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The Limited Liability Company Versus the New Generation Cooperative: Alternative Business Forms for Rural Economic Development

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In the face of increasing competitive pressures prompted by free trade, declining farm supports, and domination by multinational agribusinesses, farmers are searching for new ways to remain profitable (Hagen 2000; National Farmers Organization 1999). One recent strategy in the upper Midwest has been for individual farmers to collaborate in a range of cooperative purchasing, processing, and marketing enterprises (Patrie 1998). The challenge for farmers is to choose an appropriate business form for their proposed enterprise. This is an important decision because the legal status of a collaborative enterprise will affect a range of issues, including how profits are distributed among investors, how taxes on profits are paid, who can join or invest in the enterprise, and the long-term impacts on the community hosting the enterprise.

The purpose of this report is to compare the benefits and drawbacks of two specific types of collaborative agricultural enterprise: (1) the Limited Liability Company (LLC) and (2) the New Generation Cooperative (NGC). This comparison has received only scant attention in the agricultural economics literature (Frederick 1997, 1998). The report also expands on the opportunities of LLCs and NGCs.

The first section of the report expands on the underlying economic conditions prompting farmers to form collaborative enterprises, including a discussion of value chains and the role of NGCs in economic development. The second section argues that rural businesses are an important component of the rural community—often linking the local farm and non-farm populations—and discusses the origins and operations of LLCs. The third section offers a comparison between LLCs and NGCs, paying particular attention to the impacts these two business forms can have on local economic development. The conclusion presents some thoughts on the future of cooperative development.

Cooperatives and Rural Economic Development

Commodities follow a chain or series of steps as they travel from the farmer's field to the consumer's pantry. At each step along the way, value is added to the commodity through processing, marketing, distribution, and retailing. A key problem, according to many farmers, is that they receive a disproportionately small return on their investment if they simply sell unprocessed commodities. One source argues that for every dollar spent on food in 1998, farmers received just $.23. In 1980, farmers received $.37 out of every food dollar (Paul 1999).

Farmers need to control more steps along the value chain in order to earn a larger share of profits. By processing and marketing their own commodities, farmers eliminate middlemen and move closer to the marketplace. The problem is that shortening the value chain requires resources beyond the means of a single farmer. Compounding the problem is the market consolidation that has occurred in the agricultural sector. The National Farmers Organization (1999) estimates that just four companies control 80 percent of soybean processing, 75 percent of corn processing, and 60 percent

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of wheat processing in the United States. How can farmers afford to build processing facilities while attempting to penetrate markets dominated by large agribusinesses at the same time?

One solution lies in the formation of cooperative ventures that allow members to pool resources to build processing facilities in rural communities. These cooperatives provide economies of scale to individual farmers, allowing them to compete against larger enterprises without having to acquire more land. The cooperative processing facility also provides stronger linkages between the farmers and the local community. Many communities with stagnant economies attempt to lure new industry with no relationship to agriculture. While a non-agriculture industry may help diversify and stabilize the economy, it does not take advantage of the local comparative advantage in agriculture. Economic development professionals need to work with farmer coalitions to search for agribusiness opportunities, particularly those that might be formed around NGCs or other cooperative ventures (Walzer, Merrett, and Holmes 1999).

> . . . NGCs allow farmers to process the commodities they grow, keeping profits in the community.

Researchers have already paid considerable attention to NGCs because of their ability to help farmers capture additional value from their farm production (Buschette 2000; Egerstrom 1994, 2000; Merrett and Walzer 2000; Patrie 1998). Traditionally, farmers sold their commodities to processors outside their community, surrendering any opportunity to add value through processing the raw commodities. In contrast, NGCs allow farmers to process the commodities they grow, keeping profits in the community. NGCs also allow farmers to raise capital, obtain technical assistance, and hire management and marketing expertise as a group—actions they could not afford to take as individuals. It is important to note, however, that there are enough failures to make it clear that NGCs are fraught with risk and uncertainty for those involved (Carter 2000; Miller 1999), just as is any new business start-up.

