

The National Agricultural
Law Center



A research project from The National Center for Agricultural Law Research and Information of the University of Arkansas • NatAgLaw@uark.edu • (479) 575-7646 • www.NationalAgLawCenter.org

An Agricultural Law Research Article

An Introduction to the Federal Securities Laws As They Might Apply to Agricultural Operations

by

Carol R. Goforth

The National Agricultural Law Center
University of Arkansas School of Law
1 University of Arkansas
Fayetteville, AR 72701

May 2002

An Introduction To The Federal Securities Laws As They Might Apply To Agricultural Operations

Table of Contents

1.	Introduction	1
2.	What Are the Federal Securities Laws?	2
2.1.	General Framework of the Statutes	2
2.2.	What is a Security	4
2.2.a.	Note, Bonds, Debentures and Evidence of Indebtedness	5
2.2.b.	Stock and Treasury Stock, Voting Trust Certificates and Other Interests in Stock	8
2.2.c.	Investment Contracts, and Certificates of Interest or Participation in Profit Sharing Agreement	9
2.2.d.	Certificate of Deposit for a Security	11
2.2.e.	Fractional Undivided Interest in Oil, Gas or Other Mineral Rights	12
2.2.f.	Put, Call, Straddle, Option or Privilege Relating to Certain Interests	13
2.2.g.	Any Interest or Instrument Commonly Known as a Security	14
2.3.	Why it Matters	14
2.4.	The Effect of Exemptions from the Federal Laws	16
2.4.a.	Exempt Securities and Transactional Exemptions	17
2.4.b.	The Exemption for Agricultural Cooperatives (§ 3(a))	17
2.4.c.	The Intrastate Offering Exemption (§ 3(a)(11))	19
2.4.d.	Regulation A: Mini-registration	21
2.4.e.	Rule 701: Compensatory Plans and Contracts	22
2.4.f.	The Private Offering Exemption (§ 4(2))	23
2.4.g.	Regulation D and the Limited Offering Exemptions	26
2.4.h.	The Section 4(6) Exemption	28
3.	How the Securities Laws Might Apply to Equity Participants in Agricultural Ventures.	29
3.1.	The Family Farm	29
3.1.a.	Setting up a Corporation and Transferring Stock	29
3.1.b.	Setting up an LLC and Transferring Membership Interests	31
3.1.c.	Setting up a General Partnership or Joint Venture	34
3.1.d.	Setting up a Limited Partnership and Transferring Partnership Interests	36
3.2.	Agri-Businesses	37
3.2.a.	The Publicly Held Enterprise	37
3.2.b.	Special Securities Laws Limiting the Obligation of Agricultural Enterprises to Register under the '34 Act	38
3.3.	Participation in Traditional Marketing Cooperatives	40
3.3.a.	What Is a Traditional Cooperative?	40
3.3.b.	Application of the Securities Laws to Traditional Cooperatives	42
3.4.	Participation in Value-added Cooperatives	52
3.4.a.	What Is a Value-added Cooperative?	52
3.4.b.	Application of the Securities Laws to Value-added Cooperatives	56
3.4.c.	Policy Considerations Relative to the Securities Laws Treatment of Interests in Value-added Cooperatives	59
3.4.d.	Potentially Significant Variations in the Way of Organizing Operations	61

4.	The Need to Borrow Funds.	63
4.1.	General Rules Applicable to Debt	63
4.2.	Special Considerations Applicable to Debt in the Agricultural Sector	66
5.	Non-traditional Transactions	66
5.1.	Application of General Rules to Businesses that Happen to be Based on Agriculture	67
5.2.	Unusual or Highly Speculative Ventures	67
5.3.	Cattle-based Operations	68
	5.3.a. Maintenance and Feeding	68
	5.3.b. Breeding and Embryos	69
	5.3.c. Leasing	70
6.	A Final Note on Futures and Commodity Trading	71

AN INTRODUCTION TO THE FEDERAL SECURITIES LAWS AS THEY MIGHT APPLY TO AGRICULTURAL OPERATIONS

Carol R. Goforth
Clayton N. Little Professor of Law
University of Arkansas

1. Introduction

This article is intended to provide an overview of some of the ways in which federal law might impact the sale of “securities” by those in an agricultural enterprise. While there are occasional references to state securities laws, this article does not purport to address the myriad ways in which the various states have chosen to regulate the sale of securities. A generic article of the kind that this is intended to be would likely do more harm than good, because there is so much variation from state to state, both in terms of what is considered to be a security and what kinds of transactions might be exempt from state-imposed registration requirements. In fact, even the registration requirements imposed by the states vary considerably, and once it is understood that a particular transaction implicates the federal securities laws, it is probably good advice as a general matter to check the state law of every state where potential purchasers reside to make sure that a proposed transaction will not be illegal under state law. Information on the federal securities laws contained in this article is not intended as a substitute for the individualized advice available from experienced securities counsel.

In many cases, however, persons involved in agriculture may be unaware that a proposed transaction might require the advice of a securities lawyer. In fact, because securities law is a relatively specialized area of the law, even general practitioners who are quite capable of providing legal advice and assistance on other matters may wish to have a general reference guide to the kinds of securities issues that might be raised by their agricultural clients. This document is intended to provide such guidance. Because this article may be used by both laypersons and lawyers, the textual material is designed to be understood by anyone; the footnotes contain specific legal citations, explanations, and additional references more appropriate to those with legal training.

The following section contains a brief overview of the federal statutes that play a part in the current scheme of federal securities regulation. This is followed by a more detailed look at the types of transactions by agriculturally-based enterprises that are most likely to involve the issuance or sale of “securities,” because this is not always obvious. The material presented will also include information about why it is important to accurately identify the types of interests that will be regulated as securities. After this information is presented, a portion of this article will examine the issue of what kinds of securities or transactions will be exempt from at least a portion of the federal securities laws.

2. What Are the Federal Securities Laws?

The federal securities laws are a system of statutes and regulations designed primarily to promote full and fair disclosure of important information in connection with sales of securities. There are a number of federal statutes in this regime, but this article will focus on only one of them as being of primary importance to agricultural operations that are likely to be operating without the specialized assistance of one or more securities lawyers.

2.1 General Framework of the Statutes

Generally speaking, transactions involving “securities” are subject to a dual system of regulation at both the federal and state levels. As mentioned above, this article focuses only on the federal securities laws which are based on Congress’ constitutional authority to regulate interstate commerce. The requirement that a transaction must in some way involve “interstate commerce” has been very broadly interpreted so that virtually all securities transactions will, in fact, be covered by the federal laws. For example, use of the mails to accomplish any part of the transaction, including payment or confirmation after a sale, has been found to be sufficient to support federal jurisdiction.¹ Delivery of the security via the mails would likewise suffice. In what may be the most extreme example, an intrastate telephone call has also been found to involve the use of interstate facilities.²

Although this article focuses on the federal securities laws, state laws will also apply to any securities transactions. While there are some exemptions from federal law that are also recognized by the state law in every jurisdiction, in many cases a single securities transaction will have to be structured to comply not only with federal law, but also the law of every state where the party issuing the security or any purchaser (and sometimes persons who are offered the right to purchase) resides.

In general terms, federal securities law is based upon six statutes and the regulations which have been promulgated under the authority granted therein:

The Securities Act of 1933 (often called the ‘33 Act)³

The Securities Exchange Act of 1934 (often called the ‘34 Act)⁴

The Public Utility Holding Company Act of 1935⁵

The Trust Indenture Act of 1939⁶

The Investment Company Act of 1940⁷

The Investment Advisers Act of 1940⁸

The Securities Investor Protection Act of 1970⁹

For the purposes of this article, far and away the most important statute is the first. The Securities Act of 1933 regulates the sale of securities, and in very general terms, prohibits all sales of securities unless the sale is exempt pursuant to express statutory provisions or is accompanied by very detailed disclosures. The disclosure process is generally referred to as “registration,” and registration materials (if required) must be filed with the Securities and Exchange Commission (SEC) and made available to purchasers. The statute also contains numerous anti-fraud provisions which cannot be avoided even if the sale of the security is exempt from the registration requirements.

-
1. *E.g.*, Franklin v. Levy, 551 F.2d 521 (2d Cir. 1977).
 2. *See, e.g.*, Dupuy v. Dupuy, 511 F.2d 641(5th Cir. 1975).
 3. The ‘33 Act is codified at 15 U.S.C.Secs. 77a *et seq.*
 4. The ‘34 Act is codified at 15 U.S.C. Secs. 78a *et seq.*
 5. This Act is codified at 15 U.S.C. Secs. 79 *et seq.*
 6. This Act is codified at 15 U.S.C. Secs. 77aaa *et seq.*
 7. This Act is codified at 15 U.S.C. Secs. 80a-1 *et seq.*
 8. This Act is codified at 15 U.S.C. Secs. 80b-1 *et seq.*
 9. This Act is codified at 15 U.S.C. Secs. 78aaa *et seq.*

The Securities Exchange Act of 1934 primarily regulates securities which are already issued and outstanding. This statute addresses a number of distinct topics, each of which are intended to regulate different participants in the securities trading process. This statute established the SEC, which now has the responsibility for general administration of the federal securities laws. The '34 Act also imposes on-going reporting and disclosure requirements on companies that are publicly held; prohibits various "manipulative or deceptive devices or contrivances" in connection with the purchase or sale of securities; restricts the amount of credit that may be extended for the purchase of securities; regulates securities brokers and dealers; and provides for the SEC to supervise national securities exchanges and associations, clearing agencies, transfer agents and other professionals.

The Public Utility Holding Company Act of 1935 was designed to address various abuses in the financing and operation of electric and gas public utility holding company systems and to physically integrate and simplify those systems. Under the current system of regulation, it accounts for very little of the SEC's resources and is not really applicable to agricultural enterprises.

The Trust Indenture Act of 1939 applies generally to public issues of debt securities in excess of a specified amount, which the SEC has currently fixed at \$10 million.¹⁰ Even though the issuance of the debt securities is also regulated by the '33 Act, this statute imposes additional standards of independence and responsibility on the indenture trustee and requires other provisions to be included in the indenture for the protection of the security holders. While larger agriculturally-based enterprises may issue debt securities in amounts sufficient to trigger the application of this statute, this will almost certainly be done with the assistance of experienced securities counsel and is unlikely to catch either the attorneys or the enterprise by surprise. For this reason, this statute will not be addressed in detail in these materials.

The Investment Company Act of 1940 regulates publicly-owned companies engaged primarily in the business of investing and trading in securities. The Act includes provisions dealing with the management of investment companies, their capital structure, approval of their advisory contracts and changes in investment policy, and requires SEC approval for any transactions by such companies with directors, officers or affiliates. While the Investment Company Act provides a potential trap for companies with a shortage of operating assets in comparison to their passive investments, it is unlikely to affect agricultural enterprises, with the possible situation of an agriculturally-based company that sells the bulk of its operating assets and invests the proceeds in securities while it searches for new assets or operations to acquire.

