted cooperative principles. The analysis is intended as a useful end in itself but also as a contribution to the factual and analytical foundation required in debates about the identity, character, and importance of cooperative principles.

Objectives and Overview

This paper has four objectives: (1) Identify obligations that cooperatives have to holders of outside equity; (2) describe ways such obligations modify or conflict with fundamental cooperative principles, (3) identify and describe how such obligations modify cooperatives' objectives, and (4) describe how cooperatives' "generally expected" behavior toward member-patrons must be modified to meet obligations to holders of outside equity.

The paper first describes corporate and cooperative fundamental characteristics as generalized by statements of corporate and cooperative principles. A small working set of stylized outside equity situations is described to establish a framework for analysis. The paper then explores sources of obligations to holders of such equity and the general character of those obligations. The obligations are then applied to cooperative structures and practices to assess modifications that may be required of cooperatives to respond to the new situation. Finally, some implications for the cooperative character of organizations are discussed.²

² The general approach follows a stepwise process for research on cooperatives outlined by the author at the American Agricultural Economics Association conference in Denver, Colorado, August 3, 2004, in a presentation "Corporate Essentials and the Cooperative Firm."

Framework for Analysis

A Rights and Obligations Analysis

A direct resort to the rights and obligations established for all involved parties by the existence and characteristics of financing methods has several advantages.³ It focuses on those characteristics of relationships that are most likely to define behavior by the cooperative, management, and investors. It facilitates an analytical separation of various interests relevant to the relationships established. Similarly, a rights and obligations focus highlights conflicting interests that are resolved through a combination of negotiated specifications and economic objectives that are ultimately determined by markets.

The analysis simply takes the rights and obligations established by relevant legal relationships, identifies the interests affecting those rights and obligations, and assesses the objectives of each of the interests. The interplay of rights and obligations for each interest represented in the relationship establishes the economic motivation for behavior by those interests, suggests the economically driven strategies applied by all interests, and assesses the tradeoffs among all parties as they pursue their individual objectives given the rights and obligations set they have established and to which they are bound.

Outside Equity Described

For purposes of this study, “outside equity” is defined as having two essential characteristics. It is equity capital that is not contributed and owned by farmers who either currently patronize the cooperative or that have patronized the cooperative in the past. This eliminates capital that was contributed to the cooperative on a patronage basis at one time but that has not been redeemed to those who are no longer active cooperative patrons. Outside equity is invested by non-member, non-patrons with or without formal rights to participate in the control of the cooperative by vote or board membership. Such interests may be transferable by one holder to another at a privately negotiated price. The second characteristic is that outside equity is not invested as part of a patronage relationship but rather has the characteristics of an investment instrument. Thus stock issued to the general public but that is also purchased by a member-patron of the cooperative is considered “outside equity” because the relationship between the investor and the cooperative is that of investor-corporation, not primarily patron-cooperative.

Two types of equity demonstrate issues to be addressed. One is preferred stock and is treated as equity capital rather than debt capital.⁴ The example preferred stock carries no voting

³ Some analysts have generalized an analogous approach as “property rights” analysis. The present approach goes directly to the rights and obligations relevant to the issue.

⁴ While preferred stock is generally treated as equity, it has characteristics of a hybrid between debt and equity.

power other than that commonly assigned in corporate change situations (merger, dissolution), has a set rate of dividend established by terms of the stock ownership, dividends are payable prior to patronage refund allocation, the stock is callable by the cooperative under specified terms but stockholders cannot force redemption, and the stock is tradeable without restriction. A variant that carries voting rights based on stock ownership may also be considered.

The second type of equity is common stock that carries full rights to vote and participate in the cooperative⁵ but without preference on dissolution. Voting is on a share basis, no patronage is required, stockholders do not receive patronage refunds, dividends on the stock are declared at the option of the cooperative, stock is tradeable, and stockholders cannot force redemption. A variation of this example places limits on comparative voting power of holders of common stock who do not patronize the cooperative.

Stakeholders, Interests, and Objectives

Any person or entity who is in some way affected by the actions of a business entity is typically called a stakeholder. Precisely what the stake is in the business entity depends on the relationships developed. For purposes of this paper, the focus will be on interests rather than stakeholders, although the two may coincide. The difference between stakeholder and interest is paramount in cooperatives where one stakeholder, a member, for example, possesses multiple interests with respect to the cooperative entity. A cooperative member has the interests of a user (customer), the interests of an investor owner, the interests of one who has the rights and responsibilities of control, and the interests of one who will receive the benefits of the organization. Specific interests may be in direct conflict with each other. Where interests are in conflict but possessed by the same stakeholder, the individual stakeholder performs the task of balancing the interests, yielding decisions about his or her relationship with the cooperative given the stakeholder's aggregated set of objectives.

Where, on the other hand, a singular interest held by one stakeholder conflicts with an interest of another stakeholder, each with their own objective with respect to that particular interest, the process of resolving the conflict is quite different. It is at this point where the role of specific rights and obligations plays a central role. The struggle is no longer an internal issue for a stakeholder that is trying to determine what course of action is best given all of the alternative paths and the economic or other consequences of each for that stakeholder. It becomes an economic process that relies on external relationships, on inter-entity conflicts, on negotiated resolutions, and on market forces. Each stakeholder will make decisions based on his or her own peculiar interests. The set of actions that can be taken to advance each such interest is defined by the rights and obligations imposed on the inter-party relationship through which the interests are recognized and the stakeholders' actions express themselves.

⁵ The organization will be called a "cooperative" for purposes of discussion, although arguments may be made that this cannot properly be called a cooperative. This nomenclature eliminates the need for excessive, distracting quotation marks around the word cooperative or introduction of some new, likely confusing, terminology.

The fact that an interest exists, that is, that a stakeholder has one or more interests in the business entity through some association with that organization, does not define exactly what that interest is. More precisely, the fact that an interest exists and is recognized does not define either why the stakeholder has placed himself or herself in the position of having the interest nor the objectives of the stakeholder with respect to that interest. Interests and objectives apply, of course, to the business entity as well. The relative positioning of interest, stakeholders, and the firm itself play out in multiple markets, transactions, and strategies, all given the rights and obligations to which each player is subject. The business entity itself may be viewed as an independent set or as an aggregation of stakeholder interests and objectives.⁶

Organizational Principles

Every form of business enterprise rests on some set of generally understood principles. Cooperatives are no exception. Interestingly, however, cooperative principles are sometimes portrayed as unimportant, unworkable, unnecessary, of only academic or philosophical interest, and in some ways impediments to “effective” farmer-owned organizations. These debates are intimately tied into discussions of outside equity, particularly when combined with larger issues of member control, patron benefit, rapid and deep changes in the agricultural sector, cooperative limitations, and cooperative survival. For purposes of this paper, three generally accepted cooperative principles will be accepted as a statement of cooperative fundamentals. The issues then fall into considerations of (1) whether some principles are more important than others, (2) whether some modification of one principle can be offset by careful adherence to other principles, and (3) whether the use of outside equity of various kinds has significant impact (positive or negative) on one or more cooperative principles.

The ultimate subject of this inquiry is the corporate form of business. Corporate principles are sometimes listed as are cooperative principles, although not with the focus and attention devoted to cooperative principles.⁷ While formulations differ widely, a list of seven characteristics describes the corporate business enterprise form. (Cox Hazen and O’Neal, p. 6).

1. Shareholders are not personally liable for the obligations of the corporation other than to the extent they can lose the value of the equity owned.
2. The corporate entity has perpetual existence that does not depend on changes in the makeup of its shareholders.

⁶ The distinction in views is reflected in differing theories of the firm in economics and law. The latter view fits the theory of the firm as a nexus of contracts (*See* Baarda (2003), Jensen and Meckling, Alchian and Demsetz, Cheung, Klein, Hart, and Spence). The former fits entity, statutory, or production function theories (*See* Baarda (2003), Clark, Eisenberg, McChesney, Bebchuk, Coffee, and Kornhauser).

⁷ Corporate characteristics are important for a number of reasons such as Federal income taxation, limited liability, or financing purposes, among many others. This leads to specialized formulations that depend on the purpose for which principles are being used.

3. Corporations have centralized management implemented through the authority and actions of a board of directors.
4. Shares of stock or other interests in the corporation are generally freely transferable. This applies to publically held corporation but less so to close corporations. Close corporations restrict ownership and transferability for a number of reasons primarily through contractual agreements.⁸
5. The corporate business has access to debt and equity capital in a great variety of forms and in many markets. This capability to garner financing from many sources is one of the main advantages of the corporate business form and accounts for the growth of corporations, particularly in the latter part of the 19th century as business enterprise size and financial needs outstripped the capacity of individuals, families, or small consortia to provide adequate financial resources.
6. The corporate entity has most of the legal rights of an individual. It acts as a single unit to hold property, to contract, and to resort to the legal system to enforce its rights.
7. Many of the relationships among stakeholders are standardized by operation of corporate statutes giving stability and predictability to corporations, stakeholders, and those dealing with corporations. This standardization includes institutional stockholder and creditor protections.