> Is the formation of a value-adding agribusiness intended to raise income for the individual farmer or is it to improve the economy of the farm community?

While some writers discuss the rise of “Co-op Fever” (Patrie 1998), it is apparent that this enthusiasm for cooperatives varies geographically. For example, in a recent publication, only two NGCs were recognized in Illinois, while 29 were recognized in Minnesota and ten in Iowa (Merrett and Walzer 2000). Yet, the interest for value adding agriculture is high in Illinois. One author identified ten cooperatives in the state that are now in various stages of formation (Williams 2000).

This is an opportune time for farmers in Illinois and elsewhere to pay more attention to cooperative forms of economic development. Between 1960 and 1990, the rural population in Illinois declined from 1,940,843 to 1,762,050 (U.S. Census Bureau 1995). Communities in the rural Midwest continue to experience population decline and economic stagnation. The lack of job opportunities is a key reason for the out-migration of people. As rural populations stagnate or decline, the viability of local businesses, churches, hospitals, and other rural institutions is brought into question. In response, farmers organizing for the future might consider their role in rural economic development by addressing the following question: Is the formation of a value-adding agribusiness intended to raise income for the individual farmer or is it to improve the economy of the farm community? An LLC may be a better way to organize the business if the objective is to create wealth for the rural community as a whole.

It appears that Illinois farmers interested in value-added processing look first to the idea of forming a cooperative. This orientation is probably influenced by the information available on NGCs in states to the west, thus creating a certain level of comfort and interest. In addition, the lack of interest in LLCs could be due to it being a relatively new development and also due to the lack of information concerning its role in value-added agriculture. This new brand of business organization now has an example to watch as it develops. Adkins Energy, LLC in Lena, Illinois, is in the construction phase of a $68.5 million ethanol production facility. As noted on the website, www.adkinsenergy.com, the membership is over 400, including producers, local investors, and several corporations with the expertise to turn the idea into reality.

Origins of the Limited Liability Company

It is the premise of this report that the economic stability of rural America is an interdependent relationship between farmers and non farmers. As a result, the business of value-added farming should be considered a partnership between these two sectors of the rural community. Given this assumption, one approach is to form a company owned by farmers, local businesspeople, and other community members to process locally grown commodities. The challenge is to organize the business to include an array of investors and producers. The LLC business format might provide a viable solution to this challenge.

One of the most prolific writers to compare LLCs versus NGCs is Donald Frederick (1997, 1998). This section draws heavily on his cogent analysis. To begin with, the concept of the LLC is relatively new to the United States. It has existed in Western Europe since the 19th century, but did not become a concern for Americans until 1960. At that time, the Internal Revenue Service (IRS) sought to clarify the rules which classified unincorporated, multiowner businesses for taxing purposes. Before that could happen, the IRS had to distinguish between an incorporated and an unincorporated business entity. According to Frederick (1998), the IRS identified the four characteristics of a corporation as follow:

1. Continuity of life of the firm
2. Centralization of management
3. Limited liability for the owners
4. Unrestricted transfer of ownership interests

According to the IRS, if a firm had three or more of the above characteristics, it was viewed as a corporation for tax purposes. If it possessed two or fewer of the characteristics, it was treated as a partnership—with full ownership liability. This distinction worked until 1977, when the State of Wyoming legalized unincorporated businesses that also limited the liability of the owners. This prompted the IRS to challenge the validity of Wyoming's statute—a process that prevented that state from promulgating its business law until 1988. At that time, the IRS decided that an LLC with two or fewer of the corporate characteristics had to pay taxes as a partnership. This decision forced LLCs to decide between incorporating to achieve limited liability for the owners or "forming their business as a partnership to quality for single tax treatment" (Frederick 1998, 37).