The Investment Advisers Act of 1940 established a scheme of registration and regulation of investment advisers. It is not likely to apply to agricultural enterprises.

The Securities Investor Protection Act of 1970 established the Securities Investor Protection Corporation (SIPC), which is authorized to supervise the liquidation of securities firms that are in financial difficulties. Again, this statute is not of any particular relevance to agriculturally-based companies.

Before we focus on the application of the federal securities laws and upon the definition of the word "security," one final point is worth making. In most cases, the securities laws discussed in this document will apply to anyone who sells a security. The concept of "seller" is one which is probably well understood and needs no discussion here. However, there is a related concept which is very important in the securities laws: every security will originate with an "issuer." This person may, but need not be, the same as the seller. Because many of the securities laws and rules talk in terms of "issuers," and because this is a term which probably is not in general use, it is worth defining this concept more carefully.

10. See Trust Indenture Act Rule 4a-3.

An issuer can be almost any judicial "person," including an individual, corporation, partnership, limited liability company, other unincorporated association, government, etc. When any such person creates an interest which fits within the definition of the word "security," that person is an issuer. Even if the security is later resold by the original purchaser, the identity of the issuer will not change. In addition, "issuer" also includes persons who propose to issue securities, as well as those who follow through and actually complete the transaction(s). For example, a promoter who takes pre-incorporation subscriptions is considered to be an issuer.

With this background in mind, it is important to consider whether a particular transaction will be deemed to involve the transfer of something which qualifies as a "security." The statutes and rules which are the subject of this article apply only if a given transaction involves the transfer of an interest that qualifies under the applicable definition.

2.2 What Is a Security

The federal securities laws were originally issued in response to the economic crisis precipitated by the collapse of the stock markets in 1929. The first federal securities statute, the Securities Act of 1933, was clearly designed to address the kinds of interests that were traded on these markets. Recognizing, however, the innate creativity of con artists who might seek to avoid application of any federal laws if their application was too narrowly prescribed, Congress adopted a broad and relatively amorphous definition of "security" as part of this statute. The statutory language is the obvious starting point for any consideration of what is meant by the term "security."

The '33 Act says that the term "security" will have the following meaning, "unless the context otherwise requires":

The term `security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a `security' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.¹¹

11. 15 U.S.C. Sec. 77b(1) (1987). Note that the definitions which appear in the other federal securities statutes are very similar but not necessarily identical. For example, the '34 Act definition generally tracks the '33 Act, but excludes from the definition of security "currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." 15 U.S.C. Sec. 78c(a)(10) (1987). Notes, drafts, bills of exchange or banker's acceptances generally meeting this description are exempted from the registration provisions of the '33 Act under Sec. 3(a)(3), but remain subject to the anti-fraud provisions of that Act. 15 U.S.C. Sec. 77c(a)(3) (1987). However, it is generally accepted that the '33 and '34 Acts are to be construed "*in pari materia*." *E.g.*, *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). Note that this does not necessarily mean that the term "security" will be equivalently construed in all of the federal statutes. In particular, the term may be differently interpreted under the Investment Company Act of 1940. For a detailed discussion of this issue, see Joseph Franco, *The Investment Company Act's Definition of 'Security' and the Myth of Equivalence*, 7 STANFORD J. L., BUS. & FIN. 1 (2001).

In line with the congressional purpose of ensuring that the '33 Act could be applied broadly and flexibly, this statutory definition contains lists of specific interests that are "securities" but does not purport to include a substantive definition applicable to all such interests. Some of the listed interests have relatively well-defined contours; others are relatively elastic and appear designed to cover a broad spectrum of interests.

It is probably worth emphasizing that this represents the federal approach to the definition of the term, "security." State securities law statutes generally employ similar definitions of what constitutes securities, but they may include other classes of interests that are not present in the federal definition or make other changes in the statutory language. Each applicable state statute will likely need to be reviewed for a separate determination of what interests are regulated, which is beyond the scope of this article.

The following materials provide a very basic discussion of some of the more commonly employed terms in the statutory definition. The specific application of these rules to interests in agriculturally-based enterprises will be covered in more detail in parts 3 and 4 of this article. Equity or ownership interests in such enterprises will be examined in part 3; debt interests will be covered in part 4.

2.2.a. Notes, Bonds, Debentures and Other Evidence of Indebtedness

The first item listed in the statutory definition of security is "note." "Note," as used in this context, clearly refers to a promise to repay a debt at some future time. A note may be for a fixed duration or payable on demand of the holder. It may bear interest at either a fixed or floating rate or no interest at all. It may or may not be secured. It may be payable in installments, partially amortized with a larger balloon payment at maturity of the note, or the only required payment may be a lump sum of the total indebtedness when the note comes due. All of these variations are possible within the commonly understood meaning of the word, "note."

However, although "notes" are included in the laundry list of interests that are to be classified as securities, there is universal agreement that not all notes should be considered securities, rendering the literal approach inappropriate. Remember that the definition of the word, "security," is prefaced with the phrase: "unless the context otherwise requires." It has been widely acknowledged and universally accepted that Congress could not have intended to make every check written by every individual a "security," even though a check is a particular form of a promise to pay a debt. Similarly, it is generally acknowledged that Congress did not intend to regulate ordinary consumer debt, whether represented by credit card obligations, car loans, in-store financing agreements, or even home mortgage loans, as securities. The harder question is how to tell when other kinds of notes, particularly those issued by business enterprises, should be excluded from the reach of the federal securities laws.

After years of heated debate among the courts,¹² it has now been determined that notes which bear a so-called "family resemblance" to consumer notes which are clearly not securities will not be treated as securities.¹³ There is, however, a presumption that promissory notes are securities; it is only

12. Before the Supreme Court answered the question, the lower federal courts had developed a number of conflicting approaches for determining when a note counted as a security under the federal securities laws. The Second Circuit had adopted its own "family resemblance" test. *Exchange Nat'l Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir 1976). The D.C. Circuit, the Seventh Circuit and the Fifth Circuit all applied a commercial/investment approach. *Bauer v. Planning Group, Inc.*, 669 F.2d 770 (D.C. Cir. 1981); *American Fletcher Mortgage Co. v. United States Steel Credit Corp.*, 635 F.2d 1247 (7th Cir.), *cert. denied*, 451 U.S. 911 (1980); and *United American Bank v. Gunter*, 620 F.2d 1108 (5th Cir. 1980).

13. The Supreme Court resolved the dispute in *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

where the issuer of the note (the debtor) can show that the note in question bears a strong family resemblance to other notes which are recognized as being something other than securities that the presumption can be overcome.

To determine when a note bears such a family resemblance, the U.S. Supreme Court has established a four-part test. The test requires courts to examine the motivations of a reasonable buyer and seller of such notes, the plan of distribution of the instruments, the reasonable expectations of the public, and whether some other factor, such as the existence of another regulatory scheme, sufficiently protects investors.¹⁴ Each of these elements deserves some additional explanation.

As to the motives of the buyer and seller, the Supreme Court has indicated that "[i]f the seller's purpose is to raise money for the general use of a business enterprise . . . the instrument is likely to be a security."¹⁵ At first glance, it might appear that every time a business borrows funds, it will be to raise money for the use of the enterprise. However, if the debt is incurred, not for general operations but to fund the acquisition of a particular piece of property, the debt can be closely analogized to consumer loans to acquire similar property. Similar arguments can be made if the purpose of the loan is simply to avoid cash flow problems, and the business has a revolving pool of debt that functions much like credit card indebtedness of individuals. In these cases, although the proceeds do indeed fund business functions, the proceeds are not treated as additional capital to finance general operations, and therefore the indebtedness in question is not likely to be a security.

The second element of the family resemblance test suggests that in order to be classified as a security, it should be expected that the interests will be traded for speculation or investment. However, in the very case where the Supreme Court developed the test, the demand notes which were found to satisfy this criteria could not be traded.¹⁶ According to the Court, it was enough that they were "offered and sold to a broad segment of the public." This may be a very critical element for businesses: a debt that is marketed in small sections to a broad section of the public may well be the kind of indebtedness that Congress would want to see regulated under the securities laws.

As to the third element, the reasonable expectation of the purchasers, it is hard to say in a vacuum what this means. Only in the context of a particular form of note is it generally possible to tell whether the creditor is likely to believe that the note represents the kind of investment which is regulated by the securities laws.

The final element of the "family resemblance" test asks if there is some other reason, such as the existence of an alternative regulatory scheme, which reduces the risk of the investment. For example, loans from federally-regulated banks and savings and loan associations are already regulated. Loans from individuals may not be. The presence of an alternate regulatory scheme makes it less likely that the interests in question will be found to be within the ambit of the federal securities laws.

This general discussion is also applicable to the appropriate treatment of specific types of indebtedness, such as bonds or debentures. In common parlance, bonds usually have a relatively long time to maturity, often as long as 20 years, and are usually issued in large amounts, typically in the millions of dollars. While debentures share these characteristics, the two types of instruments differ in the degree of risk associated with each. Bonds, the less risky of the two, are secured by collateral, while

14. *Id.* at 66.

15. *Id.*

16. *Id.*

debentures are unsecured.¹⁷ Although it is true that the statutory definition of "security" contains "bond" and "debenture" as well as "note," it is understood that both "bond" and "debenture" should be construed the same way "note" is interpreted.¹⁸ Under appropriate circumstances, both have been found to be securities.¹⁹

Moreover, the fact that a debt instrument may be called something other than a note, bond or debenture will not be sufficient to prevent application of the securities laws. Because the definition of "security" technically covers all "evidence of indebtedness,"²⁰ the courts must generally look at the economic realities of the underlying transaction. "Evidence of indebtedness" is often discussed in connection with the question of whether particular notes are securities,²¹ and some documents which might literally evidence certain kinds of indebtedness will not necessarily be securities.²² On the other hand, things like passbook savings certificates and thrift certificates issued by finance companies have been treated as securities because they represent "evidence of indebtedness."²³

Again, particular kinds of debt instruments that may be issued by agricultural enterprises will be examined in more detail in part 4 of this document. This information provides only the background concerning what is covered by the federal securities laws.

2.2.b. Stock, Treasury Stock, Voting Trust Certificates and Other Interests in Stock

The second item listed within the statutory definition of the term, "security," in the '33 Act is "stock." "Stock" generally represents an equity or ownership interest in a corporation, and may be common or preferred. Generally speaking, anything which qualifies as corporate "stock" will be a security under the federal laws; this is one instance where the literal approach prevails.

17. Arnold S. Jacobs, 5B Disclosure and Remedies Under the Securities Laws Sec. 9:117 (1981), citing A.G. Becker Inc. v. Board of Governors of Federal Reserve System, 693 F.2d 136 (D.C. Cir. 1982).

