**Understanding the Closed Cooperative Model**

A cooperative is a for profit business that is owned by its users and distributes profits or losses in proportion to use. Cooperative businesses are organized as corporations but are incorporated under separate statues. The system of distributing profits and losses in proportion to use is fundamentally different from that of investor owned firms where profit and loss is allocated in proportion to ownership. The profit distribution system, which is unique to the cooperative business model has major implications for the equity structure, financial management and governance.

**Open Membership versus Closed Membership**

There are many variations of structure within the cooperative business model. One important structural issues is the choice of organizing a cooperative as a open membership or closed membership cooperative. Open membership and closed membership cooperative have different structures for admitting potential members. They also have very different structures of obtaining and managing equity and vary in terms of the member’s commitment to use the cooperative and the basis for pricing.

Most traditional input supply and commodity marketing cooperatives are organized under the open membership model. Under this structure the member can join at any time by purchasing a share of membership stock, often a nominal fee. The cooperative distributes profits in a combination of cash and stock patronage. The member therefore builds equity over time and the equity is created out of the profit stream. Because profit is distributed in proportion to use, there is no direct benefit of owning equity. For this reason, equity in an open membership cooperative has no market value and is not bought and sold. Instead, the equity is eventually redeemed by the cooperative at face value under a prescribed system which is often based on the year the equity was issued or the member’s age. Open membership cooperatives typically sell inputs and purchase commodities at market price and the member-owners are not under any contractual obligation to use the cooperative.

Many processing and specialty marketing cooperatives as well as a few input supply cooperative operate under the closed membership structure. Under the closed cooperative model the organization creates the majority of its equity from direct investment in membership stock during an initial drive. Each share of equity has an associated usage right. Members can only use the cooperative, and receive usage based profits to the extent that they hold equity investment and usage rights. Profit distribution is therefore still in proportion to use, but because use and equity investment are linked, it is also in proportion to investment. This structure creates the potential for the exchange of equity between members or between exiting members and new members. A market for the equity can therefore be developed and, based on the perceptions of future profitability and patronage, the value of the equity may appreciate. Under the closed cooperative model equity is always held in proportion to use. Because the equity was obtained from an initial membership investment (which can be substantial) the cooperative is able to distribute the majority of profits in the form of cash patronage.

**Advantages and Disadvantages of the Open Cooperative Model**

Historically the open membership structure has worked very well for commodity based cooperatives with somewhat homogeneous membership. Members can join an open membership cooperative with a nominal investment and without any contractual commitment to use the cooperative. They receive benefits over time through access to the cooperative’s services and through cash patronage. The system of retained patronage and revolving equity provides a vehicle for the cooperative to replace infrastructure without out-of-pocket investment from the members. While almost ever cooperatives can benefit from closer coordination with their members, cooperatives operating in commodity markets can often function very adequately under a system of voluntary transactions at market prices.

The open membership structure can be a disadvantage for a start up cooperative that is trying to raise sufficient risk capital to fund the initial infrastructure. Open membership cooperatives typically have low threshold for membership investment. Additionally, since there is no penalty for joining at a later date and no possibility of equity appreciation potential members have an incentive to delay membership until the cooperative has proven successful. In the open membership cooperative model a member’s investment is often not proportional to their use of the cooperative. New members are typically underinvested while older and inactive members are over invested. Various membership groups can have differing opinion on the cooperative’s strategy with new underinvested members favoring investment in infrastructure (which will benefit them through future use and patronage), while older members favor accelerating equity retirement since future use of the cooperative is declining.

The lack of proportionality coupled with the absence of usage commitments can be especially problematic when the cooperative has a fixed throughput or marketing capacity. For example an ethanol cooperative has a fixed amount of corn that can be converted to ethanol and needs a large per bushel investment to finance the plant. Members with high equity investment are unlikely to want a new member, who had made only a modest investment, to crowd out their use of the processing capacity and ethanol profits. Additionally, some marketing cooperatives operate in specialty commodities or in the production of branded products. In those situations in can be important for the cooperative to have a firm handle on the volume of member deliveries. In some cases a market price for the commodity does exist. In those cases the cooperative often operates a marketing pool where all members receive the average price received net of processing and marketing costs. The committed volumes inherent in the closed membership structure are an advantage in successfully operating a marketing pool..