As in the case of cooperative principles, several formulations of corporate characteristics are offered as summary descriptions of the corporate entity. For example, a list of four (Solomon, *et al.*) may include:

1. A corporation is a separate entity with perpetual existence. It exists apart from those who provide risk capital or who manage its business.
2. Liability for corporate debts is limited to the assets the corporation owns and does not extend to owners' assets.
3. The power to manage the corporation's business is centralized by delegation to the board of directors.
4. Stockholders can transfer their ownership interests to others without terminating the corporation's existence.

⁸ Cooperatives may have some of the characteristics of close corporations such as limited transferability. Implications of this are being studied elsewhere.

Given these few fundamental principles, an enormous variety of organizational characteristics can fit within the corporate fold. The importance of each principle is largely dependent on the circumstances that bring the principle into question.

Cooperative principles are an overlay on corporate principles, with some corporate principles being directly applicable but with others modified or eliminated by cooperative principles. Contemporary formulations of cooperative principles vary, but do not differ fundamentally from traditional principles.⁹ The most definitive set of principles has been developed by USDA. (Dunn). Modern cooperative principles are:

1. The User-Owner Principle: Those who own and finance the cooperative are those who use the cooperative.
2. The User-Control Principle: Those who control the cooperative are those who use the cooperative.
3. The User-Benefits Principle: The cooperative's sole purpose is to provide and distribute benefits to its users on the basis of their use.

Comparison of corporate principles and cooperative principles leads to several observations. For the most part, cooperatives have all of the essential characteristics of a corporation, the exceptions being unincorporated cooperatives or cooperative organizations using a limited liability company (LLC) legal form. Thus, the first five Cox formulation corporate principles are the same for cooperatives as for corporations. Two distinctions remain. The first is that cooperative corporations do not share corporate principles six and seven – corporations have a broad range of capital sources available to them and interests in the corporation are freely transferable. Neither of these differences is total, however. Cooperative corporations can, in fact, draw upon a wide range of capital sources in that they can borrow capital from a multitude of sources and can obtain equity capital from a broad range of individuals and businesses, their member-patrons. Sources of equity capital are not as extensive as those available to non-cooperative corporations, but cooperative corporations can access capital from multiple sources outside the firm and use it as a single entity, the same characteristic that defines a critical feature of the modern corporation. The pool of equity for cooperatives is simply more limited. This limitation is the impetus for outside equity.

Transferability carries a somewhat clearer distinction between a cooperative and a non-cooperative corporation because equity capital in a cooperative is limited to those who have an additional relationship with the cooperative. To maintain this requirement, cooperative membership is typically not transferable, although this is not an unvarying rule. In any case, the transferee must meet cooperative requirements such as a patronage relationship with the cooperative that collects multiple interests in the stakeholder transferee. To the extent that the

⁹ For background on cooperative principles as they have developed in the United States, *see*, Baarda (1986).

free transferability of equity in a non-cooperative corporation emphasizes the continued existence of the corporate body regardless of the precise identity of equity holders, cooperatives, too, carry this key corporate feature of ownership transferability.

A closer focus on cooperative principles indicates that little direct conflict exists between non-cooperative corporate principles and cooperative principles. Some of the essential organizational and operational characteristics defined in cooperative principles are simply not addressed in corporate principles as generally summarized. The user concept, for example, so essential to cooperative definition, does not appear in corporate principles. Users have no relationships to the corporate entity that require special recognition in general principles. A second group of relationships, those relating to control, are found in the centralized management corporate principle, but the actual specification of control through voting power, for example, comes only in more detailed organizational descriptions by statute and corporate documents.

Corporate principles, at least as summarized above, differ most from cooperative principles, also as summarized above, in the subject covered by the user-benefits principle. Nowhere in the corporate principles is the objective of the corporation specified, unlike the objective description in cooperative principles.

From Objectives to Obligations

Objectives are inseparably associated with sets of rights and obligations that define business-oriented relationships. In most cases a set of relationships defined by rights and obligations would not be created in the first place unless different stakeholders possessed objectives that the parties believe would be advanced by entering into relationships. Once the relationships are established, the rights and obligations define the parameters by which actions by all parties lead to collective and individual objectives.¹⁰

General Objectives of the Firm

Obligations to various interests by a business entity are derived from the organization's objectives. Where firm objectives define what the business organization must do to satisfy the objectives of the stakeholders possessing interests in the organization, the firm takes on obligations to those stakeholder interests. The corporate entity obtains its objectives in turn from the character of the organization and from the objectives of the interests represented by the collection of stakeholders. In a modern non-cooperative corporate entity, obligations are oriented nearly exclusively toward the stakeholders who stand in the role of stockholders.

Objectives of the Public Corporation

¹⁰ This is the basis for contracts, legal theory of contracts, and economic theory of contracts. For business entities, rights and obligations are either established by multiple contractual relationships (the nexus of contracts theory of the corporation is adopted) or by the institutionalized entity that defines rights and obligations, (non-contractarian, corporate entity theories of the firm).

The objectives of an incorporated business entity, owned by stockholders but an entity separate from them, are relatively easy to state. In the last two decades, stockholder value has become the central legally-mandated objective of corporate firms although the general law and economics view of corporations has long held that position. (*See* Baarda, (2003) and citations therein).

Simply defined from a financial point of view, “[t]he objective in corporate finance is stated, most broadly, as the maximization of firm value and, more narrowly, as the maximization of the stock price.” (Damodaran, p. 117). Several factors are intermediate between the value of the firm broadly stated and the stock price. The value of the firm differs from the value of the firm to its equity holders because a portion of the firm’s value is represented by liabilities. In addition, distinctions exist between the value of the firm, however defined, and stock prices. Stock price in an efficient equity market is assumed to be a reasonably accurate reflection of the value of the firm to its owners. Regardless of views or measures of firm value, firm value is focused solely on those who ultimately benefit from that value, the owners of shares of stock.

From a basic microeconomic viewpoint, the standard firm objective is profit maximization. This does not necessarily convert to an objective oriented toward maximizing the value of the firm to its owners, though a rather direct extension of the profit-maximizing objective would presumably yield that result. Nevertheless, where a firm is owned by a collection of stakeholders, profit maximization is a crucial element in the process of converting profit to firm value to owner value.

When we begin to consider the rights and obligations implicit in a business entity’s objectives, mere generalizations about what is economically or financial desirable fall short. Actual rights and obligations growing directly from objectives must be identified. The process begins with statutory and judicial mandates for objectives. The process continues by identifying specific situations in which business objectives focus on equity owner value in such a way that some aspect of the business entity can be forced to meet its obligations to stockholders. The interests of that group of stakeholders are recognized as a set of rights. The other side of the rights and obligations mirror imposes obligations on the business entity to engage in behavior that responds to the objectives of stockholder interests.

A general expression of the stockholder value mandate is found in direct statements of corporate objectives. This line of defining objectives relates directly to pricing and profitability decisions by the corporation. The larger question is whether a corporation is permitted to make deliberate pricing and operating decisions that do not maximize the value of the corporation to the stockholders. A classic statement on mandated corporate objectives and pricing practices was given by the Michigan Supreme Court in 1919. Henry Ford had decided that the Ford Motor Company would forgo special dividends to its stockholders for the purpose of reducing the price

of automobiles for the public benefit. The decision was challenged by the Dodge brothers¹¹ who owned stock in Ford Motor Company and whose returns on the stock and therefore its value would decrease because of Ford's decision. The Michigan Supreme Court held that the company could not implement that policy. The Court said:

it is not within the lawful powers of the board to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefitting others, and no one will contend that, if the avowed purpose of the [Ford] directors was to sacrifice the interest of shareholders, it would not be the duty of the courts to interfere.¹²

Mandated objectives to maximize the value of a corporation for the benefit of stockholders is also found in connection with incorporation statutes. Concerns with the stockholder benefit only view of corporations led to discussions of the issue in the context of corporate governance. What actions can be taken by those charged with governing the affairs of the corporation that may deviate from the stockholder-benefit objective? The issue was addressed by the American Law Institute's (ALI) corporate governance project of the early 1990s.¹³ ALI stated the overall objective principle and described three exceptions to the stockholder-interests-only rule in §201.

The Objective and Conduct of the Corporation

(a) Subject to the provisions of Subsection (b) ..., *a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.* [emphasis added]

(b) Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:

(1) Is obliged, to the same extent as a natural person, to act within the boundaries set by law;

(2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and

¹¹ The same Dodge brothers who subsequently designed automobiles and created the Dodge motor company.

¹² *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919).

¹³ The American Law Institute's Corporate Governance Project, while focusing on governance issues, addressed corporate objectives after more than a decade of sometimes heated discussions. The ALI published the *Principles of Corporate Governance: Analysis and Recommendations* in 1992.

- (3) May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

Sources of Obligation

The generally stated but specific corporate firm objectives just described lead to rights and obligations within the business entity and between the business entity and other interests. Rights and obligations are the methods by which the objectives are implemented with respect to distinct interests.

