Center for Cooperatives
UNIVERSITY OF WISCONSIN–MADISON

Cooperative Preferred Stock: Basic Concepts

Preferred stock offerings are sometimes used by cooperatives to meet their capitalization needs. In contrast to other types of cooperative stock, preferred stock:

- may be sold to member and non-members, which expands the potential number of equity investors;
- offers dividends and other preferential terms to its shareholders.

Preferred stock, however, may not be appropriate for every situation in which a cooperative is raising equity. Some basic information about cooperative stock and securities is essential when considering the possibility of offering preferred stock.[1]

STOCK BASICS

One tool that a business can use to raise money for start-up or growth is to sell shares of stock in their businesses. The shareholder, by purchasing the stock, has made an equity investment that is "at risk," with no guarantee of a return.

In return for the equity investment, stock gives shareholders certain ownership rights that are laid out in the terms associated with the stock. The terms define voting and redemption rights and requirements, and any claims on earnings. The stockholder's ownership control is exercised through the level of voting rights associated with the share of stock. A shareholder's number of votes increases with the number of shares owned.

The terms are set by the business that issues the stock. The "class" of a stock – class A, class B, etc. – is a label assigned by the business to stock shares that are issued with the same purpose and general set of terms. The class name by itself has no stand-alone legal meaning.

Stocks are securities, which are legally defined as a monetary investment made in an enterprise with the expectation of a profit from the efforts of others. Securities are subject to federal and state regulations that are designed to support transparent and fair market transactions, and must be registered with the appropriate agencies.

[1] This review is not meant to replace legal advice about cooperative securities. An attorney should review and be consulted on a cooperative's development of stock offerings.

COOPERATIVE STOCK

Most classes of cooperative stock do not meet the definition of a security, which exempts the cooperative from securities registration requirements.[2] Usually cooperative stock is not purchased or issued to generate a financial return for an investor. Rather, it is a vehicle for member equity investment in the cooperative business for the purpose of providing needed goods or services.

The value of cooperative stock does not appreciate, and the stock cannot be traded on the open market. Stock repurchase by the cooperative is at the discretion of the board of directors, usually at par value.

Membership stock

Cooperatives organized on a stock basis[3] have a class of stock that members are required to purchase to join the cooperative. Often this is labeled as Class A by the cooperative. Owning a share of this type of membership stock gives the member ownership rights, including the right to vote on cooperative affairs. Members are limited to owning a single share of voting stock, so that members cannot purchase additional votes through member stock ownership.

Equity stock

Other equity stock may be required or issued by cooperatives for additional investments from members. Often labeled as Class B, purchase of additional shares of stock may be required as part of a member's initial equity investment. Class B stock also may be used to implement base capital plans.[4]

Cooperatives may issue equity stock to members in exchange for their retained portion of patronage allocations. Sometimes this class of stock offers a dividend; however, this may vary by state and by individual cooperative. In worker cooperatives especially, wealth-building by providing a return on contributed or retained member equity may be a priority.

This class of stock may only be purchased or issued to members. The additional stock shares do not give the member additional voting rights. The redemption policies of this type of stock may be different than membership stock.

COOPERATIVE PREFERRED STOCK

Cooperative preferred stock is different from other classes of cooperative stock. In some states, including Wisconsin, preferred stock may be offered to non-members as well as members. This allows a cooperative to raise equity capital from a wider pool of investors than members.

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[2] Depending on state cooperative statutes, there may be limits or other requirements for stock issued by the cooperative.
[3] For information on stock versus nonstock cooperatives, see Stock v. Nonstock Cooperatives in Wisconsin
[4] For information on base capital plans, see Base Capital Financing of Cooperatives. USDA Cooperative Information Report 51, 1995.

Preferred stock terms describe dividend and redemption date commitments by the cooperative. Preferred shareholders have priority over other shareholders when annual distributions are made, and when proceeds from asset sales are distributed in the event of dissolution.

Wisconsin Chapter 185 limits the voting rights of preferred stockholders to ensure that members maintain control of the cooperative. Holders of preferred stock may only vote on actions that affect the base value of the shares such as mergers, dissolution, or other situations as specified in the articles of incorporation. In these specific situations, each preferred shareholder has one vote, regardless of the number or value of preferred shares they own.

Preferred stock terms need to be sufficiently attractive to investors to meet the capital goals of the cooperative. However, the commitments in the terms must not jeopardize the cooperative's financial stability and its ability to meet member needs for services.

Cooperative preferred stock: Dividends

The dividend rate offered in the preferred stock terms is based on the cooperative's expected financial performance until the redemption date.[5] The dividend rate can be a specified percentage or a range (including zero). Terms may include a cap for rates that may be declared for a given year.

It is highly recommended that the terms give discretion to the board of directors in declaring an annual dividend rate. This preserves the board's ability to manage the cooperative's balance sheet for long-term financial stability. As an example, the terms might state "dividends up to 6% as determined by the board."