18. Van Kampen Merritt, Inc. v. Avondale Properties Partnership, 702 F. Supp. 1412 (N.D. Ill. 1989) (bond's status as a security governed by the law regarding notes); Braniff Airways, Inc. v. LTV Corp., 479 F. Supp. 1279 (N.D. Tex. 1979) (bond is not significantly different from a note).

19. First Fin. Sav. Bank, Inc. v. American Bankers Ins. Co., Fed. Sec. L. Rep. (CCH) ¶ 94,824, at 94,449 (E.D.N.C. 1989), *dismissed in part* Fed. Sec. L. Rep. (CCH) ¶ 94,825 (E.D.N.C. 1989) (analyzing a debenture using cases involving notes).

20. For a discussion of the inherent ambiguity of the phrase, see Holloway v. Peat, Marwick, Mitchell & Co, 879 F.2d 772 (10th Cir. 1989).

21. See *generally* Holloway v. Peat, Marwick, Mitchell & Co, 879 F.2d 772 (10th Cir. 1989); In re Tucker Freight Lines, Inc. 789 F. Supp. 884 (W.D. Mich. 1991); Smith v. Manausa, 385 F. Supp. 443 (E.D. Ky. 1974); SEC v. Thunderbird Val., Inc. 356 F. Supp. 184 (D.C. S.D. 1973).

22. A number of transactions that might technically involve some "evidence of indebtedness" have been held not to involve securities. See Cocklereece v. Moran, 532 F. Supp. 519 (N.D. Ga. 1982) (involving an escrow deposit of interest for 3-year loan commitment which arose in a commercial context, after having been individually negotiated and issued); LTV Federal Credit Union v. UMIC Government Securities, Inc., 523 F. Supp. 819 (N.D. Tex. 1981) (involving a standby commitment obligating federal credit union to purchase securities); Avenue State Bank v. Tourtelot, 379 F. Supp. 250 (N.D. Ill. 1974) (involving ordinary commercial bank loan transaction).

23. Holloway v. Peat, Marwick, Mitchell & Co., 879 F.2d 772 (10th Cir. 1989). *Accord* MacKethan v. Peat, Marwick, Mitchell & Co., 439 F. Supp. 1090 (E.D. Va. 1977) (involving "certificates of investment"); Superintendent of Ins. of State of N.Y. v. Bankers Life & Cas. Co., 300 F. Supp. 1083 (S.D.N.Y. 1969) (involving certificate of deposit issued for cash by a bank).

The characteristics of stock are that unless the owner has agreed otherwise, the owner will be entitled to: (1) receive profits based on the proportion of the owner's interest in the entity; (2) vote in proportion to the interest owned; (3) transfer ownership of the interest; (4) pledge the interest to secure repayment of debts; and (5) share in any appreciation or increase in value of the underlying enterprise.²⁴ These are the normal attributes of corporate stock, and thus, if an agriculturally-based enterprise is formed as a corporation under state law, the sale of stock in that enterprise will involve the sale of securities.²⁵

This does not, of course, mean that every sale of corporate stock is illegal under the securities laws unless it has been properly registered. It does, however, mean that an appropriate exemption from the federal and usually state laws must be found and complied with. What this means for agriculturally-based businesses will be addressed in more detail in part 3 of this article.

In addition, the definition of "security" also includes a reference to treasury stock. This term refers to stock which was once issued, was outstanding in the sense that it was owned by a shareholder, but has now been repurchased by the corporation. Under traditional principles of corporate finance, the stock would have been held as treasury stock and would have had to have been listed as such on the corporation's balance sheets. Most of the reasons for treasury stock have disappeared or diminished with the modernization of federal statutes, and many modern statutes now presume cancellation of repurchased shares so that they are never held in "treasury," even if the corporation reacquires them. For purposes of this article, this is likely to be of academic, rather than practical, importance. As described in the preceding section, if shares are being sold, the question of whether they are or might once have been considered treasury shares is irrelevant to the question of whether they will be regulated as securities.

The statutory definition of security also refers to interests in voting trusts, which are a specific arrangement by shareholders about how their shares will be voted. Voting trusts are authorized by most state corporate statutes and are used in order to protect against future changes in control, to minimize the possibility of fights over control, or to otherwise insure that voting policies are continued in the future. In order to form a voting trust, shareholders transfer the legal ownership of their shares to a voting trustee, while retaining the beneficial or economic interest in the shares. This economic interest is generally documented by a voting trust certificate. Thus, the reference to voting trust certificates in the securities law really refers to one possible way in which ownership of corporate shares might be handled.²⁶

2.2.c. Investment Contracts, and Certificates of Interest or Participation in Profit-Sharing Agreement

One of the most important categories of interests within the definition of "security" is that of investment contract. Unlike notes and stock, there was no commonly understood meaning of this phrase at the time the statute was enacted, and the '33 Act itself contains no definition. This meant that the

24. Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985).

25. At the risk of some redundancy, it is worth emphasizing that this will not necessarily be the case under state law. In some jurisdictions, if the sale in question involves all of the outstanding interest in a corporation, the transaction is treated as a sale of the business itself, rather than a sale of the securities. Although this was precisely the position which was rejected by the Supreme Court in *Landreth*, some states continue to apply the sale of business exclusion. Thus, even where the federal and state statutory definitions may appear to be the same, the courts will not always construe them in an identical fashion.

26. While there is very little case law focusing solely on the appropriate classification of voting trust certificates, the meaning of this phrase seems relatively straightforward. See *Foltz v. U.S. News & World Report*, 627 F. Supp. 1143 (D.D.C. 1986).

proper interpretation of this phrase was left to the courts. In 1946, the Supreme Court held that investment contract "means a transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or third party."²⁷ Unfortunately, this deceptively simple statement, which has come to be known as the *Howey* test (from the name of the issuer in the Supreme Court case), left many issues unanswered.

Does the *Howey* test really require an investment of money, or will the commitment of property or even services suffice? Precisely what is necessary to support a finding of a "common enterprise?" Does commonality require only common interests between the investor and the promoter (vertical commonality), or must multiple investors share in the same interests (horizontal commonality)? What is meant by the expectation of profits? Perhaps most importantly, what does it mean that such profits must be expected "solely" from the efforts of a third party? Finally, if these prongs are all met, does that automatically mean that the interest will be a security? All of these questions have been answered in one way or another by various courts and sometimes in more than one way. Some of the answers are relatively definite; other questions are still open.

First, consider whether the initial investment must really be in the form of "money." The answer to this question is clearly, no.²⁸ In general, any property having a genuine value may be contributed, and this element will be satisfied. The more subtle question is whether there has been an "investment" of this property. Speaking generally, if the money or property is paid in order to purchase something for use or consumption, there is no investment. This can be a difficult but critical inquiry in a wide range of circumstances.

With regard to the requirement of commonality, there is even less agreement.²⁹ In some parts of the country, courts applying the *Howey* test require horizontal commonality.³⁰ In other words, the proceeds from a number of investors must be pooled and used for a common project. The fortunes of these investors are then tied together in the necessary "common enterprise." This is the most restrictive of the possible approaches. In other jurisdictions, the courts allow vertical commonality to suffice.³¹ Vertical commonality requires only a common interest between the investor and the promoter. If the interests of the promoter and an investor are tied together such that they will either both succeed or they will both fail, commonality has been satisfied. Under this approach, there is no need to find a "pooling" of resources between investors, although this would certainly suffice. Finally, a compromise position has been employed in other parts of the country. Under this approach, the courts have clearly held that there does not have to be strict horizontal commonality in the sense that multiple investors must pool their resources. On the other hand, there must be something more than the common interest demonstrated

27. SEC v. W. J. Howey Co., 328 U.S. 293 (1946).

28. The Supreme Court held in *Internat'l Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979), that this element was met if "the purchaser gave up some tangible and definable consideration in return for an interest that had substantially the characteristics of a security."

29. As of this writing, only six circuits (the Third, Fifth, Sixth, Seventh, Ninth and Eleventh) have addressed this issue, and they are not in accord on how to handle this element.

30. See *Salcer v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 682 F.2d 459, 460 (3rd Cir. 1982); *Curran v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 622 F.2d 216, 221-25 (6th Cir. 1980), *aff'd on other grounds*, 456 U.S. 353 (1982); *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 276-77 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972).

31. See *SEC v. Continental Commodities Corp.*, 497 F.2d 516, 520-23 (5th Cir. 1974); *Villeneuve v. Advanced Business Concepts Corp.*, 698 F.2d 1121, 1124 (11th Cir. 1983), *aff'd en banc*, 730 F.2d 274, 276-77 (11th Cir. 1984).

when the promoter earns commissions from investors in exchange for advice.³² Thus this element is still ripe for litigation and likely will be until the Supreme Court resolves the disagreement among the courts.

With regard to what constitutes profits, some courts have adopted a liberal interpretation, finding that even the expectation of tax benefits will satisfy this element, while other courts have suggested a more restrictive approach.³³ However, even under the more restrictive approach, if the purchaser expects to benefit from capital appreciation or the right to share in earning, this element will be satisfied.³⁴

The aspect of the *Howey* test which has generated the most controversy is the requirement that investors must expect profits "solely" from the efforts of others. The term "solely," if interpreted literally, would rob the term "investment contract" of much of its usefulness as a general category of interests which are to be classified as securities. Only totally passive investors would be protected by the securities laws under this approach. A literal interpretation would exclude interests where the form of the transaction offered a minute degree of theoretical involvement to investors, even if the economic and practical realities of the situation were such that the investors had no meaningful control over their investment and were, in fact, forced to rely on the expertise of others.

Although the Supreme Court has yet to address this issue, the likely solution to the problem of what it means to expect profits "solely from the efforts of others" is that the proper inquiry should focus on the "essential, entrepreneurial" efforts required for financial success. Under this interpretation, if someone other than the investor provides all of the essential, managerial decisions, then the investor is left with an essentially passive role, which is the hallmark of a typical security.³⁵ While it is not entirely certain that this is the correct approach, there are substantial indications that this is likely to embody the approach that the courts will be following in the immediate future.³⁶

32. This is the approach taken in the Ninth Circuit. See *El Khadem v. Equity Sec. Corp.*, 494 F.2d 1223, 1229 (9th Cir. 1974), *cert. denied*, 419 U.S. 900 (1974); *Brodt v. Bache & Co.*, 595 F.2d 495, 461 (9th Cir. 1978). The exact parameters of the Ninth Circuit's test are not entirely clear.