Explicit directives regarding the objectives of a corporation that carry the force of law bring us one step closer to establishing a set of rights and obligations between owner and firm. This paper considers only three conflict resolution situations in which rights and obligations are developed for corporate entities that (1) further define corporate objectives and (2) implement those objectives by defining rights and obligations between the corporate entity and its owners. The three examples are (1) non-owner constituencies, (2) the “agency problem”, and (3) conflicts among equity owners.

The fact that objectives for both cooperative and non-cooperative corporations exist and are defined in terms of interests outside the firms’ boundaries does not in and of itself define adequately the obligations in which we are interested. Obligations should be more carefully defined than resorting to the statements that a non-cooperative corporation’s mandated objectives are to maximize its value to equity holders and that a cooperative corporation’s mandated objectives are to maximize its value to its users. For purposes of this paper, the focus is on obligations to outside equity holders. As noted further below, the assumption is made that the cooperative’s obligations to outside equity holders are the same as those for outside equity holders on the part of non-cooperative corporations unless otherwise specified.

The obligations portion of our rights and obligations approach to this issue can be divided into two general categories. One category of obligations may be those that carry legal implications. Specifically, such an obligation would reflect a right that is legally enforceable. That is, if the cooperative did not meet the obligation, the holder of the interest in question would have resort to the judicial system to either enforce the obligation or obtain damages for the failure to satisfy the obligation. Such obligations may be established either by public laws or by the parties themselves on a contractual basis in private law.

A second type of obligation may be “softer” and not enforceable at law standing alone. Nevertheless, because cooperatives as well as other organizations are voluntary in nature, failure to meet obligations may have a significant impact on the organization regardless of the possibly unenforceable nature of the obligation. Moral obligations, obligations based on reasonable expectations, and those based loosely on underlying economic and legal theory of corporations are of this type.

The task in addressing obligations is two-fold. The first is to determine generally the obligations to investors using general corporate and contractual principles. The second is to

assess the extent to which, if any, the rules apply to a cooperative with outside equity in the same manner as for a non-cooperative corporation.¹⁴

Non-Owner Constituencies

The “non-owner” constituencies issue addresses the situation in which the corporate entity simply gives away some of its income or assets, thus removing either from the benefit flowing to owners. At one time charitable contributions were essentially prohibited because they were contrary to the mandated objective of the business. (Cox, pp. 63 - 66). Although the rules have changed to allow corporate giving for charitable, a strong theme remains that the donation of assets be connected to the corporation’s present or prospective welfare. Sufficient corporate benefit may be found even if the benefit might be indirect, long-term, or highly conjectural.

A source of considerably more corporate objectives debate involves so-called “constituency rules.” Objections developed to the legally mandated single-minded focus on stockholder value and stock price. It was clear to most observers that corporate behavior and strategies aimed solely at maximizing stockholder value could lead to behavior and strategies detrimental to others who might or might not be generally considered stakeholders. From an economic perspective, the stockholder-only rule established that all other interests were essentially external to the corporate interests. Some who recognized the problem argued nevertheless, and still argue, that any modification or expansion of a corporate stockholder-only objective would (1) undermine the well-being of the organization itself by imposing uneconomical burdens on the organization, (2) be detrimental to society and the economy as a whole by interfering with the market-based market system that allocates resources and responds to consumer needs, and (3) undermine the criteria by which the performance of the corporation and its management are measured in the financial markets. Those who believe that the corporation must recognize and respond to the interests of others in addition to stockholder interests argue that (1) the rights of stockholders to a maximized value is not inherently superior to the interests of others in society that may be harmed as a result of the single-minded pursuit of stockholder value, (2) the size and influence of enormous corporate interests throughout the world require that societies protect themselves by moderating corporate behavior, and (3) the size and influence of corporations have grown to the point where they are imbued with a public character and a public purpose justifying a requirement, or at least permission, to consider constituencies beyond stockholder value. (Mitchell)

Constituencies become an issue upon the occurrence of major corporate actions that will affect those who are not direct stakeholders in the corporation. The most common example occurs when a corporation considers a merger or dissolution that will have a negative impact on employees and the community. Various versions of constituency statutes say that the corporation is legally permitted to consider the interest of the employees and community even if a positive

¹⁴ It is important to note that the following discussion is couched in general terms only. For purposes of this paper a rigorous legal analysis is not conducted. Such is another project and the exposition would be very different indeed than the present observations.

response to their interests would detract from the singular maximization of value for stockholders. Other constituency statute versions require such consideration, although no statutes go so far as to impose a rule for balancing conflicting interests of stockholders with non-corporate interests.

For purposes of this paper, the teaching of constituency statutes is that absent specific legal authority of some kind the rule that the corporation is organized solely for the benefit of the stockholders and the corollary rule that the sole objective of the corporate entity is to maximize its value to stockholders will both hold. Constituency statutes frequently specify the objects of consideration and do not open corporations to behavior for any purpose whatever. The obligation of the corporate entity is clear, as are the rights possessed by stockholders to capture that benefit.

Conflicts Between Management and Owners – The Agency Problem

The agency problem has been a staple of corporate and business firm theory for some time in economic theory and plays an important role in corporate legal theory as well.¹⁵ Management behavior detrimental to the interests of stockholders is the subject of much current concern with corporate conduct, though sometimes not easily separable from the issue of improper behavior on the part of the corporate entity itself. In some cases the forum for dispute resolution is directed at the harm caused directly to stockholders, in others cases directed to harm caused by the behavior to the value of the corporation, and thus indirectly to the stockholders.

Behavior of the corporation itself toward its stockholders reflecting the mandated stockholder value maximization objective of the corporation is found also in reorganization situations such as mergers and consolidations. In a second typical situation, the behavior of management is scrutinized to see if management's actions have caused harm to the value of the corporation to its stockholders. Third, the considerable litigation based on Federal securities laws or state blue sky laws is founded on the rights of stockholders to information from the

¹⁵ See Baarda (2003). Solutions to the separation of ownership and control problem (Berle and Means) engendered several theories of the firm.

Ownership and control issues have directly and indirectly raised a number of issues in law and economics that have been developed into firm theories. The most well-known is the principal-agent model of the corporation in both law (Easterbrook and Fischel, Brudney) and economics. (Fama, Fama and Jensen, Jensen and Meckling). Generally, the principal-agent model has led to two themes in the literature. One theme is that the central issue in corporate law and economics is to reduce agency costs by devising methods to keep those controlling the corporation true to the task of managing the firm for the benefit of the owners – the stockholders. A second theme is that the primary goal of the public corporation should be to maximize shareholders' wealth. That principle leads to the question of relative positions of firm owners and resource owners. (Greenwood).

corporation that will make their decision-making process an informed one on the premise that stockholders can only realize the value of their ownership interest in the corporation through an efficient and honest market place. In all of these situations, the thrust of the rights and obligations defined in the legal conflict is ultimately the obligation of the corporate entity to maximize its value to its stockholders in such a way that the stockholders can use the market place to realize the value of their ownership in the corporation.

Conflicts Among Equity Holders

Internal stockholder conflicts may exist in a corporation having both common stock and preferred stock. Stockholder conflicts may also exist in corporations that have only holders of common stock. The outside equity hypothesized for purposes of this paper include both. A brief discussion of the nature of the obligation to outside equity holders represented by preferred stock and common stock notes the characteristics of such a conflict.

Certain transactions may pit the interests of the voting common stockholders against holders of preferred stock. This may occur whether or not holders of preferred stock have the right to vote on a particular action such as merger that affects them.

The “hybrid” character of preferred stock between debt and equity has been noted. An additional distinction between preferred and common stock exists in the relationship between the corporation and stockholder. The corporation-preferred stockholder relationship is often referred to as “contractual” rather than purely ownership in nature. (Mitchell and Solomon). A purely ownership characteristic carries with it a fiduciary obligation on the part of the corporation to preferred stockholders. A purely contractual character does not carry such a fiduciary level of obligation.

A fiduciary relationship may be found between a corporation and holder of preferred stock although some courts are reluctant to raise the level above that of contractual obligation.¹⁶ To resolve the problem, some courts have resorted to a split duty assignment. To the extent that the issue involves the preference, it is treated as a contractual relationship only. Where the issue is one of ownership similar to that of the common stockholders, the fiduciary duty of the corporation to stockholders applies.¹⁷ In either case, the corporate entity owes holders of preferred stock obligations that are measured at a high level of duty, whether completely fiduciary or not. Numerous obligations cannot be ignored simply because holders of preferred stock may not have a specific right to vote on an issue at hand.

Where a cooperative has members who own common stock but do not have a concurrent patronage relationship with the cooperative, two distinct interests are created among holders of

¹⁶ For example, *Dalton v. American Investment Co.*, 490 A.2d 574 (Del. Ch. 1985), *aff'd*, 501 A.2d 1230 (1985).

¹⁷ *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584 (Del. Ch. 1986).

common stock. For the publically traded corporation, remedies for dissatisfaction with corporate practices or with the value of the corporation to the stockholder are easy – sale of the stock.¹⁸ If a portion of common stock representing membership in a cooperative is held by patrons whose interest is in the benefits the cooperative provides through the use of the cooperative according to cooperative principles, sale of stock is not simply that of an investor seeking more lucrative returns on invested capital. The entire relationship deemed beneficial by the patron comes to an end. Conversely, holders of common stock whose only interest is as an investment may be harmed if actions are taken by patrons, also holders of common stock, undermining the value of stock.