Despite presenting prospective businesses with this difficult choice, this clarification in tax law prompted a wave of state legislation recognizing the right of LLCs to operate. Davidson (2000) notes that 46 states recognized LLCs as a legal business form between 1990 and 1997. Illinois was one of the last major agricultural states to recognize LLCs when it did so in 1994. In contrast, other Midwestern agricultural states legalized the LLC business form as much as four years earlier (**Table 1**). The indifferent response to the LLC movement expressed by the State of Illinois may be symptomatic of its broader disregard for cooperative forms of rural economic development.

In 1997, the IRS simplified their 1988 ruling by adopting a new set of rules which allows businesses to choose how they want to be taxed, regardless of how many corporate characteristics they possessed (Frederick 1998). The outcome is that by the late 1990s, farmers and rural communities had a new business tool to promote economic development. The question is now, why should a farm group choose one business form over the other?

Table 1. Date LLCs Recognized as Legal Business Entity, Selected Midwestern States

State	*Year LLCs Recognized*
Kansas	1990
Iowa	1992
Indiana	1993
Michigan	1993
Minnesota	1993
Missouri	1993
Nebraska	1993
North Dakota	1993
South Dakota	1993
Illinois	1994

Source: Davidson 2000.

A Comparison of LLCs, NGCs, and Other Business Forms

There are few differences between LLCs and NGCs. A notable one, however, is that LLCs allow for community investment, not just farmer investment, and the option for active management. In comparison, NGCs are designed strictly for member farmers who patronize the organization with their goods. An exception is made to allow others to invest through preferred stock but without the right to vote.

When entrepreneurs organize their nascent enterprises, there are a number of different ways to structure the business. If there is only one owner, the business might be structured as a sole proprietorship; however, if two or more entrepreneurs want to synergistically develop an idea, raise capital, manufacture, and market a product, they might want to consider forming a partnership, LLC, or corporation. A summary of the structures of various closely-held joint ventures can be found in Lawless, Cropp, and Harris (1996). A simple partnership is comprised of two or more individuals, with full liability for incurred debt resting with at least one of the partners. Taxation occurs only once at the member level.

LLCs are a hybrid business structure. They are similar to a partnership in that taxes only have to be paid at the membership level. On the other hand, they offer the corporate advantage of providing members with limited liability against incurred debt. The S corporation and C corporation are also hybrid business forms (Lawless, Cropp, and Harris 1996). The S corporation can reserve the right to be taxed only at the member level, however, if it distributes profits to outside investors, it may have to pay capital gains taxes. The C corporation is subject to taxation at two levels. The corporate entity must pay taxes, and dividends paid to outside investors are also subject to taxation. In the case of partnerships, LLCs, and S and C corporations, there are no restrictions as to who can invest in the business entity.

The right to form a cooperative was formally recognized in 1922 with the passage of the Capper-Volstead Act. It allows individual farmers to come together to cooperatively purchase farm inputs, as well as to process and market harvested commodities. The law was put in place to allow farmers to compete in a consolidated market with few buyers. The Capper-Volstead Act allowed farmers to come together by exempting them from antimonopoly legislation embodied in the Sherman Anti-Trust Act (Shepherd and Futrell 1982). According to Lawless, Cropp, and Harris (1996), a cooperative resembles a partnership or LLC because only members have to pay taxes if profits are redistributed to member-owners as patronage funds. On the other hand, cooperatives provide limited liability and are, therefore, similar to corporations. Membership in a cooperative is limited to only those who patronize the entity.

Table 2 compares the business structure of an LLC with an NGC. The major difference is in the ownership structure.