33. Compare *Long v. Shultz Cattle Co., Inc.*, 881 F.2d 129 (5th Cir. 1989); *SEC v. Goldfield Deep Mines of Nev.*, 758 F.2d 459, 463-64 (9th Cir. 1985); *SEC v. Aqua-Sonic Prod. Corp.*, 687 F.2d 577, 583 (2d Cir. 1982), *cert. denied sub nom.*, *Hecht v. SEC*, 459 U.S. 1086 (1982); and *Goodman v. Epstein*, 582 F.2d 388, 407-08 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979) with *United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975). Justice Powell, writing for the majority in *Forman*, seemed to limit the definition of profits to capital appreciation or participation in earnings but the lower courts, although writing after *Forman* was decided, have adopted the broader interpretation of "profits."

34. See generally *Guidry v. Bank of LaPlace*, 740 F. Supp. 1208 (E.D. La. 1990).

35. This test was articulated by the Ninth Circuit in *SEC v. Glenn W. Turner Enterprises*, 474 F.2d 476 (9th Cir. 1973), *cert. denied*, 414 U.S. 821 (1973). The Ninth Circuit held that the appropriate interpretation of the third element of the *Howey* test was to require proof that efforts by someone other than the investor "are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." A majority of the other federal circuits have also adopted this approach. See *SEC v. Professional Assocs.*, 731 F.2d 349, 357 (6th Cir. 1984); *Goodwin v. Elkins & Co.*, 730 F.2d 99, 103 (3d Cir.), *cert. denied*, 469 U.S. 831 (1984); *SEC v. AquaSonic Prods. Corp.*, 687 F.2d 577, 582 (2d Cir.), *cert. denied*, 459 U.S. 1086 (1982); *Kim v. Cochenour*, 687 F.2d 210, 213 n.7 (7th Cir. 1982); *Baurer v. Planning Group Inc.*, 669 F.2d 770, 779 (D.C. Cir. 1981); *Aldrich v. McCulloch Properties, Inc.*, 627 F.2d 1036, 1040 n.3 (10th Cir. 1980); *Fargo Partners v. Dain Corp.*, 540 F.2d 912, 914-15 (8th Cir. 1976); *SEC v. Koscot Interplanetary, Inc.* 497 F.2d 473, 483 (5th Cir. 1974).

36. The reason for this assumption is that the Supreme Court, in *United Housing Foundation v. Foreman*, 421 U.S. 837 (1975), referred to a "reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others," omitting the word "solely" from the *Howey* formulation. The Court did, however, expressly decline to state whether it was adopting the Ninth Circuit view, so there is still some room for doubt as to the proper interpretation of this aspect of the *Howey* test.

2.2.d. Certificate of Deposit for a Security

The issue of when certificates of deposit will be subject to the securities laws is closely related to the question of when a note will be regulated as a security.³⁷ Thus, there are certain classes of certificates of deposit that are not treated as securities, just as certain notes are excluded from the ambit of the federal securities laws. For example, a federally insured certificate of deposit issued by a bank is not subject to the securities laws.³⁸ These instruments are not usually publicly marketed, these banks are already heavily regulated and neither the participants nor other members of the public are likely to believe that these kinds of certificates represent a security. On the other hand, certificates of deposit can become securities when they are marketed as such. For example, if an investment firm markets certificates of deposit as liquid investments and maintains a secondary market for the certificates of deposit, the securities laws have been held to apply.³⁹ In addition, and at least partly because of the lack of an alternate scheme of regulation, some certificates issued by foreign banks have also been found to be securities.⁴⁰ Similarly, certificates of deposit issued by institutions that are not subject to the existing federal regulatory scheme may be regulated as securities.⁴¹

2.2.e. Fractional Undivided Interests in Oil, Gas or other Mineral Rights

"Fractional undivided interests in oil, gas, or other mineral rights"⁴² are also included in this list of interests that will be regulated as securities under the '33 Act. Although unlikely to be of significance to very many farming or other agriculturally-based enterprises, it is worth at least considering this as a potential issue under the securities laws, because agriculture has always been tied so closely to the land.

37. The proper interpretation of the word "note" as used in the definition section of the securities laws is discussed in section 2.2.a of this section. For additional information on this subject, see Thomas Lee Hazen, 1 LAW OF SECURITIES REGULATION Sec. 1.6 (4th Ed. 2002).

38. *Marine Bank v. Weaver*, 455 U.S. 551, 102 S.Ct. 1220, 71 L.Ed.2d 409 (1982), *on remand* 683 F.2d 744 (3d Cir.1982). *Accord, e.g., Dubach v. Weitzel*, 135 F.3d 590 (8th Cir.1998) (certificate of deposit was not a security; the claims involved were ordinary commercial transactions). See also *Tafflin v. Levitt*, 865 F.2d 595 (4th Cir.1989) (certificate of deposit issued by savings and loan association was not a security); *Tab Partnership v. Grantland Financial Corp.*, 866 F.Supp. 807 (S.D.N.Y.1994) (CD rollover program was not a security)

39. *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir.1985). On a somewhat related issue, see *Securities Industries Association v. Clarke*, 703 F.Supp. 256 (S.D.N.Y.1988), *vacated on other grounds* 885 F.2d 1034 (2d Cir.1989) (private mortgage-backed, pass-through certificate issued by bank is a security). See also *Olson v. E.F. Hutton & Co.*, 957 F.2d 622, 628 (8th Cir.1992) (*Marine Bank* does not preclude a finding of a security where the bank's guaranty does not eliminate the security type risk); *Gomez v. Leonzo*, 788 F.Supp. 604 (D.D.C.1992) (company falsely calling itself a bank and issuing savings passbooks was issuing a security).

40. *Meason v. Bank of Miami*, 652 F.2d 542 (5th Cir.1981), *rehearing denied* 659 F.2d 1079 (5th Cir.1981) (Grand Cayman bank); *R.J. Wolf v. Banco Nacional De Mexico*, 549 F.Supp. 841 (N.D.Cal.1982), *appeal dismissed* 721 F.2d 660 (9th Cir.1983), *reversed on appeal after remand* 739 F.2d 1458 (9th Cir.1984), *cert. denied* 469 U.S. 1108 (1985) (time deposit in Mexican bank is a security).

41. For example, the existence of state regulation alone will not be sufficient to preclude application of the federal securities laws. See *Bradford v. Moench*, 809 F.Supp. 1473 (D.Utah 1992) (thrift certificates issued by a savings and loan association were securities; state regulation of savings and loan association was not sufficient risk reducing factor under the family resemblance test).

42. For a more detailed analysis of this issue, see Peter K. Reilly & Christopher S. Heroux, *When Should Interests in Oil and Gas be Considered Securities?: A Case for the Industry Deal*, 34 S. TEX. L. REV. 37, 45 (1993).

In the event that an agriculturally-based enterprise should seek to raise funds through the sale of interests in oil, gas or other minerals, there is at least the potential for securities issues to arise.

It has generally been accepted that Congress' use of the phrase "fractional undivided interests," means that in order to implicate the federal securities laws, there must be some sharing of the interest in a single oil, gas or mineral enterprise through concurrent ownership.⁴³ Based upon the current interpretations of the statute, a joint tenancy or similar legal relationship between common owners is generally required. Thus, if the seller transfers his or her entire interest in a joint tenancy, the courts have found that there is no sale of a security because the seller has transferred his or her entire interest rather than a fractional one.⁴⁴ As mentioned above, this is likely to impact agriculturally-based enterprises only tangentially, in the event that the enterprise seeks to raise capital through the sale of such interests.

2.2.f. Put, Call, Straddle, Option or Privilege Relating to Certain Interests

For the most part, this language refers to options to purchase or sell securities at some point in the future. Often, these are relatively sophisticated interests, but they may have application to an agriculturally-based enterprise that offers various options to current or potential participants if the options themselves relate to interests that would be considered to be securities (such as stock or other ownership interests that would qualify as investment contracts).

There are a variety of ways in which an option to purchase or sell securities can be structured. A "put" involves the right to sell stock (or any other security, for that matter) at a certain time, under certain conditions, at a certain price.⁴⁵ Calls, on the other hand, represent the right to buy such interests.⁴⁶ A "straddle" involves the purchase of an equal number of puts and calls on the same security.⁴⁷ Puts, calls and straddles related to stock are generally encompassed within the phrase "stock options"⁴⁸ and are all interests which are often traded on the capital markets.⁴⁹ However, such trading is not a requirement in order for these labels to apply. Moreover, the underlying interest need not be stock--there can be puts, calls or straddles on such things as partnership interests or LLC membership interests, and if the underlying interests are securities, the option will be as well.

43. This is the current position taken by the staff of the SEC. See PetroSell.com, 1999, 2000 WL 48532 n. 1 (SEC No Action Letter Jan. 20, 2000) ("The phrase 'fractional undivided interest in oil, gas, or other mineral rights' applies to concurrent ownership of oil, gas, or other minerals. 'Concurrent ownership' is a form of divided ownership where two or more persons own fractional interests in the whole. For example, tenancy in common, joint tenancy, and tenancy by the entireties.")

44. Ballard & Cordell Corp. v. Zoller & Danneberg Exploration Ltd., 544 F.2d 1059 (10th Cir.1976) (defendant selling his entire 50% interest in two oil wells did not sell a fractional interest and thus did not sell a security).Roe v. United States, 287 F.2d 435, 437 (5th Cir.1961) (since the entire lease was sold, there was no sale of a fractional interest); Darwin v. Jess Hickey Oil Corp., 153 F.Supp. 667, 671 (N.D.Tex.1957) (no security where plaintiff purchased all of seller's interest and a fractional undivided interest was not conveyed)

45. See Kirchman v. Commissioner, 862 F.2d 1486, 1488 n. 3 (11th Cir.1989).

46. *Id.* at 1488.

47. " *Id.* See also Eric D. Roiter, Developments in the Financial Futures and Options Market, 539 Practising Law Institute, Corporate Law & Practice Course Handbook Series 169, 201 (1986).

48. Norman S. Poser, Options Accounts Fraud: Securities Churning in a New Context, 39 Bus. Lawyer 571, 586 (1984) ("A stock option is a right to buy or sell a particular stock at a certain price for a limited period of time."). For additional analysis of puts and calls as securities, see Harold S. Bloomenthal & Samuel Wolff, 3 Sec. & Fed. Corp. Law Sec. 2.92 (2001).

49. *E.g.*, Moskowitz v. Lopp, 128 F.R.D. 624, 631 (E.D.Pa.1989).

Very few cases focus upon the use of the word “privilege” in the context of what types of interests constitute securities. In one case, a federal court held that stock appreciation rights, or SARs, which were divorced from an ownership interest in the underlying securities were not privileges within the statutory definition of security.⁵⁰ The original rationale for this decision was that since “privilege” was simply one of a listed series of types of option, the word privilege ought to be similarly understood.⁵¹ Failure to recognize the limitations applicable to the other listed interest might give the statute an overly broad reach. The reasoning of this opinion might continue to be valid, although the specific case was itself vacated upon rehearing so it is not certain that this analysis will be deemed persuasive in any future actions.⁵²

In any event, from the perspective of the agriculturally-based enterprise, one of the important points worth noting is that creative sales techniques, such as offering potential investors options to buy or sell in the future (whether or not accompanied by the label of “put” or “call”), may involve the issuance of a security. Thus, the sale of the option itself will be regulated by the securities laws, as well as any eventual sale of the underlying security.