Preferred stock dividends are required to take priority over other annual profit allocations or distributions. If the terms allow the board annual discretion in declaring and distributing a dividend, however, the board has the flexibility to also declare member patronage allocations in combination with preferred stock dividends.

The terms may also stipulate that dividends be cumulative. This means that a dividend may be declared but not distributed as cash to stockholders. The declared dividend is carried forward and is included with future dividends that are paid out later.

While cumulatively declared dividends can be carried forward indefinitely, declared dividends that have not been distributed must be recorded as a liability on the co-op's balance sheet. This type of liability may offset the initial balance sheet benefits of the equity raised through the preferred stock offering.

If a cooperative is dissolved, preferred stock and any cumulative dividends owed to preferred stockholders have a higher priority for payout than member equity and retained patronage allocations.

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[5] In many state statutes, there is a limit of 8% on dividends paid on cooperative stock. This aligns with the requirements of the Capper Volstead Act, which was passed in 1922 and exempted collective marketing by agricultural producers from antitrust laws. See Understanding Capper Volstead, USDA CIR 35, reprinted 1995.

Cooperative preferred stock: Redemption dates

The ability of the cooperative to make decisions about the redemption of preferred stock is completely dependent on the terms associated with that class of stock. Terms that commit to specific redemption or payout dates for any class of stock can be risky. Depending on the cooperative's financial situation at a specified redemption date, stock redemption could affect its financial stability.

It is recommended that preferred stock terms for redemption give the board discretion in the timing of the share buybacks. This gives the board the flexibility to maintain an appropriate amount of cooperative equity in relation to its assets and liabilities, and more effectively manage its balance sheet. Sometimes cooperatives will have board policies that allow for redemption in hardship cases, retirement, or when replacement equity is found, if the balance sheet can support it.

The cooperative is legally required to repurchase the stock from the stockholder as specified in the terms. If it cannot meet those redemption requirements, the equity becomes debt on the cooperative's balance sheet, further contributing to the cooperative's financial challenges.

Cooperative preferred stock: Security exemption considerations

Because preferred stock is purchased as an investment with the expectation of a return, it meets the definition of a security and may require registration. However, exemptions from the complicated and expensive securities registration process may be available to cooperatives if certain conditions are met. While there may be exemptions from securities registration, all preferred stock offerings still must provide a prospectus to the potential buyer that describes the risks, expectations, and commitments of the sale.

State securities exemptions: Although cooperative preferred stock meets the definition of a security, many states have specific state registration exemptions for cooperatives, including Wisconsin under Chapter 185.

Federal securities exemptions: There also are situations that exempt the cooperative from federal security registration requirements. The intra-state registration exemption may be available to a cooperative with at least 80% of its assets and activity in a single state. The preferred stock offering and sales must only be to residents of that single state. Cooperatives interested in multi-state offerings most commonly pursue "private placement" exemptions. These are based on rules regarding the solicitation of or advertising to accredited investors who meet certain asset or income requirements.

Farmer cooperative exemption based on tax status: Some farmer cooperatives qualify for 521 tax-exempt status if they meet certain governance and operating provisions. This exemption extends to securities offerings.[6]

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[6] For more information on the Section 521 tax status, see USDA CIR 44 Part 4, Income Tax Treatment of Cooperatives: Internal Revenue Code 521, 2005 edition.

CAPITALIZATION STRATEGIES USING PREFERRED STOCK

Perhaps a start-up cooperative is having a difficult time raising enough money through new member equity investments to get the new business up and running. Or an established cooperative may be planning for expansion and is not able to fund the needed investments through retained earnings or additional member equity contributions. A cooperative may consider preferred stock as a component of its capitalization strategies in situations such as these.

Start-up capitalization

Potential investors in preferred stock are typically looking for specific dividend rates and redemption dates of two to three years. It is risky for a start-up cooperative to offer such terms, since new businesses often take several years to become profitable.

However, if a cooperative start-up will benefit the community or is being organized to support broader social goals, it may be able to attract individual or institutional investors who are looking for investment opportunities with positive social impacts.

A preferred stock offering with terms that allow greater cooperative board discretion and provide long-term commitments, if acceptable to the investors, might provide a new cooperative business with sources of “patient capital.”

Capitalization for growth or expansion

Preferred stock offerings may be an option for raising equity needed for cooperative growth or expansion. Offering terms attractive to outside investors is more prudent in cases where the cooperative is already established and profitable, rather than during the start-up phase or when it is faced with flat or declining profit margins.

MEMBER LOANS

Member loans are an alternative source of capital for cooperatives. Member loans are debt, not equity, and must be repaid according to the terms of the loan.

Members may be willing to agree to terms that are less financially burdensome to the cooperative than the terms offered by a conventional lender.

Member loans are subordinated debt and thus have lower priority than bank loans for repayment when a cooperative is struggling financially. In some cases member loans may be considered partial equity in a financial analysis by a potential lender.

Similar to a preferred stock offering, it is important that the prospectus for a loan program fully disclose risks, expectations, and commitments of the loan.

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