Table 2. Comparison of LLC and Cooperative Corporation

Attribute	*LLC*	*Cooperative Corporation*
Membership vote	One vote per share owned	One vote per member
Membership size	Unlimited	Unlimited
Single taxation	Yes	Yes (need to confirm with state)
Distribution of profit	Based on shares owned	Based on patronage of co-op
	No distribution delay for tax advantage	Can retain for tax purposes
Ownership	Open to the community	Restricted to farmer patrons
Owner involvement	High	High
Membership restrictions	None	Restricted to material participants or nonvoting preferred
Annual profit restrictions	Unlimited	8% of equity invested or through percent of patronage (or added price to raw sales)
Liability	Limited	Limited
Transfer of interest	Via operating agreement	Consent of board

Sources: Bizfilings website 2000; Frederick 1997; UWCC 1998.

NGCs are a closed ownership organization of farmers who patronize the business. Some NGCs do permit investments from non-patrons, but only as preferred stock (UWCC 1998); therefore, the investment is made without the right to vote on any matters related to the NGC. In contrast, all LLC investors are owners and have the right to vote and be active in the management of the company. It is also important to note that patronage drives an NGC over investment since profits and liquidation proceeds are distributed based on patronage (Hanson 2000).

A comparison of LLCs with C corporations and S corporations is also useful to highlight the advantage that an LLC might have for rural organization. The critical drawback of a C corporation is the aforementioned double taxation of profits. A deficiency of the S corporation is that the number of owners is restricted to no more than 75 shareholders (Bizfeelings website 2000). LLCs are not taxed at the corporate level so the untaxed proceeds flow through to individual owners' income, and the limiting number of shareholders is not defined. So, an LLC has a combined advantage of being more tax efficient and more flexible than C and S corporations. Rural community ownership through an LLC may have numerous benefits as compared to a cooperative that is exclusively owned by farmers. The following are five specific benefits of the LLC:

1. Diversity of membership
2. Wider exposure to capital
3. Greater potential in achieving threshold membership
4. Greater community commitment
5. Flexibility in options to grow

Diversity of Membership. The formation of an LLC to conduct value-added agricultural operations requires a variety of leadership skills. As membership qualifications become restrictive, as with an NGC, the pool of diverse ideas and skills is potentially narrow. Although professional management is an option from the outset, the governing board could still benefit from a broad background of business experience and perspective. Launching any new business is risky, and the quality of management is important to reducing the risk. King (1995) points out that managerial services have significant impact on the production process of an agricultural cooperative. Large farmer groups may have the leadership base to effectively run the business but this may be more difficult with smaller groups. The quality of the leadership can also come into play when seeking loans. Having seasoned managers in the organization is a plus and non farmer owners are also potentially a source for management experience. In addition, there is a positive impact of equity holders on operations and policies of agribusiness firms that are steered by owner investors (Katz 1997).

Wider Exposure to Capital. Obtaining sufficient start-up capital is usually a major undertaking, and the lack of familiarity with financing a co-op is a potential problem faced by farmers. It is assumed that Illinois bankers, in general, lack experience in making loans to NGCs simply based on the lack of co-ops in the state. It is also suggested that this same lack of experience could result in the absence of such organizations. A survey conducted in 1996 indicates that of the loan officers that had made loans to farmers for investment in a cooperative, 79 percent had family or friends in NGCs. This compares to just 38 percent in the cases in which farmers did not receive loans (Goreham, Olson, Cobia, and Wilson 1998). The survey included 388 agriculture loan officers covering 118 institutions in North Dakota.

The suggestion that LLCs can create more exposure to capital is based on the merger of two groups and their respective, compatible objectives. The farmer objective is to add-value to their crops through the vertical integration of production. In addition to raising crops, farmers want to process commodities. Community economic development groups want to create jobs by attracting new industry to the community. An LLC can combine each group's objectives and resources to increase the probability of achieving a common goal. Concerning capital resources, Hanson (2000) indicates that unique financing is available for NGCs due to the existence of cooperative banks and government programs that target new cooperative projects; however, cooperatives can have equity in LLCs which thus allows access to cooperative financial institutions as well as other sources of capital.