2.2.g. Any Interest or Instrument Commonly Known as a Security

It has been said that the ‘33 Act is designed to reach “any novel, uncommon or irregular device, whatever it appears to be” if it can be shown that it was widely offered for sale or was dealt with in a manner which establishes that it has the characteristics of any instrument commonly known as a security.⁵³ The basic test for fitting an instrument into this catch-all category appears to be the same general approach used to determine whether the interest constitutes an investment contract: is there an investment of money in a common enterprise with the profits to come solely from the efforts of others?⁵⁴ This part of the statutory definition is therefore not to be understood as a limitation on the other descriptive terms which appear in the definition,⁵⁵ but rather a clear indication that the economic realities of each transaction will govern the application of the securities laws.

2.3. Why it Matters

Once a particular interest is characterized as a security, this triggers certain requirements and limitations under the federal securities laws and the ‘33 Act in particular. Most notably, a security cannot be sold unless the security is registered under the federal securities laws or an appropriate exemption can be found. In addition, certain anti-fraud provisions will apply regardless of whether an exemption from registration is available.

50. Clay v. Riverwood Internat’l Corp, 157 F.3d 1259 (11th Cir. 1998), *op. vacated in part on rehearing*, 176 F.3d 1381 (11th Cir. 1999), *rehearing denied* 182 F.3d 938 (11th Cir. 1999).

51. For those with legal training, this is expressed by the Latin “*noscitur a sociis*,” which literally means that “a word is known by the company it keeps.” Gustafson v. Alloyd Co., 513 U.S. 561, 575 (1995).

52. The legal argument was expressed by the Supreme Court as follows: “The maxim *noscitur a sociis*, that a word is known by the company it keeps, while not an inescapable rule, is often wisely applied where a word is capable of many meanings in order to avoid the giving of unintended breadth to the Acts of Congress.” Jarecki v. G.D. Searle & Co., 367 U.S. 303 (1961).

53. SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344 (1943).

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

55. *E.g.*, Tcherepnin v. Knight, 389 U.S. 332 (1967).

Certainly, there is nothing inherently objectionable to the idea that an interest which falls into the statutory definition of security cannot legally be sold if there are fraudulent misrepresentations or half-truths that induce the purchaser to buy the security, or if the seller fails to disclose important information which is not generally available to prospective purchasers. Indeed, since the purpose of the registration requirement is to insure that all sales of securities are accompanied by full and open disclosure, there is much that can be said in favor of the registration requirement as well.⁵⁶ In fact, many of the exemptions from registration are themselves conditioned on the availability of such information. Intuitively, it may seem that such a requirement is no more than fair.

From a practical perspective, however, the problem is that the costs of complying with the federal laws can be tremendous. The required documentation is both comprehensive and very closely regulated in terms of form and content. It is now generally expected that the costs of preparing all of the required disclosure documents in connection with an initial public offering will run to the hundreds of thousands of dollars. The required disclosures associated with many exemptions are far less extensive but may still be prohibitively expensive when a business is looking for relatively small sums of money.

In fact, a number of commentators have argued that the costs of regulation exceed the benefits of mandatory disclosure, even for interests which are widely traded on public markets to large numbers of essentially passive investors.⁵⁷ The costs of mandatory disclosure include direct costs, such as the expense of compiling and disseminating the required information, together with the opportunity costs of all those associated with the disclosure process, and indirect costs, such as those which occur when the formidable obstacle of mandatory disclosure leads to the abandonment of potentially profitable ventures. These objections are exacerbated by the fact that "many of the costs of disclosure are the same, regardless of the size of the firm or the offering."⁵⁸

Nor is it appropriate to simply ignore the requirements of the federal law, even on the mistaken assumption that a given transaction is so small that it cannot possibly be covered by such requirements.

56. The potential benefits from mandatory disclosure rules include guaranteeing that minimally adequate information is available to investors, offering a standardized format for information, thereby facilitating comparisons between potential investments, reducing the incentive for over-investment in securities research by investors, and providing a basis for national litigation to resolve common factual and legal issues in the event of a legal dispute. This listing of potential benefits from the current scheme of federal securities regulation is neither original nor comprehensive. Numerous other commentators have discussed the potential benefits of securities regulations and have commented on these as justification for mandatory disclosure and/or federal anti-fraud provisions. See Ribstein, *Private Ordering and the Securities Laws: The Case of General Partnerships*, 42 CASE W. RES. L. REV. 1 (1992); Schulte, *The Debatable Case for Securities Disclosure Regulation*, 13 J. CORP. L. 535 (1988); Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984); Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984).

57. See Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984); Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984). R. Karmel, REGULATION BY THE PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA (1982); S. Phillips & J. Zecher, *The SEC and the Public Interest* (1981); Jarelle, *The Economic Effects of Federal Regulation of the Market for New Securities Issues*, 24 J. LAW AND ECON. 613 (1981); H. Kripke, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE (1979); H. Manne & E. Solomon, WALL STREET IN TRANSITION: THE EMERGING SYSTEM AND ITS IMPACT ON THE ECONOMY (1974); Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973); Benston, *The Value of the SEC's Accounting Disclosure Requirements*, 44 ACCT. REV. 515 (1969); and Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117 (1964).

58. Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 670(1984)

Even the absence of fraud will not save a transaction from the reach of the federal securities laws, and the potential penalties for failing to comply can be costly indeed.

Violations of the federal securities laws can have several undesirable consequences. Criminal penalties such as fines or imprisonment are provided for violations of most express statutory provisions, although these sanctions are usually invoked only in the more egregious instances of misconduct. The statutes also give the SEC a wide range of civil enforcement options, including the right to obtain injunctions and supplemental relief, including disgorgement of gains obtained in violation of the law. In addition, under at least certain circumstances, the SEC can impose civil penalties upon those who are found to have violated the federal securities laws. Moreover, once an issuer is found to have violated the securities laws, it becomes more difficult to find appropriate exemptions in the future, as one illegal sale can taint other transactions which would have been valid standing on their own. Some exemptions are unavailable to issuers who have made illegal sales in the relatively recent past.

Perhaps even more important, the securities laws provide a wide range of private rights of action. Some of the private remedies overlap the SEC's civil enforcement powers while others do not. Moreover, while some of the remedies are based on a private right of action expressly described in the statute, other private remedies have been implied by the courts. The contours of these private causes of action may be both broad and complex, making it difficult for those not well-versed in securities laws to properly structure all transactions involving securities.

Generally speaking, most private remedies are designed to apply to particular kinds of securities laws violations. For example, there are broad anti-fraud remedies contained in both the '33 Act and the '34 Act.⁵⁹ Even absent fraud, however, a purchaser who buys a security in a transaction that was neither registered nor exempt is given the right to rescind or undo the transaction.⁶⁰ This could be very unfortunate for an issuer who finds that things are moving more slowly than had been hoped or anticipated. If every purchaser has the right to back out of the transaction and to a return of their investment with interest, this can essentially guarantee failure of an enterprise that may have had good longer-term prospects despite the slow start.

In addition, these materials should not be taken as a complete listing of the potential consequences of failing to comply with the federal securities laws; this has been nothing more than the briefest of introductions to the potential problems that can be caused by the improper issuance and sale of securities. Fortunately, the lesson here is relatively simple: if a proposed transaction is or may involve the sale of securities, it would be wise to seek the advice of experienced securities counsel. This is not an area of the law where laypersons, or even attorneys who may be perfectly adept when dealing with other legal issues, should feel comfortable testing the waters.⁶¹

59. See, for example, section 10(b) and Rule 10b-5 of the '34 Act. 15 U.S.C.A. Sec. 78j(b); 17 C.F.R. Sec. 240.10b-5. See also section 12(a)(2) of the '33 Act, which provides a remedy for injured purchasers against sellers of the securities. 15 U.S.C.A. Sec. 77l(a)(2). In addition to these general anti-fraud provisions, there are also remedies designed to provide remedies in the case of fraud in connection with specific kinds of securities transactions such as public offerings, tender offers, or proxy solicitations. These types of violations are not the focus of this document, since these kinds of transactions are unlikely to have been undertaken without the assistance of securities counsel.

60. Section 12(a)(1) of the Securities Act of 1933, 15 U.S.C.A. Sec. 77l(a)(1). The right of rescission requires no fraud or misrepresentation, but instead is based on violations of the registration requirements of the '33 Act.

61. One further word of warning for attorneys: there is substantial potential for malpractice liability in the area of securities law. For a discussion of such issues, see Stephen G. Christianson, *Legal Malpractice in a Securities Offering*, 22 AM. JUR. PROOF OF FACTS 3d 559 (1993 & 2001 Supp.).

2.4. The Effect of Exemptions from the Federal Laws

The foregoing materials should not be understood as standing for the proposition that once an interest is classified as a security all sales must be registered under the federal and state securities laws. Rather, there are a myriad of potential exemptions available, and many small offerings can be structured so as to comply with one or more of these provisions. The following information outlines some of the more important exemptions that may be available to an agriculturally-based enterprise. Keep in mind that these exemptions will not exempt the transaction in question from the reach of the anti-fraud provisions of the federal securities laws. These exemptions apply only to the registration requirements, and all of the preceding remedies relating to fraudulent misrepresentations will still apply if the transaction does, indeed, involve the sale of securities.

In addition, although offers and sales of securities must either be registered or exempt on both the federal and state levels, the following material discusses only commonly available federal exemptions. Every sale in any state must also be structured so as to comply with state law requirements as well.

As one final preliminary matter, it should also be noted that the burden of proof is on the person claiming the exemption from registration, and this burden applies to each required element of the claimed exemption. Thus, it is especially critical that legal counsel responsible for seeing that the requirements of one or more exemptions are met knows what he or she is doing.

2.4.a. Exempt Securities And Transactional Exemptions

In terms of how the '33 Act is structured, after the statute defines key terms, including "security," it then lists exempted securities⁶² and exempted transactions.⁶³ The registration requirements appear in the next section.⁶⁴ Generally speaking, if there is an exemption, the security or transaction is exempt from the registration provisions of the 1933 Act but not the anti-fraud requirements of the statute.

In other words, securities exempt pursuant to section 3 of the '33 Act need not be registered. They may be sold and resold without registration, but the federal statutes will provide remedies if the seller makes fraudulent misrepresentations about the business in order to induce the purchaser to buy the interests. Similarly, transactions which comply with section 4 of the '33 Act are also exempt from the registration requirements, although the anti-fraud provisions of the act continue to apply. Moreover, securities sold pursuant to one of these exemptions cannot be resold without registration or availability of a new exemption, making section 4 somewhat narrower in scope than section 3. Potentially relevant exemptions for agriculturally-based enterprises may be found in either section 3 or 4, so both will be addressed here.