The situation described is somewhat analogous to the position of minority stockholders in a close corporation. A close corporation is commonly characterized by a combination of control, ownership, and management in a relatively few owners.¹⁹ In most cases, the relationship is formalized by contractual arrangements on management and control going beyond simple ownership of common stock. These relationships along with contractual constraints may result in a minority stockholder group that has no meaningful way to avoid oppression by the majority because no ready market for the stock exists.

The relative position of owners in close corporations has been addressed by imposition of fiduciary duties on those who have the power to make decisions that can harm minority stockholders. As stated by Cox:

[M]ost modern courts have accepted the principle that the controlling shareholders as well as the directors and officers owe a fiduciary duty to other shareholders – to public shareholders in a publicly held corporation to minority shareholders in a close corporation. Some courts have gone further and have held that persons in control of close corporations owe an especially strict fiduciary duty to minority shareholders – a duty said to be similar to the duty that partners owe each other and more stringent than the duty shareholders in a publicly held corporation owe to each other.²⁰

Where outside equity is held in the form of preferred stock, the cooperative's obligation is defined by the terms of the documents with an overlying degree of fiduciary duty, although circumstances may vary the degree somewhat. Where outside equity is held in the form of common stock not meaningfully distinguishable from common stock representing membership by patrons who look to patronage-based benefits from the cooperative, two circumstances create a special level of obligation. The most common would be where the outside equity holders are the minority stockholders in which case the majority (member/patrons) must take care not to

¹⁸ Assuming no fraud or other impermissible actions that undermine the market process through which stockholders seek relief.

¹⁹ For a general discussion of close corporations, *see* Cox, pp. 358 - 394.

²⁰ Cox, p. 393.

oppress the minority. The other case would be where the outside equity holders of common stock are in the majority in which case the member/patrons would be a minority.

Expectations play an important role in determining what actions qualify as oppressive. (Cox). Where actions of a majority lead to a defeat of the “reasonable expectations” of minority stockholder interest, courts may measure the expectations by objective standards and determine that such actions are oppressive. Expectation principles are not uniform and different courts will apply the rule on a case by case basis.

Privately-Defined Documents

Rights and obligations that define an ownership interest in an entity are largely created by the entity itself and are described in various documents that the entity produces. While articles of incorporation, bylaws, policy statements, board minutes, resolutions, and other documents may describe relevant rights and obligations, direct review of the document evidencing stock ownership is most instructive.

Obligations Inferred by Other Relationships

Obligations that are not legally enforceable may nevertheless be potent forces in a cooperative’s relationship with outside equity stockholders. While the consequences of not satisfying such interests’ needs may not subject the cooperative to a legal mandate to do so, the business, personal, and economics consequences of such behavior may be significant in both the short run and the long run. One source of such obligations may be the expectations of stockholders for compensation for their investment regardless of the cooperative’s legal obligation to them. Certain economic principles may underlay obligations to outside equity holders. Finally, the cooperative may face a moral obligation to give compensation to outside equity holders based on the dynamics of the community or the circumstances surrounding the investment. While these may be important for some purposes, they are not discussed further.

Application to Cooperative Corporations

The three perspectives of the mandated objective that a corporation maximize the value of the corporation (and derivatively the market share of the stock) are instructive when cooperative corporation obligations to outside equity holders are considered.

First, the central objective of the corporation, indeed the same central objective, is expressed in law, economics, finance, and management. All require that the corporation focus its efforts on enhancing the value of the organization for the benefit of those who own it in relation to their ownership interests. An obligation is imposed on the corporation to conduct its business affairs accordingly. Correspondingly, ownership interests, represented by stockholding, have rights to expect such activity on the part of the corporation in which they have an ownership interest. To some degree, therefore, those rights can be enforced to make the corporate entity meet its corresponding obligations.

Second, deviations from the central objective are permitted, but such deviations are defined and limited. For example, the corporation is required to obey business laws applicable to it even if under some circumstances the value of the corporation to stockholders is diminished because of that obedience. The corporation also “may take into account” ethical considerations appropriate to the responsible conduct of the business. The more general window of leeway for deviation from the strictly stockholder value maximization mandate is that of the public interest or philanthropic purpose. According to the ALI commentary noted above, a “reasonable amount” may be devoted to this purpose, presumably amounts that would otherwise enhance the interests of the stockholders.

The third instructive perspective is that all of the deviations from a mandated owner value maximization are based on an explicitly public interest. In none of the “alternatives” to strict value maximization requirements are other private, competing, or profit-seeking interests included. Indeed, in instances where expenditures are made for public or charitable purposes that in fact represented significant private interests, the stockholder primacy rule trumps the exception.

A survey of corporate objectives shows that very few interests are involved in the process of defining corporate objectives. The corporation’s own objective is quite simple – maximize value for the shareholders. The only “outside” interest, that is, an interest not within the boundaries of the corporate entity because the investors are themselves entities, are the owners represented by stockholders. The objectives of those interests is likewise quite straight-forward – to maximize the returns on their investment. This for most purposes is one and the same with the objectives of the corporation.

Cooperative Objectives

Cooperative objectives have been the subject of inquiry for many years and continue to be of interest for cooperatives given changes in perspectives and fundamental perceptions of cooperatives. Cooperative objectives are inherent in much cooperative theory, though not always explicitly addressed.²¹

Review of corporate principles reveals no organic statement of corporate objectives. As shown in the previous discussion, corporate objectives have been developed derivatively. Corporate obligations derived in turn from the objectives are the focus of the development, given that the objectives discussion is intended to draw rights and obligations into relief for purpose of this paper. Unlike general corporate principles, cooperative principles directly and explicitly address objectives. In large part cooperative principles are the objectives. Cooperative principles can be used as statements of the cooperative corporation’s entity objectives.

²¹ Extensive literature on cooperative theory as it may relate to objectives is not reviewed here. Research is underway to revisit the issue of cooperative objectives.

The objectives of a cooperative corporation are oriented differently, but in totality are only somewhat more complicated than those of a non-cooperative corporation. Cooperative objectives can be distinguished from non-cooperative corporate objectives in two regards, though in broad perspective the objective of a cooperative is to maximize its value to a single group of “outside” interests as well. It is (1) the identity of this “outside” group and (2) the nature of the cooperative’s value that define the distinguishing features of a cooperative. The implementation of such peculiarly cooperative objectives is reflected in cooperative principles just as corporate objectives are reflected in corporate principles.

While a comparison of cooperative and non-cooperative corporate objectives is necessary for purposes of this discussion, a thorough analysis is not. When a cooperative possesses outside equity the relationship between the cooperative and investor becomes just that, an investment relationship. This relationship then defines the obligations of the cooperative to the outside investor interests, and the cooperative must behave as a non-cooperative corporation at least with respect to those interest. The cooperative takes on some degree of corporate objective to maximize the corporate entity’s value to investors as investors, as those objectives were outlined above for corporations.

The fundamental cooperative, non-cooperative distinction is that the cooperative’s objective is oriented entirely toward user interests rather than entirely toward investor interests. This summary, of course, does not reflect the complications of such arrangements which are, indeed, different than the rubric used to define corporate objectives. The three cooperative principles are descriptions of objective implementation. However the cooperative’s corporate objectives may differ and however they are defined by cooperative principles, the fundamental statement of cooperatives’ objective is as simple and as powerful as is the statement of corporate objectives. Non-cooperative corporations generate value to their investors as investors – cooperatives generate value to their users as users.

The second distinction between cooperative and non-cooperative corporations resides in the identity of the interests to which the two types of entities are responsible. The interests to whom the corporate entity owes its objectives are singular – the investor. In a cooperative, the user interest to which the cooperative owes its sole allegiance (and existence) is necessarily and inseparably combined in member entities with the investment interests. The combination of user interests and investment interests exist in the same entity – the member – whereas in a non-cooperative corporation the interests of users are separable and not part of the central corporate objective. A similar distinction separates or combines non-investor control in a cooperative corporation. Objectives of user interests and investment interests most likely diverge. In a non-cooperative corporation, only entities holding investment interests are relevant to corporate objectives. In a cooperative corporation, to the contrary, the entities with user interests also have investment interests. Any divergence of these two interests is resolved by the entity and the resultant is conveyed to the cooperative corporate entity by a single stakeholder representing all interests. Needless to say, different entities may conduct the internal balance quite differently

and resolutions presented to the cooperative will not be the same for every entity. This leads to a decision-making process within the cooperative to balance member/patron interests.²²

Applicability of Corporate Rules to Outside Cooperative Investor Interests

To this point the assumption has generally been made that to the extent that the cooperative-outside investor relationship is similar to that for corporate-outside investor relationships, the obligations will be similar for the cooperative corporation as for a non-cooperative corporation. Several examples show how outside investment is distinguished from other investment in a cooperative and emphasizes the non-cooperative corporate basis for the cooperative-outside investor relationship. One such example is the fundamental definition of a security for purposes of the securities laws. The purpose here is not to discuss the consequences of securities law application to a security issued by a cooperative (though it is of critical and considerable importance when securities laws do indeed apply) but to note the relationships distinguishing outside equity investment from cooperative-based investment.