**Advantages and Disadvantages of the Closed Cooperative Model**

The major advantage of the closed cooperative model is that it addresses the previously discussed issues of non-proportionality and lack of coordination that can occur in the open membership model. In the closed cooperative structure, equity investment is automatically maintained in proportion to use. Members have a greater incentive to invest in the cooperative during the initial equity drive because the equity has the potential to appreciate and they will not be able to join at a later date without purchasing equity from an existing member. To the extent that an active market for the equity develops, their equity is transferable and has much greater liquidity. The cooperative is also able to match equity investment to its infrastructure needs. Fixed processing capacity is automatically rationed across members in proportion to their investment. Usage commitments can allow the cooperative to compete more effectively in specialty product or branded markets and to successful operate marketing pools.

A major disadvantage of the closed cooperative model is the amount of upfront investment and usage commitments required by members. The organizing committee must be able to identify a sufficient number of potential users that are able and willing to make the proportional investments during the initial equity drive. Many start up attempts for the formation of closed cooperative fail because of insufficient investment. Potential members must also be willing to make fixed long term usage commitments. Many producers value the ability to make a price comparison on each transaction. Potential members must also anticipate that their usage will be relative stable for a period of time. A producer with a usage commitment in a cotton ginning cooperative cannot elect to rotate their farm into corn production when the anticipated price ratios shift.

While a market for the cooperative stock with associated usage right may develop, investment is limited to producers who are able to deliver commodities or purchase inputs from the cooperative. There have been cases when the usage right market did not function despite the fact that the underlying cooperative was profitable. For example, since members in a closed membership cooperative must deliver corn, the delivery right market is limited to other corn producers. A retiring corn farmer may find that there are not younger corn farmers in the area that have the ability or interest in purchasing stock and delivery rights.

**Choice of Cooperative Form Impacts Bylaws and Membership Agreement**

Either form of agricultural cooperative (open or closed membership) would generally be incorporated under the same state statue. The choice between the two structures would be reflected in the provisions in the bylaws and membership agreements. It should also be noted that open membership cooperatives can incorporate some aspects of the closed cooperative structure. For example and open membership cooperative can use a base capital system to require that equity be held in proportion to use. An open membership cooperative could also require usage commitments. An open membership cooperative could create a structure to allow for exchange of equity between members. However, in the absence of usage rights members would have little incentive to create a market for the cooperative’s stock.

**Investment in Closed Cooperative May Trigger Securities Regulations**

Due to the reliance on direct investment in membership stock, the initial equity drive is a major aspect of closed membership cooperative formation. In an open cooperative, the membership shares are likely not to be considered securities since they do not appreciate pay no dividends and are redeemable at face value only at the discretion of the Board. Membership shares in a closed cooperative are likely to fall under a securities designation. Both federal and state governments regulate the sale of securities with close scrutiny. Just like any other business, cooperatives must comply with regulations regarding the sale of securities. Regulation relates to two areas, registration and disclosure.

Registration is the process for approval of securities with the security division of the federal Securities and Exchange Commission (SEC) and the applicable state agency. Registration is a lengthy and expensive process, and should be avoided if an appropriate exemption is available. Legal guidance is recommended for any decisions about qualification for an exemption from registration. At the federal level, the registration occurs with the SEC and is likely to occur if securities (membership investment) are being sold to members live outside the state where the cooperative is incorporated. If securities are being issued only to members that live in the cooperatives s state of incorporation, the cooperative may be able to take advantage of intrastate exemption from SEC registration. At the state level, securities laws vary by state. The steering committee should check with their state to determine if there are appropriate exemptions from registration for cooperatives.

Disclosure of all material risks is always required for any offering of securities. Disclosure is done whether or not federal and/or state exemptions from registration have been received. The disclosure document (usually described as a “confidential information statement”, or “private placement memorandum” or "prospectus") details any material risks that could affect the member's decision to invest in the co-op. A few examples of material risk are a significant bank loan that the cooperative has taken on, or significant deficiencies in the building the cooperative is purchasing. The disclosure document is a legal document, and legal expertise should be obtained in the writing of the document. The cooperative and its incorporating board or steering committee are liable for any deficiencies in disclosure whereby material risks are not included or misrepresented in the disclosure document.

**Summary**

Historically, most U.S. agricultural cooperatives have been formed under the open membership model. Most of those cooperatives were formed over 50 years ago and concentrated on bulk inputs and bulk commodity marketing. While many producers are satisfied with the open membership model it has inherent issues relating to free riders, time horizon, and the liquidity and transferability of the equity investment. Open membership cooperatives also have more difficulty in matching throughput to available infrastructure and with market opportunities. The closed cooperative model has been most prevalent in processing and value-added cooperatives and in cooperatives marketing specialty crops. The closed membership model requires greater commitment and investment. While there are many advantages to the closed membership structure the commitment can prove to be an insurmountable obstacle to formation.