2.4.b. The Exemption for Agricultural Cooperatives

From the point of view of agriculturally-based enterprises, one of the most important exemptions from the federal securities laws may be the exemption which is found in section 3(a)(5) of the '33 Act.⁶⁵

62. Securities Act of 1933 Sec. 3, codified at 15 U.S.C.A. Sec. 77c.

63. Securities Act of 1933 Sec. 4, codified at 15 U.S.C.A. Sec. 77d.

64. Securities Act of 1933 Sec. 5, codified at 15 U.S.C.A. Sec. 77e.

65. Section 3(a)(5)(B)(i) of the 1933 Act provides that any security issued by a section 521 farmer's cooperative is exempt from the provisions of the Act, except as otherwise expressly provided. 15 U.S.C.A. Sec. 77c(a)(5)(B)(i).

This provision exempts from registration requirements any securities issued by a farmers' cooperative that is exempt from tax under Internal Revenue Code section 521.⁶⁶

The continuing importance of this exemption may be diminishing as fewer and fewer cooperatives are complying with the relatively rigorous requirements of section 521.⁶⁷ Speaking in general terms, in order to comply with the requirements of section 521 of the tax code, the farmers' cooperative must be both organized and operated on a cooperative basis, and its purpose must be either to market products for members or producers and return proceeds to them on the basis of the quantity or value of goods provided, or to purchase and distribute equipment for their use at cost.⁶⁸ In addition, the tax code places limits on the interest which can be paid on the organization's capital stock and limits ownership of stock to persons who produce and market their products or buy their equipment through the association.⁶⁹ Finally, the cooperative can do no more than 15 percent of its business for non-members and non-producers.⁷⁰ If the cooperative in question, however, meets the relatively stringent requirements of section 521 of the Internal Revenue Code,⁷¹ securities which it issues should be exempt from the registration requirements of the '33 Act.

Before turning to the next exemption, it is worth mentioning that the mere existence of this exemption should not be taken as irrefutable evidence that equity interests in such cooperatives will always be securities that need to fit within an exemption. Some observers have contended that Congress never considered equity interests in such cooperatives to be securities and that the exemptions in the '33

66. Securities Act of Sec. 3(a)(5)(B)(i), codified at 15 U.S.C.A. Sec. 77c(a)(5)(B)(i).

67. Numerous commentators have observed that the importance of section 521 has diminished in recent years as fewer cooperatives qualify under the terms of that provision. See *generally* James R. Baarda, *United States Cooperatives and Income Tax Policy* 111 (1997), and *COOPERATIVES IN AGRICULTURE* 295 (National Council of Farmer Cooperatives)(David W. Cobia ed., 1989).

68. The actual language of the Internal Revenue Code is that the farmers' cooperative must be "organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses." 21 U.S.C.A. Sec. 521(b)(1).

69. The tax code provides that if the organization issues capital stock, the interest rate payable on such stock may not exceed the greater of "the legal rate of interest in the State of incorporation or 8 percent per annum . . . on the value of the consideration for which the stock was issued," and substantially all stock "(other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) . . . [must be] owned by producers who market their products or purchase their supplies and equipment through the association." 21 U.S.C.A. Sec. 521(b)(2).

70. Under the tax code, the exemption from federal income taxes will be available so long as the association does not market the products of, or purchase supplies and equipment for, nonmembers in an amount exceeding "the value of the products marketed [or supplies and equipment purchased] for members," provided also that "the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases." 21 U.S.C.A. Sec. 521(b)(4).

71. For a more thorough discussion of section 521 cooperatives, see *generally* Donald A. Frederick, *Income Tax Treatment of Cooperatives: Internal Revenue Code Section 521*, USDA, Rural Bus.-Coop. Serv., Coop. Info. Rept. 44, pt. 4, (June 1996).

Act were ultimately included as a precautionary measure.⁷² On the other hand, one of the basic principles of statutory construction is that wherever possible a statute should be construed so as to avoid rendering portions of the statute superfluous.⁷³ This precept supports the conclusion that absent the statutory exclusion, interests issued by these co-ops would have been subject to regulation.

This distinction may be quite significant. If the interests being issued are not securities, the federal statutes do not apply at all. There would, for instance, be no possibility of a cause of action under the federal securities laws for fraud or misrepresentation, although it is always possible that state securities laws or the common law might apply to the transaction. On the other hand, if the interests are classified as securities, at the very least the anti-fraud provisions of the federal securities laws will apply, even if the securities are technically "exempt" from any requirement of registration. Beyond that, it is also possible that the registration and other requirements of the federal securities laws will be imposed, depending on whether the agricultural cooperative has complied with the often demanding requirements of other available statutory exemptions. A more detailed consideration of whether various interests that might be issued by a farming cooperative will be securities is included in section 3 of this article.

2.4.c. The Intrastate Offering Exemption (Sec. 3(a)(11))

Another exemption that might be of use to an agriculturally-based operation also appears in section 3, although it is generally acknowledged that this is more an historical accident than an intentional placement in the exempt securities section of the law.⁷⁴ Section 3(a)(11) of the '33 Act exempts "[a]ny security which is part of an issue offered and sold only to persons within a single State ... where the issuer of such security is a person resident and doing business, or, if a corporation, is incorporated by and doing business within, such State..."

The primary justification for the continued existence of this exemption is that state regulation suffices, even though there is considerable variation in the degree of enforcement from state to state. Although most intrastate offerings are small, and all must be "local in character," some are quite large, involving millions of dollars and hundreds of investors. The difficulty with this exemption stems primarily with the extensive requirements imposed by the SEC to insure that the transaction is appropriately "local" in character.

First, this exemption applies only to transactions where every security involved is offered and sold to residents of a single state; one offer to a non-resident destroys exemption for all of the sales, even if that offer is not accepted.⁷⁵ There are a couple of factors that further complicate this requirement: first, it is not always easy to determine the state of residence for each offeree, and second, it is not always easy to tell which offers count as part of the same "issue" or general transaction.

72. See *Mid-American Dairymen, Inc.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,110 (Feb. 2, 1977); R. Taylor, PROBLEM AREAS IN APPLICATION OF FEDERAL SECURITY LAWS TO FARMER COOPERATIVES, PROCEEDINGS OF THE THIRD NATIONAL SYMPOSIUM ON COOPERATIVES AND THE LAW 11 (1976), cited in Terence J. Centner, *Retained Equities of Agricultural Cooperatives and the Federal Securities Acts*, 31 U. KAN. L. REV. 245, 267 n.176 (1982).

73. This principle has been articulated by the Supreme Court (*U.S. v. Evans*, 333 U.S. 483 (1948)), and myriad lower courts over the years. *E.g.*, *Halverson v. Slater*, 129 F.3d 180 (D.C. Cir. 1997); *In re Butcher*, 125 F.3d 238 (4th Cir. 1997); *U.S. ex rel. Harlan v. Bacon*, 21 F.3d 209 (8th Cir. 1994); *Sutton v. U.S.*, 819 F.2d 1289 (5th Cir. 1987); *Jackson v. Kelly*, 557 F.2d 735 (10th Cir. 1977); *U.S. v. Blasius*, 397 F.2d 203 (2d Cir. 1968); *U.S. v. Korpan*, 237 F.2d 676 (7th Cir. 1956).

74. In Exchange Act Release No. 5450, the SEC made it clear that Sec. 3(a)(11) covers the transaction, not the security (despite placement of language in section 3).

75. SEC Release No. 4434

In determining the state of residence for the offerees, mere presence (such as might occur if an individual is temporarily stationed at an in-state military post) is insufficient. In addition, mere representations of residency by the issuer or statements that sale is void if to a non-resident are not enough. The issuer must be able to prove actual residency of each offeree, and this requires that certain specific steps must be taken. First, the initial communications should be addressed only to persons whom the issuer reasonably believes to be residents of the appropriate state. Moreover, it should be clear that the initial contact does not constitute an offer. Before an offer is made, the issuer will need to obtain specific knowledge about each person, including his or her place of residence.

Secondly, in order to determine whether there has been any offer to an out-of-state resident, one has to determine what offers and sales are to be counted as "part of an issue." If an offer is part of the issue, it has to be counted. The question of what sales count can only be answered by a close examination of facts. Significantly, one must look to ultimate purchasers, not intermediaries such as underwriters or others who buy the security intending to resell it in the foreseeable future. This rule applies if the security has not "come to rest" in the hands of a resident. If the securities have come to rest, subsequent resales to out-of-state residents will not affect the original exemption. A good rule of thumb is that if the original purchaser owns the securities for at least two years, they will have come to rest. Resales before that time may have to be integrated with the original sales and might destroy the exemption for everyone, retroactively.

In addition to the residency requirement for all offerees, the intrastate exemption will only be available if the issuer is "doing business within the state." This means that the issuer must not only have its primary office or place of business (including any employees) in the state, it must also intend to use the bulk of the proceeds from the sales in state.

Case law generally confirms that the requirements for this exemption are very strict. The SEC's position on "doing business in a state" requires "substantial operational activities," and the courts have required that the in-state business be "predominant."⁷⁶ This means that a substantial portion of the proceeds must be used in the state.⁷⁷

Because much of the intrastate exemption depends on an examination of the totality of the circumstances, it could be very risky to rely on the exemption because of the risk that it might subsequently be found to have been unavailable. The SEC, in order to decrease the uncertainty caused by the imprecise nature of much of the language of Sec. 3(a)(11), promulgated a rule which was intended to act as a "safe harbor" for this exemption. In other words, if an issuer complies with the rule, which is designed to include clear limits, the issuer will automatically be deemed to have complied with Sec. 3(a)(11). The safe harbor is found in Rule 147.⁷⁸

76. Chapman v. Dunn, 414 F.2d 153 (6th Cir. 1969), rejected the argument that "doing business" was to be determined by standards used for service of process. In Chapman, the Sixth Circuit held that in order to be doing business in-state, most income must be produced from property held inside of state. The test was phrased in terms of whether "a predominant amount of business" was in-state.

77. For example, SEC v. McDonald Inv. Co., 343 F. Supp. 343 (D. Minn. 1972), found that sales of installment notes were not eligible for intra-state exemption where the proceeds were to be used to make loans to developers outside of the state.

78. 17 C.F.R. Sec. 230.147.