The United States Supreme Court considered the problem of membership stock in a housing cooperative in *United Housing*²³ when deciding whether cooperative membership stock is a security for purposes of Federal securities laws. The Supreme Court decision included four principles of importance to cooperatives that issue outside equity. The subject of securities laws and the protection they are intended to afford investors are based on the existence of equity markets. Equity requiring protection is a tradeable commodity the market value of which determines the value to owners.

The primary purpose of the Acts of 1933 and 1934 was to eliminate serious abuses in a largely unregulated securities market. The focus of the Acts is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchanges on which securities are traded, and the need for regulation to prevent fraud and to protect the interest of investors.

The Supreme Court in *United Housing* also focused on the “economic realities” of the transaction, not the name noting that “[b]ecause securities transactions are economic in character Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto.” Quoting from an earlier Supreme Court case,²⁴ the Court said that “in searching for the meaning and scope of the word ‘security’ in the

²² It should be explicitly recognized that the interests of corporate investors are not homogeneous by any means. Changes in control, takeovers, mergers, consolidations, deadlocks, and dissolutions are only a few examples of inter-investment, intra-stakeholder interest conflicts leading to major changes in the corporate entity.

²³ *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975).

²⁴ *Tcherepnin v. Knight*, 389 U.S. 332 (1967).

Act[s], form should be disregarded for substance and the emphasis should be on economic reality.”

Motivations for the purchase of an equity interest in a corporation are of prime importance in distinguishing an equity interest in a cooperative by member/patrons from an equity interest in any corporation, cooperative or not, based on a return on investment. Again citing previous opinions, the Supreme Court in *United Housing* said:

This test, in shorthand form, embodies the essential attributes that run through all of the Court’s decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. By profits, the Court has meant either capital appreciation resulting from the development of the initial investment ... or a participation in earnings resulting from the use of investors’ funds... . In such cases the investor is “attracted solely by the prospects of a return” on his investment. ... By contrast, when a purchaser is motivated by a desire to use or consume the item purchase ... the securities laws do not apply.²⁵

The lessons from judicial decisions discussing securities and investments for purposes of this paper are that (1) economic realities determine the relationship between a corporate entity and its investors, (2) where economic realities determine that the relationship is a corporation-stockholder one, not an inherently cooperative relationship, the security is subject to market forces, and (3) the protections needed for investors generally will be applied to investments that meet the criteria for a market based investment. The character of an outside investment instrument issued by a cooperative depends on the economic realities of any corporate-stockholder relationship. The economic realities of outside investment in a cooperative are no different from investment in a non-cooperative corporation.

Miscellaneous judicial and administrative decisions have also emphasized the difference between a cooperative relationship and a purely corporate-stockholder relationship, though addressing member/patron issues rather than securities issues. While the decisions apply only to the subject matter of the case, general statements enforce the premise that a clear distinction exists between member/patron investment and outside investment in a cooperative. Two miscellaneous examples for tax law are noted more for their language than content.

The 5th Circuit Court of Appeals²⁶ discussed a failed attempt to obtain cooperative tax treatment for owners of a cement production operation by assigning ownership of the cement to the firm’s owners. The Court distinguished clearly between a patronage relationship and a stockholder relationship. The district court had held:

²⁵ The rules were applied to an agricultural cooperative in *B. Rosenberg and Sons, Inc. v. St. James Sugar Cooperative, Inc.*, 447 F. Supp 1 (1976).

²⁶ *Mississippi Valley Portland Cement Co. v. United States*, 408 F. 2d 827 (5th Cir. 1969).

There is nothing in the method of doing business by the taxpayer in this case that distinguishes it from the average or normal corporation doing business for profit, no matter that the taxpayer is called a cooperative, or that the dividends to stockholders are referred to as patronage rebates. Other characteristics of this taxpayer akin to that of a corporation for profit are that the dividends were payable only to stockholders of record at the end of each fiscal year, leaving stockholders, who might have sold their shares prior thereto, with no entitlement to a rebate on the basis of earnings during the fiscal year; and the fact that, as stipulated, actually no stockholder used the cement produced. ...

It is the opinion of this Court, after carefully scrutinizing the structure of this taxpayer and its method of doing business, that it was not doing business with its consumer patrons or assigns in the historical sense of a consumer cooperative, but that its stockholders are in no different category from that of any corporation interested in profits, no matter whether the source of that profit be from the production of cement or any other product, and that accordingly the sums paid here are not excludible from taxable income.

The Circuit Court said “[w]e have lifted the cooperative veil and have unmasked the economic realities of these transactions.” It went on to say:

The only thing these shareholders had in common was an investment in what they hoped would be a money making venture, and in this respect their relationship to each other and to the corporation was no different from that of shareholders in any other publically held corporation.

The IRS applied *Mississippi Valley* and reached a similar conclusion in a case involving poultry integrators.²⁷ It said:

The functions performed by the taxpayer are consistent with a corporation-shareholder relationship but not consistent with a cooperative-patron relationship. There is no business or economic reason to sell the chicks to the member-shareholders other than to try to secure for the member-shareholders the status of a patron. The member-shareholders are nonessential links to the outside and not consumers of the corporate products. In reality, the taxpayer's method of doing business is indistinguishable from the normal corporation doing business for profit, even though the taxpayer calls itself a cooperative. Any distributions to the member-shareholders are merely dividends paid to its shareholders.

Outside investment in a cooperative brings with it two significant modifications of the user-only, value enhancement cooperative objectives. First, the investment interest is distinct and separated from all other interests. It stands with a single objective with respect to the

²⁷ Revenue Ruling 82-51, 1982-1 C.B. 117.

cooperative, and the cooperative addresses only that interest in its dealings with the investor entity. Second, the cooperative stands in the same position as a non-cooperative corporate entity with regard to the investor interest. Its objectives with respect to the investor become those of a non-cooperative corporate entity rather than a cooperative entity. Specifically, to the extent of the outside investment, the cooperative maximizes its value to the outside investment interest rather than to its users.

Given this, the obligations of a cooperative corporation to outside equity holders can be analyzed in terms of the obligations of a non-cooperative corporation. Obligations to corporate equity holder, thus to holders of outside equity in a cooperative, revolve around two measures stockholders use to extract value for their ownership in the corporate entity. Using total stockholder returns (TSR) as the central measure of the corporations value to its stockholders (the value to be maximized as the corporation's objective), a corporation maximizes its value as judged by capital markets and maximizes monetary returns to stockholders. The two are inseparable with both complimentary and opposing effects. Specifically, obligations imposed on a cooperative may include:

1. A requirement that something be paid as a return on equity to the investors,
2. The organization operate in such a manner to generate funding to make such payments,
3. The organization maintain a capital structure that protects the equity-holder interest, and
4. The organization conduct its affairs in such a manner as to enhance the value of the organization and derivatively the value of stock held by investors.

These four obligations can be used to identify cooperative practices that may require modification when a cooperative obtains outside equity and the obligations that come with it.

Applications and Implications Considered – A Brief Survey

Implications of the obligations imposed on a cooperative by outside equity can be seen in five situations roughly associated with cooperative principles. The five are: Operating and pricing strategies, allocation and distribution of benefits, financing and strategies, governance, and secondary implications. Each of these is deserving of thorough analysis, but only a brief note on each will suggest the significance of this approach to outside equity and cooperative fundamentals.

Selected Operating Strategies

The user-benefits cooperative principle provides the first, most comprehensive framework for discussing applications and implications of outside equity. The user-benefits principle entails two processes, though not always clearly separable. The first is the method used

to generate benefits. The second is the allocation and distribution of that benefit in whatever form it takes. In these processes, particularly in the allocation and distribution process, the cooperative, non-cooperative corporate distinctions are stark. The first is discussed by addressing a selected few operating strategies. The second is described in the following section on the distribution of benefits.

The effect that obligations to outside equity holders have on a cooperative's operating strategies depend, of course, on the extent of such obligations. In this section, we consider a few selected operating strategies that may be affected by obligations to outside equity holders. The discussion is necessarily broad each topic is deserving of more detailed economic and business analysis. In keeping with the theme of the paper, the general approach is to inquire if obligations to outside equity holders might modify operating strategies that would otherwise be possible for cooperatives to meet cooperative objectives.

Pricing and Profitability

Generation of benefits to patrons by a cooperative may include pricing practices that give a better price to patrons at the expense of overall cooperative firm profitability. In the extreme, a cooperative may price so as to cover all costs and expenses but to yield no net margin. Benefits are created directly by the pricing practice rather than through generation of net margin with subsequent allocation to patrons. To the extent that equity holders are compensated solely from the disposable income generated by the differential between total revenue and total costs, the described cooperative pricing practice eliminates the source of funding for compensation to equity holders. This same effect is felt by member/patrons, of course, but the benefits of the pricing practice are obtained directly by the patrons through advantageous prices.