Greater Potential in Achieving Threshold Membership. NGCs require that farmers have a certain level of patronage to qualify for membership. This may prohibit some prospective farmers from participating simply because they do not produce the particular commodity, or it could be that the level of commitment is prohibitively large for a small farm operation. The LLC may provide more flexibility for smaller groups of producers, unwilling or unable to build a large-scale processing facility. An LLC can respond to membership shortfalls by recruiting non farmer owner-investors. Capital in the form of equity may be raised much easier, and, as Cook (1995) has pointed out, investment decisions tied to patronage are no longer an issue. The absence of the co-op arrangement means that farmer owners are under no obligation to provide a portion of their commodity to the facility and, instead, are able to seek the best market price for their goods. This may create stress to the LLC during cycles of higher commodity prices since an LLC farmer is not obligated to sell a portion of his product to the facility; however, with good strategic management the operation should remain competitive.

Fosters Community Commitment. Ownership by a cross section of the community has the potential to create a stronger linkage between those seeking to add jobs and those seeking to add cash to their existing operation. Communities of all sizes are interested in promoting economic development (Logan and Molotch 1987). A traditional approach to development has been to focus on business recruitment. In rural communities, this might mean recruiting a nonagricultural manufacturing plant to rural areas because of low wages. Instead of relying on low wages as a comparative advantage, it may be possible to generate jobs based on the comparative advantage of agricultural commodities. This creates a firm owned by members of the community, both farmers and non farmers, that simultaneously provides increased income for farmers while generating jobs and creating wealth for local residents.

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Flexibility in Options to Grow. For NGCs—a closed membership organization—there are two methods to raise capital after the initial offering sale: (1) securing loans and (2) the sale of nonvoting equity. According to Cook (1995), 98.7 percent of equity raised by co-ops in the upper Midwest was in the form of preferred (nonvoting) stock. LLCs can secure loans and raise capital through issuing additional common (voting) stock. The flexibility is also evident in the fact that LLCs can be used by existing cooperatives to spin off a subsidiary enterprise or to enter into joint ventures with other cooperatives (Frederick 1997). The implication is that LLCs can satisfy growth and product diversification needs for existing NGCs, and are a complementary business structure for expanding NGCs.

Conclusion

In a broad sense, both farmers and their communities are striving to achieve the same objective, which is to improve local economic conditions. In a narrower sense, the farmer desires more value per unit of production while community leaders want more and better paying jobs. Can these related, but not identical goals be linked to garner benefits for both parties? Yes they can, and, indeed, they have, in a range of cooperative and collaborative ventures. Large NGCs, such as Dakota Growers Pasta Company, have an enormous local economic impact. Dakota Growers is comprised of 1,100 members and employs 480 workers in their Carrington, North Dakota, processing facility (Nadeau and Wilson 2000).

On the other hand, even small collaborative efforts such as Southwest Quality Pork, LLC, in Mt. Ayr, Iowa, make an important impact on their host community. It has hired ten full-time and two part-time employees. The state of Iowa promotes Southwest Quality Pork (SQP) as a good corporate citizen by noting an annual payroll in excess of $310,000, along with one of the most competitive employee compensation packages in the region. Ron Dunphy, president of SQP, summarizes the far-reaching benefits of the LLC when he notes that expanding pork production in the area has improved local markets for corn. It has also created jobs, increased use of the state's processing capacity, and generated profits which are circulated through the local economy (Iowa Department of Agriculture n.d.).

Cooperative ventures organized as LLCs and NGCs have both reinvigorated the communities in which they operate. The decision to organize as an LLC or an NGC must be carefully considered because each business structure has its benefits and its drawbacks. Interested parties need to be aware that LLCs are a relatively new business form, without the track record of success established by cooperatives (Frederick 1997). The future will provide a better understanding of the LLC experience, including to what extent the expectations of farmers and non farmers have been achieved.

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