The safe harbor clearly states that failure to comply with its requirements by itself will not be evidence that the issuer has failed to comply with the intrastate offering exemption.⁷⁹ The safe harbor also includes a cautionary note reminding issuers that they must still comply with state law.⁸⁰ Perhaps more important, the rule includes a number of factors to be used in determining whether separate offers and sales will need to be counted as part of a single issue. In legal jargon, the question is whether the offers and sales will have to be “integrated.”⁸¹ The factors are as follows: 1) Are the offerings part of a single plan of financing? 2) Do the offerings involve the issuance of the same class of security? 3) Are the offerings made at or about the same time? 4) Is the same type of consideration to be received? and 5) Are the offerings made for the same general purpose? here than appears in the statute. In addition, there are some bright-line rules concerning integration contained in the safe harbor: if a sale is exempt under Sec. 3 or Sec. 4(2), or is made so pursuant to a registration statement, it will not be treated as part of the issue if it occurs more than six months before the first sale or six months after the last sale which is part of the issue.⁸²

The other parts of the rule also contain some bright-line requirements as to when a issuer will be considered to be a resident of the state and doing business in the state. The requirements are that the issuer must have been formed or created under the laws of that state, have its principal office located in the state, derive at least 80 percent of its gross revenues from operations or real estate located in the state (unless its total gross revenues were less than \$5,000 for the preceding year), and have at least 80 percent of its assets located in the state.⁸³ These thresholds are very strictly applied.

The safe harbor also sets out rules to determine the residence of offerees and purchasers.⁸⁴ The rules are very specific and differ based on the nature of the offeree. For example, most business enterprises are deemed to be a resident of the state where their principal place of business is located, and individuals are residents only in the state or territory where they have their principal place of residence. In addition, if the business was formed for the express purpose of investing in the issue and thereby avoiding residency requirements, all owners have to be residents of the state as well.

Finally, the safe harbor addresses the issue of resales. As mentioned earlier, if the securities have not “come to rest” in the hands of a particular purchaser, any person to whom that purchaser offers the securities will also have to comply with the restrictions of the rule. Absent a safe harbor, the rule of thumb is that it takes up to two years for securities to come to rest. In this instance, however, the safe harbor provides that nine months after the last sale, the issuer will no longer have to worry about resales.⁸⁵ The safe harbor also lists precautions against interstate offers and sales which are strongly advised in order to avoid inadvertent violations of the terms of the rule, including placing legends on shares, being prepared to issue stop transfer orders, and obtaining written representations from purchasers.⁸⁶

79. Rule 147 is divided into a series of preliminary notes, followed by substantive provisions. Preliminary note one specifies that Rule 147 is not the exclusive method of complying with Sec. 3(a)(11).

80. This appears in preliminary note 2.

81. See preliminary note 3, 17 C.F.R. Sec. 230.147.

82. 17 C.F.R. Sec. 230.147(b)(2).

83. 17 C.F.R. Sec. 230.147(c).

84. 17 C.F.R. Sec. 230.147(d).

85. 17 C.F.R. Sec. 230.147(e).

86. 17 C.F.R. Sec. 230.147(f).

2.4.d. Regulation A: Mini-Registration

Section 3 (b) of the '33 Act contains a relatively broad grant of authority pursuant to which the SEC is authorized to adopt rules and regulations exempting securities where, "by reason of the small amount involved or the limited character of the public offering," there is no need to require registration of the sale.⁸⁷ The only real limitation on the SEC's authority under this provision is that the aggregate amount of securities offered to the public under the exemption cannot exceed \$5 million.

One of the most important administrative exemptions authorized by the SEC pursuant to this provision is "Regulation A" (or Reg. A), which is often referred to as the "mini-registration" provision.⁸⁸ The rules for Regulation A are as follows. First, over any 12-month period, sales cannot exceed \$5 million, less the amount of all securities sold under any Sec.3 (b) exemption in the one-year period prior to the start of the Reg. A offering. Note that this would include sales pursuant to other administrative exemptions promulgated pursuant to this same statutory provision. Included in the list of such administrative exemptions are Rule 701 (compensatory plans) and Regulation D, Rules 504 and 505 (limited offerings). These exemptions will be described in more detail in the following pages. Any resales may be integrated with issuer's Reg. A offering until the securities come to rest in the hands of the public.

The heart of Reg. A is the requirement of a detailed "Offering Circular"⁸⁹ which must be filed with the SEC prior to the first offer or sale. This documents constitutes the "mini-registration" document that gives this regulation its popular nickname. Part I of the Offering Circular is the "notification," which allows the SEC to determine if the exemption is available; Part II is the "Offering Circular," which is a concise disclosure document plus unaudited financials for last two years. The form and content of this document is prescribed by SEC requirements and probably needs to be prepared by experienced securities counsel. It will not be cheap, although the expenses are far less than those associated with a full-scale registration statement.

Note also that this is one of the exemptions which contains so-called "bad boy" disqualifications. Issuers who have previously violated the securities laws may not be allowed to utilize this exemption.⁹⁰ New or "unseasoned" issuers (*ie*, those formed within the past year and without income from operations, or formed earlier but without income for last the two years) are also subject to special requirements.⁹¹

Despite the relatively strict disclosure requirements, there are also some very convenient aspects associated with Regulation A. First, so long as the securities have come to rest, resales are not restricted.⁹² In addition, there are no stringent limitations on advertising or solicitation. ⁹³ However, Reg. A is more than intricate enough to justify the assistance of experienced securities counsel.

87. 15 U.S.C.A. Sec. 77c(b).

88. 17 C.F.R. Secs. 230.251 - .264.

89. 17 C.F.R. Sec. 230.251(a).

90. 17 C.F.R. Sec. 230.262.

91. 17 C.F.R. Sec. 230.253.

92. This is a potential problem with Regulation D offerings (17 C.F.R. Secs. 230.501 - .508). See section 2.4.g. of this document.

93. Many other exemptions have very stringent limitations. See in particular Rules 505 and 506, both are which included in Regulation D (17 C.F.R. Secs. 230.505 & .506). See section 2.4.g. of this document for more information about these requirements.

2.4.e. Rule 701: Compensatory Plans and Contracts

Another administrative exemption authorized by section 3(b) of the '33 Act is Rule 701, which covers compensatory plans and contracts.⁹⁴ Smaller businesses, including those which are agriculturally based, may use their securities to compensate employees and other personnel. Because smaller business may be unable to offer salaries which are competitive with larger, well-established companies, stock-option plans or arrangements involving other types of equity participation in the business may be an essential component of the compensation structure. Such equity participation may, in fact, be the most powerful inducement and incentive available to attract and motivate employees. Making sure that such plans comply with the securities laws is, however, a potentially significant problem.

While there are a number of exemptions which might apply to compensation plans which utilize securities, Rule 701 deals with this situation explicitly. Promulgated in 1988, Rule 701 is designed to meet the need for a completely separate compensation exemption which is not restricted with respect to the number or qualifications of eligible participants and is not conditioned upon delivery of expensive disclosure documentation.

The exemption covers only offers and sales by a nonpublic issuer of its own securities which are either: (1) pursuant to a written compensatory benefit plan established for the participation of its employees, directors, general partners, officers, consultants, advisers, or trustees (where the issuer is a business trust); or (2) pursuant to a written contract relating to such compensation.⁹⁵ The exemption only covers bona fide compensatory transactions. Capital-raising or other types of transactions are not covered, even if conducted in a manner which appears to come within the scope of the exemption.

Within this general structure, there are actually not that many specific requirements. The first is that every participant must be provided with a copy of the written plan or contract. Mere availability of the plan or contract is not enough. Second, the amount of securities that may be subject to outstanding offers in reliance on Rule 701 is limited. The maximum amount of such outstanding offers, which includes all exercisable options, warrants and other offers, must be combined with the amount of securities sold in the preceding twelve months in reliance on Rule 701 and all other sales pursuant to section 3 (b) exemptions. The total may not exceed the greatest of: (a) \$500,000; or (b) an amount in aggregate offering price equal to fifteen percent of the issuer's total assets (as of the end of the last fiscal year); or (c) an amount of securities equal to fifteen percent of the outstanding securities of that class. In addition, there is an absolute ceiling of \$5 million for the aggregate offering price.

Rule 701 has no numerical limitations or sophistication requirements with respect to offerees or purchasers, and the exemption is not conditioned on an absence of general solicitation or advertising. In addition, Rule 701 makes it clear that attempted compliance with Rule 701 does not constitute an exclusive election.⁹⁶ The issuer may also claim the availability of any other applicable exemption (such as section 4(2)⁹⁷ or one or more of the Regulation D⁹⁸ exemptions) with respect to the offers and sales in question.

2.4.f. The Private Offering Exemption (Sec. 4(2))

94. 17 C.F.R. Sec. 230.701.

95. 17 C.F.R. Sec. 230.701.

96. 17 C.F.R. Sec. 230.701, Preliminary Note 3.

97. See section 2.4.f. of this document.

98. See section 2.4.g of this document.

All of the exemptions which have been discussed to this point are either included within section 3 of the '33 Act (whether by design or otherwise) or were promulgated by the SEC pursuant to authority granted in this section. The following exemptions are either found in section 4 of the '33 Act or are based, at least in part, on its language.

Note that there are also exemptions in section 4 that are not within the scope of this document. Section 4 of the '33 Act contains exemptions for transactions not involving an issuer, underwriter or dealer,⁹⁹ certain dealers' transactions,¹⁰⁰ and certain transactions by brokers.¹⁰¹ However, the section 4 exemption which is likely to have the most utility for agriculturally-based businesses appears in section 4(2), which exempts any "transaction by an issuer not involving any public offering."¹⁰²

As mentioned earlier, an issuer can be almost any judicial "person," including an individual, corporation, partnership, limited liability company, other unincorporated association, government, etc. The term also includes persons who propose to issue securities as well as those who follow through and actually complete the transaction(s). A promoter who takes pre-incorporation subscriptions is considered to be an issuer. Thus this exemption is potentially available to a very wide range of persons, although it is limited to issuers. The difficult question, of course, is what constitutes a "public offering."

It might seem logical to think in terms of the number of purchasers involved, or the number of people to whom offers to buy are directed. If too many people are involved, common sense would suggest that the offering should be considered to be "public" in nature. In fact, this was the original approach taken, with the general suggestion being that any offering to fewer than 25 persons would not normally be public, so long as certain other factors were also considered.¹⁰³ The other factors worthy of consideration were: (1) the number of offerees and their relationship to each other and the issuer; (2) the number of units offered; (3) the size of the offering; and (4) the manner of the offering.¹⁰⁴ Over time, however, both the SEC and courts have become convinced that a numerical focus is not appropriate.