The cooperative's ability to use this pricing method to generate benefits for patrons may be restricted by the cooperative's obligation to outside equity holders. The cooperative may not be able to strategically price where the pricing strategies reduce funding sources for outside equity holders. This does not mean that the cooperative cannot generate benefits for patrons. If the cooperative prices in such a manner as to generate a margin, a portion of that margin can be allocated and distributed to patrons as a refund after the fact. The exact portion will depend on the level of claims that the outside equity holders have on the cooperative's funds. However, to the extent that obligations to outside equity holders require margins for payments to such equity holders, the cooperative's pricing strategies are limited.

Profit Maximization and Economic Theory

More generally, the pricing issue is a part of a larger view. Cooperative theory has addressed pricing and other practices in various ways. An optimization strategy is determined based on the firm's objectives as a cooperative organization, taking into account its economic obligations to member/patrons. The optimization position for a non-cooperative may be quite different. To the extent that the cooperative firm is obligated to maintain some modicum of a non-cooperative corporate optimization on behalf of and because of outside equity holders' rights, the cooperative's optimizing behavior must be modified with second best behavior.

A more generalized concept relates to the overall objectives of a cooperative that may go beyond services that are measurable in strictly economic or accounting terms. Cooperatives may have objectives that go well beyond simple profit maximization or even solely economic activities. The question then arises whether obligations to outside equity holders restrict those perhaps unmeasurable objectives because the obligations are based on the economic/accounting performance of the corporate firm.

Valuation and Value Maintenance

Based on corporate objectives, whether mandated or expected, maximizing the value of a non-cooperative corporation will differ from maximizing the value of a cooperative corporation. The obligation to maintain corporate entity value depends on precisely what gives value. The more direct provision of value to equity holders is the receipt of income as a return on their investment, income generated from the corporation's operations. A second and critically important source of value for corporate stockholders is the market value of the stock. This value depends on a number of factors but most importantly for purposes of this analysis on the value of the corporate entity as an investment. Net earnings generation levels and stability, retention of net earnings to increase the entity's book value, and strategic factors such as growth combine to determine the value of the corporation as measured by stock value.

Cooperative practices that maximize its value to member/patrons as users of the cooperative may be limited by obligations that the cooperative has to maintain stock value for outside equity holders. To the extent that net margins (generated from business done with or for the patrons on a patronage based) are distributed to holders of outside equity rather than to patrons on a patronage basis, the value of the cooperative to its member/patrons is diminished. A somewhat more difficult problem is presented where the cooperative organization must not just share its annual net margins among outside equity holders but must maintain the overall stock price for the benefit of the outside equity holders.

Scope and Choice of Market Participation

If we assume that the objective of a corporate entity is to engage in activities that maximize its value, including returns to investors, then the scope of its activities and the choices of market participation becomes objects of an obligation. The corporation makes investments and engages in the kind of business that maximizes stockholder value, business that may change significantly over time. In addition, if this basis for obligations to equity holders extends to cooperatives who have obligations to outside equity holders, cooperative strategies regarding the scope of their activities and their participation in markets that are contrary to this objective may be limited. If that limitation reduces the cooperatives' objectives to benefit solely its member/patrons as users, the cooperative is restricted by such obligations.

Free Cash Flows

One of the broader measures of businesses is based on free cash flows. These are generally cash flows remaining after specified obligations are satisfied. Free cash flows to the

firm are cash flows before required payments to compensate for debt capital. Free cash flows to equity are cash flows available after compensation to providers of debt capital. For cooperatives with outside equity holders, the free cash flow to the outside equity holders requires reduction of total cash flow by amounts that would otherwise be dedicated to users on the basis of their use. The question then is whether the cooperative with outside equity must modify its commitment to users to provide free cash flow the benefits of which are captured by outside equity holders.

Non-Patronage Source Income

Cooperatives engage in business done with or for patrons as they conduct business on a cooperative basis. While this terminology is drawn from Subchapter T of the Internal Revenue Code, the principle is fundamentally cooperative. It captures the essence of the cooperative user-benefit principle – the sole purpose of the cooperative is to generate benefit to its users in proportion to use.

Cooperatives may also generate income from business that is not conducted with or for patrons. When this occurs, the cooperative has several choices about what to do with the net income generated from that business. Generally speaking, after taxes are paid on the non-patronage source income, it is available for the cooperative to use as it sees fit or return it to patrons on the basis of patronage (but not as a patronage refund). Importantly, it can be made available to outside equity holders as dividends on capital stock. The main issue presented here is whether the existence of outside equity places any obligations on a cooperative to generate more non-patronage source income.

Two possibilities for this pressure exist. First, the non-patronage income may be a source of funds for returns on equity. If no non-patronage source income were generated, any payment to outside equity holders would need to come from income that could otherwise be returned to patrons on a patronage bases. Only by engaging in activities that produce non-patronage source income can the cooperative compensate outside equity holders for their investment without raiding the funds that would otherwise be available for distribution to patrons on a patronage basis.

The second pressure to increase non-patronage income business is based on the obligation of the cooperative to maximize its value to outside equity holders. Non-patronage income may be retained by the cooperative as retained net earnings, thus adding to the cooperative's equity base. This practice may be viewed positively by outside equity holders as a hedge against losses in case of dissolution or bankruptcy. More generally, as the equity base increases, the cooperative's capital structure may be viewed as positive in the capital markets, thus increasing the market value of stockholders.

Allocation and Distribution of Cooperative Benefits

The user-benefit principle describes distribution of benefits on a patronage bases. Margins distributable to those who purchase from or through the cooperative or who sell to or through the cooperative are allocated to users in proportion to their use of the cooperative.

Equity ownership in the cooperative is not a factor in determining distributions. To the contrary, any income allocated to outside equity holders must necessarily be allocated on a basis other than that of use. Allocations to holders of outside equity are typically based on the relative amount of equity held.

Discussion of allocation and distribution cannot be clearly separated from the fact of benefits generation noted in the previous section. Four considerations are relevant to the purposes of this paper. The complete distinction in allocation methods is quite obvious. Distinctions are also seen in the relational structures of cooperative, patron, and outside investor. Timing differs in allocation and distribution. Finally, the variability of benefit generation and distribution is an important consideration.

Benefits Allocation

Two processes falling within the general concept of allocation relate to obligations to outside equity holders. The larger issue is the proportion of benefits that would otherwise be allocated and distributed entirely to patrons on the basis of their business with the cooperative. This is the substance of cooperative operation as expressed in the user-benefits principle. The distinctions between cooperative and non-cooperative operation is clear. To the extent that the cooperative must make distributions to outside equity holders, the funds so allocated cannot be allocated to member/patrons and thus are lost to the cooperative's users.

An associated difference is found in the proportions by which benefits distributions are made. For non-cooperative corporations, benefits derived from ownership, whether through the generation of income in excess of expenses or the increase in market value of stock, are allocated to owners on the basis of the share of equity owned. The investor's decision process essentially determines how much to invest given the returns obtained based on investment. For a cooperative, on the other hand, where benefits are distributed on the basis of business done with the cooperative, the decision process is quite different.

Objectives differ between the recipients of benefits allocated on the basis of use and the basis of equity ownership. Recipients of the benefits based on use – patrons – match their benefits allocation only with their use of the cooperative. The only way to receive added benefits is to increase patronage, a process dependent on many factors not related to investment but on farming operations, pricing, etc. Recipients of benefits based on equity ownership on the other hand can adjust the amount of benefits allocated to them by simply changing their level of investment in the cooperative, a process wholly dependent on return on investment criteria.

Relational Transactions

The transaction between an outside equity investor and the cooperative is rather limited in scope and time. One transaction is, of course, the purchase of the equity interest. This is a neutral transaction in the sense that it occurs only once and has a specific, limited affect on both the cooperative and the investor. At the end of a fiscal year, the cooperative will provide whatever compensation is required by the terms of the investment. The transactions between a

cooperative and its member/patrons is relational not only because the transactions incorporate and recognize the multiple relationships between cooperative and member/patron but because the transactions are ongoing over a period of time. Purchase or sale transactions between cooperative and member/patrons may occur at multiple times within a fiscal year or over many years. In addition, such transactions involve the immediate transaction, later calculation of the impact the transaction had on the cooperative's income, allocation of amounts as refunds, allocation of refunds or per unit retains to equity accounts, and a continuing relationship because of the equity retained until it is redeemed, also years later. The neutral and at arms length outside investor may modify a cooperative's behavior that was based on traditional relational association.

Timing and Distribution

A cooperative calculates its net margins at the end of the fiscal year and makes distributes patronage refunds within eight and one-half months after the end of the fiscal year. The refunds may be paid in cash or in the form of retained patronage refunds but in either case the distribute occurs at that time. With few exceptions, the amount distributed as patronage refunds reflects the income for the relevant fiscal year and only for that fiscal year. The recipient patron will receive benefits related only to that patron's patronage during the relevant fiscal year.

In contrast, distributions to outside equity holders will be in the form of dividends on capital stock and may generally be made at any time. Flexibility in payment will depend on the terms of the equity interest. Variation in corporate profits is not necessarily directly reflected in correlated payments to equity holders. Indeed, dividends may be paid even in years in which the corporate entity suffers a loss. If the cooperative takes on an obligation to holders of outside equity that permits this timing difference, the cooperative's equity may be depleted regardless of when the equity will be replenished with retained net earnings.

Fixed or Variable Funds Flows

The fixed or variable funds flows problem is related to the timing and distribution problem but identifies an additional issue with outside equity investment. Funds flowing into and out of the cooperative will vary from year to year. To the extent that outflows are in the form of patronage returns, those outflows will depend on the amount of margins available each fiscal year. If no net margins are generated, the cooperative will have no outflows because no patronage refunds will be made. Obligations to patrons whose relationship with the cooperative is based on cooperative principles will be limited to cooperative net margins and will not force the cooperative to deplete its funds or capital in years in which net margins are nil or diminished.

Obligations to outside equity holders may not be so limited. To the extent that the obligation requires the cooperative to compensate outside equity holders regardless of current or past profits, the outflow of funds is fixed. In almost all cases, the outflow to equity holders is "more fixed" than outflows based solely on patronage refunds paid out of net margins. The result of this difference is an increase in net margin fluctuation brought about by the change in leverage, where leverage is defined in terms of obligatory payments versus payments required only from margins are generated.

Financing Practices and Strategies

Outside equity has its primary effect on a cooperative's financial structure. It adds a new element to the owners' equity portion of the balance sheet and a new requirement for compensation for capital. Several distinctions from member/patron equity and from capital generally contributed to the cooperative through membership and patronage relationships are noted briefly here.

Decoupling

Cooperative equity is based primarily, usually exclusively, on the patronage relationship. Additions to capital from membership fees, retained patronage refunds, and per unit retains make up the bulk of cooperative equity capital, and unallocated reserves are also generated by cooperative business though not usually business done with or for patrons. In every case, the addition of equity capital depends on the cooperative's operation. Obligations to holders of cooperative equity likewise is integrally associated with the patronage relationship, from return based on use rather than level of equity ownership to the cycle of investment and disinvestment similarly based on the patronage relationship.

Outside equity is decoupled from the member/patron relationship. It is not added by any relationship with the patronage process nor are the obligations to equity holders for compensation or redemption based on the patronage process. Nor is it added because of what the cooperative does with the funds on behalf of the equity holder. Obligations to the outside equity holders are not associated with a patronage relationship unlike cooperative obligations to member/patrons.

The cooperative must venture into new arenas to obtain outside equity because of this decoupling. Relationships and transactions necessarily a part of obtaining outside equity will require of the cooperative that it take on a set of obligations entirely different from those associated with member/patron equity. These obligations are based not on internal factors but on the capital market practices and forces.²⁸ In return for obtaining the investment, the cooperative creates obligations to the investors.

Costs of Capital

Cooperatives costs of capital have been a difficult subject for cooperatives because of the multiple relationships of the investor as member/user and because benefits are not distributed directly on equity ownership but through the patronage relationship. Returns made to equity holders required by them as a condition for their investment are not in a one-to-one relationship with ownership but with use. Outside equity changes this in several ways.

²⁸ The relevant capital market is not necessarily an organized market, nor is it necessarily an active one. It is any forum through which the equity is sold by the cooperative and traded by the equity holder.

Costs of capital may be direct or indirect. Indirect costs of obtaining outside equity may include the diminution of the strength of cooperative principles, limitations on strategies and practices in which the cooperative may otherwise engage noted above, or impositions of new governance burdens and requirements as noted below. Direct cost of the outside equity capital is generally the monetary outlay required to compensate investors. Intermediary costs are those that diminish the value of the cooperative for its member/patrons because it may not maximize its value to them as member/patrons given restraints associated with its obligations to outside investors. All these factors influence the total cost of outside equity in the cooperative. Their measure is unfamiliar to cooperatives with no outside equity. Outside equity creates a requirement that the various facets of obligation with direct and indirect implications for costs be measured. Such is not an easy task but incorrect conclusions can be seriously harmful to the financial condition of the cooperative.

Leverage

One form of leverage with outside equity may place member/patrons in a disadvantageous position. As one example, where half of a cooperative's equity is provided by preferred stock, the risks to members of being junior to the preferred stock is increased. The cooperative's obligation to outside equity holders to give them priority upon the occurrence of certain events comes at the expense of member/patron equity holders. Similarly, where the cooperative is obligated to make either sum certain payments or payments is require before distribution to member/patrons, fluctuations in the income generated by the cooperative will be multiplied.

Objectives

Turning to the objectives of interests in the cooperative, differences between member/patrons holders of equity and the holders of outside equity are clear. The objective of an outside investor is to obtain returns on the equity that justify investment given opportunities for alternative investments. The objective of member/patrons who invest in a cooperative is to obtain the benefits of the cooperative in the multiplicity of methods cooperatives have to generate and distribute benefits. Outside investment is made for the purpose of obtaining income from the investment, while member/patrons invest to generate income in their farming operation. Outside investment is associated with the savings sector whereas member/patron investment is part of the production sector.

The character of the obligations to outside equity holders and to member/patrons reflect the different objectives. One of the issues raised by the presence of outside equity is whether member/patron investors are encouraged to adopt the objectives associated with outside investment. If this occurs, the nature of obligations to member/patrons may change to look more like obligations to outside investors. At this point the cooperative will face a significant reevaluation of the character of a cooperative, principles that define a cooperative, and the totality of the rights and obligations that make the cooperative a business enterprise. From another perspective, if member/patrons are already viewing their equity investment in a cooperative from an investor's perspective with required returns on equity and liquidity, the

rights and obligations set within the cooperative will differ little from that directed to outside investment.

Valuation – From Member/Patrons to Markets

Valuing a firm is a central problem in finance. The ultimate value of a corporation is measured primarily by the value of the equity ownership in a market, whether that market is a public market or a private transaction. The focus of a cooperative on the other hand is the value it provides member/patrons through the patronage relationship. Starting with the proposition that the objective of the corporation is to maximize value, obligations based on those objectives are transferred from obligations to maximize the patronage benefits for member/patrons on the part of cooperatives to maximizing the market price of the equity held by outside equity holders. Perceptions of value are moved from an entirely internal forum based on complex interrelationships to a market forum based on the market value of the equity. Not only is the valuation different, those who determine value are different. It may also be expected that those who determine value from the perspective of the market place may not fully understand the internal dynamics of the cooperative being judged, or even its fundamental character.

Benefits Bias

Equity (and other capital) is obtained by business firms and is invested in assets that yield returns greater than the cost of capital. Cooperatives are no exception, though as noted the cost of capital is not as determinable as non-cooperative corporate equity. Returns to member/patrons justifying their equity investment in the cooperative are not based directly on equity but on several other factors. Nevertheless, if total benefits are not sufficient to justify equity investments, entities will not be cooperative member/patrons.

Outside equity would likewise be expected to generate income to the cooperative in excess of its costs, the excess providing the advantage to the cooperative of the outside investment. Total benefits to the cooperative will be divided between compensation to holders of outside equity and to member/patrons as users. The question then arises about the relative distribution of benefits that are generated by the addition of outside equity to the cooperative's capital structure. A bias will exist if the benefits generated by the outside equity are captured by the outside equity holders disproportionately to total benefits generated by all equity capital. Theoretical and empirical investigations are necessary to provide an answer to the question but the cooperative's obligations to outside equity holders will determine the rules to be applied and consequently on any biases in the process.

Governance

The argument is sometimes made that so long as farmer members maintain at least a majority of the votes in a cooperative, the cooperative control principle is met and other principles become less important. This proposition may be questionable for several reasons. Obligations to outside equity holders may modify the normal control expected in a cooperative setting, perhaps significantly. The term "governance" encompasses a broad spectrum of

decision-making processes in a cooperative from long-range and strategic planning to specific implementation and operation practices. Governance is far more than just voting for a board of directors.

Voting Power and Cooperative Control

The governance issue and outside equity can be divided into parts. The first question is whether holders of outside equity have formal rights to vote in the affairs of the cooperative. This is further divided into the specific situations in which outside equity holders may vote whether in the ordinary affairs of the cooperative or only on some event such as merger, consolidation, dissolution, or perhaps sale of all assets. Voting on special events may be a statutory requirement even where the investment agreement gives no rights to vote.

The second and more difficult aspect of outside equity holders and cooperative control occurs when the outside equity holders have no right to vote in the affairs of the organization but the cooperative's obligation to such equity holders limits the range of decisions the cooperative can make. This constraint on the full set of decisions is an effective control feature imposed on the cooperative and thus becomes part and parcel of the cooperative's governance process.

A further distinction is found in the source of voting power and the ability of equity holders to adjust their relative voting power. Voting power for cooperative member/patrons is typically limited to either one vote per member or some voting power based on patronage. Equity ownership is not a factor in voting power and member/patrons have limited ability to adjust equity ownership proportions that have any impact on voting power. For voting based on outside equity ownership, however, the non-cooperative corporate rule is that voting is based on equity ownership. To the extent this is true for holders of outside equity in a cooperative, the equity owners may gain voting power in the cooperative simply by purchasing more equity. Of course, such voting power is unrelated to the use of the cooperative.

The result of applicable voting rules along with limitations on some aspects of the cooperative's decision-making process, including the range of decisions that can be made, shows that numerical voting power is not the same as the concept of control inherent in the user-control cooperative principle. Governance issues extend beyond measured voting power and relative control by those with a right to vote. The touchstone of voting is selection of boards of directors. Boards of directors will confront the issue directly in the range of decision they can make in the affairs of the cooperative. To the extent that obligations to outside equity holders affect what a cooperative can or must do in a myriad of situations, board of directors will be required to consider such factors and make decisions on behalf of the cooperative accordingly.

Levels of Obligation

The presence of outside equity holders whose interests diverge from the interests of member/patrons will place a duty on the board of directors to take such interests into account. This has been couched in terms of obligations running from the cooperative to holders of outside equity. In practice, the board of directors is required to consider cooperative obligations in the

decisions it makes about the cooperative's performance and strategies for future actions. Thus the board of directors is faced with an added constituency carrying rights that the cooperative must recognize. The fiduciary relationships within a cooperative have been modified, and the cooperative as an entity and board of directors specifically will need to reconsider fiduciary relationships to include another set of participants.

Constraints on Cooperative Decisions

A number of constraints and requirements have been outlined with the addition of outside equity ownership. The full range of constraints and obligations will limit and form cooperative decisions. This may range from short-term pricing practices to decisions about business strategies to long-term goals, some of which are noted above. The consequence is that effective control is limited by constraints regardless of formal voting rights. When obligations to conduct business in certain ways limit the usual full range of options, cooperative control is limited. This is not to say that the cooperative operates at the whim of others. The obligations were accepted in the first place by the cooperative so any resulting constraints are also within the cooperative's control. The cautionary tale is that the many implications of incurring such obligations to obtain outside equity must be fully understood and appreciated as part of the initial decision-making process.

Measuring Performance

Cooperative performance is often somewhat problematic in the best of circumstances given cooperative objectives that focus on users. The meaning of the bottom line at the end of a fiscal year, tradeoffs between profit and pricing benefits to patrons, the satisfaction levels of member/patrons, adjustment of services whether added or deleted, growth or contraction, financial ratios, and many other factors enter into measuring a cooperative's performance. Obligations to outside equity holders will to some degree change measures of performance. The cooperative will need to incorporate into the performance measures such items as its payment to outside equity holders, generation of funds to make such payments, capital structure satisfying the interests of equity holders in the investment value of the cooperative, and the impact of its performance for the year on the stock prices of outside equity holders. Failure to meet obligations to outside equity holders is detrimental to the cooperative regardless of the seeming excellent performance as performance is measured solely by member/patrons.

From Member/Patrons to Capital Markets

Governance and decision-making processes in a cooperative whose users, owners, and beneficiaries are the same stakeholders representing the same sets of interests are essentially internal. Both the character of cooperation and the corporate nature of the cooperative corporation keep decisions, objectives, and tradeoffs "within the firm." Divergent interests and objectives and the resultant cooperative policies and strategies are part of a process whose decisions are kept within the cooperative. The forces are all based on member/patron interests and obligations.

Outside equity interests are not member/patron interests when the equity is a traded commodity. The value of the equity is determined not by member/patrons who use the cooperative but by capital market forces. To the extent that the cooperative has an obligation to holders of outside equity to maximize the value of the cooperative and enhance the market value of the equity, the cooperative is judged not by its member/patrons but by those outside the cooperative. The value of the cooperative is judged in a different arena for different purposes.

For governance purposes, this phenomenon requires that the cooperative, particularly its management and board of directors, look outside of the cooperative and its member/patrons to determine how well it is meeting its obligations to outside equity holders and, even more challenging, how the cooperative must act to satisfy the participants in a entirely different market place. Both of these functions may strain the abilities of a board of directors whose fundamental purpose is the operate the cooperative for the benefit of member/patrons as users of the cooperative.

Secondary Issues

The above issues lead to several observations about the broader impact of outside equity in a cooperative. These go beyond the rights and obligations focus of the paper and are offered as ideas to consider for future inquiry.

Local Benefits

Cooperatives are frequently said to have a peculiar benefit to the community or region in which they exist because the income or other benefits stay in the community or region. In some cases it is possible that no business would exist in the community were it not for the intent of the cooperative to locate locality. Even if an business existed in the community, if the same business were carried out by a cooperative the argument is made that business profits will stay in the community in the case of a cooperative and not the non-cooperative. For a non-cooperative the profit will be benefit investors wherever they are located. Benefits generated by the business in the form of profits will leave the community. The same argument may be made in the case of a cooperative with outside equity holders. Benefits captured by the equity holders are not necessarily connected with the community in which the cooperative exists. The extent to which this occurs depends on many factors, of course. Outside investors may indeed be part of the community, and the profits may not be distributed but may be retained in the business to further enhance its profitability and growth. Although the general argument is true and appealing, specific facts determine the consequences of outside equity on the local community.

Consumption Functions

Multiplier effects of a business depend in part on the use made of business profits. The benefits of a cooperative whose members are producers become part of the producers income and thus the production process. The added income facilitates continued production or growth and adds to the production economy. Income to investors, on the other hand, is added to the savings sector as a return on investment. It may well be that the funds in the savings sector will find their

way back into equity in another business, thus facilitating its continued operation and growth. That step, however, does not have as direct an impact on production, particularly at the local level, as does cooperative returns to users based on use. Theoretical and empirical investigation may shed light on this possibility.

Cooperative Roles

Cooperatives have traditionally been perceived to play important roles in the economy beyond merely marketing and purchasing on behalf of their own producer members. Cooperatives correct market failures, increase the efficiency of markets by adding effective competition, and according to Nourse establish a competitive yardstick by which other businesses can be measured. Such benefits presume certain types of behavior and performance on the part of cooperatives.

The presence of outside equity in a cooperative would not be expected to make a considerable difference in the roles cooperatives play. However, an inquiry may identify several concerns. In broad terms, one example may be demonstrated where a cooperative is expected to provide a competitive yardstick function in a poorly functioning market by lowering prices for a farm input. According to the competitive yardstick rule, the lower prices would force competitors to lower their prices as well. The price change would squeeze excess profit from competitors. If, however, a cooperative's obligations to outside equity holders prevented the described pricing practice, the cooperative would not play its competitive yardstick role in the economy. While this is an extreme example, nevertheless unexpected implications of outside equity in a cooperative may be found.

Trickle Down

A cooperative's sole focus is on providing the maximum benefit to its member/patrons. To the extent that obligations to outside investors cause the cooperative to deviate from that single purpose, member/patrons are disadvantaged. The extent to which the user-benefit principle is compromised is a matter of degree. The concern with significant amounts of outside investment, especially when accompanied by significant control shifts, is that the farmer members will get what is left after the primary outside investors are duly compensated under whatever terms between cooperative and investors have been agreed upon. They will again be mere price takers in the market.

The concern is raised by some of the more forceful arguments for the need for outside equity investment. The argument is that unless outside investment is obtained, farmers will have no way to participate in value-added business and will have no means by which to capture profits of the value-added business. Only if farmers accept significant outside capital can they participate in a profitable enterprise. At some point the value-added business is essentially investor-driven. The argument may still be made that the farmers are receiving at least something that they would otherwise not otherwise receive. However, they are left essentially with only what remains after profits have been largely distributed elsewhere contrary to the central premise of the cooperative enterprise.

Conclusions

The methodology used was that of a survey of concepts. Obligations that a cooperative may incur when it adds equity from non-member, non-patrons to its capital structure were assessed by analogy, not with a complete legal analysis.

Corporate objectives are directed to the maximization of value for stockholders. To the extent that a cooperative corporation has outside equity, its obligations follow those for non-cooperative corporations for the holders of the outside equity. Such obligations may require the cooperative to operate in a manner different that it would without such equity. Required changes may go beyond compensating outside equity holders for their equity in the cooperative.

The paper shows that obligations to holders of outside equity (1) are significant in a wide range of circumstances, (2) often are not recognized, and (3) reach beyond obligations that can be readily discovered by assessing formal voting rights for holders of outside equity. The survey also finds that newly acquired obligations to holders of outside equity modify every cooperative principle to some degree, though the precise point at which a cooperative loses its essentially cooperative character is not necessarily evident. Arguments that an organization maintains essential cooperative features so long as farmer members have majority voting rights in the organization are not supported when the relative position of farmers – the defining goal of cooperation – is assessed. Obligations are found to have multiple impacts on firm and member objectives. Costs of outside capital, both explicit and implicit, cannot be properly measured without careful analysis, presenting a situation that may lead to serious *post hoc* internal conflicts in objectives, expectations, and governance.

The precise implication of obligations is fact sensitive. Further detailed research is required to answer specific questions about the impact of outside equity on a cooperative.

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