As a preliminary matter, it is worth noting that a transaction will be deemed to be one "not involving a public offering" if, at the time of the transaction it is not public, even though the issuer subsequently decides to make a public offering or to file a registration statement.¹⁰⁵

With this time frame in mind, current doctrine holds that the critical inquiry is whether the securities laws are necessary for the protection of offerees. Note that this is far broader than looking merely at

99. This exemption appears in section 4(1) which is codified at 15 U.S.C.A. Sec. 77d(1). While this exemption is easy to state, it is actually very complicated to apply in many instances, due to the convoluted and extremely broad definition of "underwriter." Because this document focuses on securities laws issues that may apply to agriculturally-based enterprises, the precise contours of this exemption will not be dealt with here. For practitioners wishing additional information about this exemption, see *generally* Thomas Lee Hazen, 1 LAW OF SECURITIES REGULATION Sec. 4.26 (4th ed. 2002) or J. William Hicks, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 Sec. 9.03 (2000).

100. This exemption appears in section 4(3) which is codified at 15 U.S.C.A. Sec. 77d(3).

101. This exemption appears in section 4(4) which is codified at 15 U.S.C.A. Sec. 77d(4).

102. 15 U.S.C.A. Sec. 77d(2).

103. 1935 Securities Act Release No. 285 (1935).

104. Probably the leading case from the era when numerical information was the most important factor was *S.E.C. v. Sunbeam Gold Mines*, 95 F.2d 699 (9th Cir. 1938), which held that loans from 530 individuals involved a public offering, even though the offers were limited to company's shareholders.

105. 17 C.F.R. Sec. 230.152.

whether the eventual purchasers need the protection of the securities laws. Because the focus is on persons to whom an offer is directed, sellers would generally be well-advised to prequalify offerees by obtaining background information about all potential purchasers. This should be done before any offer is actually made.

Relevant qualifications should relate to the potential purchaser's wealth (because that suggests that the person can bear the risks of any investment), their sophistication or education (because that will bear on their ability to evaluate the merits of any offer), and any prior relationship with the issuer. These kinds of qualifications are often referred to as "suitability standards." Commonly, potential offerees are pre-qualified by means of a suitability questionnaire or other pre-offering document which allows the issuer to gauge in advance the suitability of any particular potential investor.

In addition to prequalifying offerees, sellers should keep records of the number of offers and should probably number the offering documents distributed. Because the issuer has the burden of proof with regard to the suitability of all offerees, these and similar steps may be very important if an offering is later challenged.

As currently conducted, most private placements involve the direct sale of securities to a limited number of knowledgeable investors (such as institutions or high-level managers of the issuer).¹⁰⁶ The use of offeree representatives to help the offeree understand the disclosures is sometimes expressly permitted (as in the Reg 506 safe harbor in Reg. D) and sometimes allowed by implication. No court has said you can't consider the aid of an offeree representative in determining sophistication. Outside of certain safe harbors, the ability of the offeree to withstand the risk of the investment has not emerged as a major factor, although some commentators have suggested that it should be considered. This is still a flexible and developing area of the law.

In order to minimize the risk of a successful challenge on the basis of the offerees' inability to understand the disclosures, many issuers try to limit their private placements to institutional investors. If offerees are institutional investors, they cannot claim to be unsophisticated and cases hold that they can fend for themselves; in their case, sophistication may even be a substitute for actual disclosure.

In addition, and especially where there are offerees other than institutional investors involved, most private placements are conducted with offering circulars complying with the terms of Regulation A.¹⁰⁷ These are lengthy and are usually prepared by counsel. An offering circular may cost many thousands of dollars to prepare and are sufficiently complex that the assistance of securities counsel is recommended. If the information that would be required under Regulation A¹⁰⁸ is not included, the issuer runs the risk that a court will later find inadequate disclosure and decide that the exemption is or was not available.

Note that there is a problem with resales for the Sec. 4(2) exemption, just as there was for Sec. 3(a)(11) (the intrastate exemption).¹⁰⁹ If a resale occurs before a security has come to rest, it will be treated as if it was part of the original transaction. This may result in a deal being treated as a public

106. Courts are split as to whether you can make a private placement to a small number of unsophisticated investors. The Tenth Circuit has suggested that sophistication is a necessary condition and only one of four facts. The Fifth Circuit emphasizes actual disclosures.

107. See Part II, to Form 1-A, Forms Under the Securities Act of 1933.

108. See section 2.4.d of this document for a more detailed description of Reg. A.

109. See section 2.4.c. of this document.

offering even when this was clearly not the issuer's intent. To avoid this, issuers typically place legends on securities restricting their transferability, requiring consent of the issuer for resales within a specified time frame, etc. In general, if the securities are acquired for investment purposes, and come to rest in the hands of a purchaser, thereafter the securities can be resold without affecting the original exemption. (In this case, of course, the new seller would also have to find an applicable exemption from the registration requirement, but resales such as this are generally outside the scope of this document.)

To summarize the major considerations in a Sec. 4(2) offering, all of the following elements are important. The issuer must make sure that the offering does not involve any general solicitation or advertising. All offerees should be appropriately qualified. This can either be done with the prior relationship/sophistication approach, so long as all offerees have meaningful access to important information (keeping in mind that institutional investors almost automatically meet this standard), or so long as all offerees are actually provided with the relevant information. Generally speaking, any information that would be provided under form 1A is likely to be found to be quite important (or, in securities parlance, "material"). There should also be a relatively limited number of offerees and purchasers. A reasonable number is all that seems to be required, despite the fact some early cases tended to focus on "25" as having some special significance. The issuer should also take reasonable steps to avoid redistributions of the securities before they have come to rest.

2.4.g. Regulation D and the Limited Offering Exemptions

As the preceding discussion probably makes abundantly clear, the precise parameters of section 4(2) are impossible to outline with any clarity or certainty. Thus, a cautious issuer is likely to want to fit a private offering into a safe harbor with clearer guidelines, assuming one is available. The safe harbors which most clearly fit this requirement appear in Regulation D ("Reg. D").¹¹⁰

Reg. D, by its terms, applies only to the '33 Act's registration provisions, not to its anti-fraud requirements.¹¹¹ In addition, it is clear from the terms of the regulation that state law requirements are not superseded and that reliance on a particular exemption is not a binding election.¹¹²

The organization and wording of the regulation is a little confusing. The first three rules (501 to 503) contain general provisions applicable to the different exemptions which are part of Reg. D. Rule 501 contains a number of definitions, the most important of which are the definitions of "accredited investor" (generally institutions or very wealthy and sophisticated individuals) and "aggregate offering price" (special rules if non-cash compensation is involved). Section (e) gives rules for calculating the number of purchasers, and section (h) talks about the purchaser representative. Rule 502 sets out a number of general conditions to be met, including integration of offerings (with a safe harbor if more than six months has elapsed between the last Reg. D sale and a new sale), information requirements, limits on the manner of offering and limits on resale. Rule 503 contains the requirement that a Form D be filed with the SEC to give the SEC notice that a Regulation D offering is being conducted. The actual exemptions appear in rules 504, 505 and 506.

110. Reg. D is codified at 17 C.F.R. Secs. 230.501 -508. Moreover, there are really three distinct exemptions embodied in this regulation, each with different requirements as to the required disclosures, manner of offering, number of offerees, the sophistication required of the offerees, and the dollar amount that can be raised in reliance on each of those exemptions. The three exemptions (rules 504, 505 and 506) are dealt with separately in the text, albeit all under the general rubric of Regulation D.

111. The appears in preliminary note 1 in the preliminary notes to Reg. D, which is codified at 17 C.F.R. Secs. 230.501 -508.

112. *Id.* at preliminary notes 2-3.

Rule 504, which was promulgated by the SEC in accordance with authority granted in section 3(b) of the '33 Act, offers an exemption for offerings of up to \$1million by privately-held businesses.¹¹³ This exemption is not available for publicly-held companies. There are no limits on the number of purchasers and no specific affirmative disclosure requirements.¹¹⁴ Copies of Form D, which is not terribly complicated, must be filed with the SEC at the appropriate times.¹¹⁵ In addition, if the offering is required to be registered under state law and appropriate disclosures must be prepared and provided to purchasers under state law, the federal rules do not restrict advertising or limit resales of the security.¹¹⁶ Alternatively, if the offering is conducted exclusively in jurisdictions that have an exemption which allows general solicitation and advertising, resales are not restricted and general advertising is permissible under federal law only so long as sales are restricted to accredited investors.¹¹⁷ If all applicable state laws exempt a particular offering and do not restrict public communications, it might be possible for counsel to assure compliance with this Rule 504 and (the state requirements) even if the attorney does not generally do securities work.¹¹⁸ On the other hand, if state registration requirements are implicated or there are specific disclosure requirements, it would probably be helpful to seek the assistance of securities counsel.

Rule 505, which is also a section 3(b) exemption, applies to offers and sales not exceeding \$5 million,¹¹⁹ and is further limited to 35 purchasers (although 501(e) excludes a number of kinds of persons from this calculation--including accredited investors).¹²⁰ There is no specific limitation on the number of offerees. Specific affirmative disclosures must be made to all nonaccredited investors, regardless of whether they become purchasers.¹²¹ General advertising and solicitation is prohibited.¹²² There are limitations on the ability of purchasers to resell the securities.¹²³ In general, the moment nonaccredited investors are included in a 505 offering, this exemption becomes complicated enough that experienced securities counsel should probably be consulted.

113. 17 C.F.R. Sec. 230.504(b)(2). This amount must also be reduced by the amount of all other sales conducted pursuant to Rule 504 or any other Sec. 3(b) exemption within the 12 month period prior to the start of the current offering.

114. See generally 17 C.F.R. Sec. 230.504.(b)(1).

115. 17 C.F.R. Sec. 230.503.

116. 17 C.F.R. Sec. 230.504(b)(1)(i) & (ii).

117. 17 C.F.R. Sec. 230.504(b)(1)(iii).

118. This should not be read as blanket encouragement for inexperienced attorneys to provide securities advice. For one thing, many malpractice policies specifically exclude or require advance disclosure of securities work, and premiums may be higher for attorneys who render securities advice. For another, it may not always be simple to determine which state laws are applicable, or what they require. In case of doubt, there is much to be gained by seeking the assistance of experienced securities counsel.

119. 17 C.F.R. Sec. 230.505(b)(2)(i). This dollar limit is also reduced by the amount of all other sales conducted pursuant to Rule 504 or any other Sec. 3(b) exemption within the 12 month period prior to the start of the current offering.

120. 17 C.F.R. Sec. 230.505(b)(2)(ii), incorporating Sec. 230.501(e) by reference.

121. 17 C.F.R. Sec. 230.505(b)(1), incorporating Sec. 230.502(b) by reference.

122. 17 C.F.R. Sec. 230.505(b)(1), incorporating Sec. 230.502(c) by reference.

123. 17 C.F.R. Sec. 230.505(b)(1), incorporating Sec. 230.502(d) by reference. In securities terms, the securities will be "restricted," and before they can be resold a purchaser must find another available exemption from the registration requirements of the '33 Act.

Rule 506 is also included within the ambit of Reg. D. It is truly a safe harbor for Sec. 4(2), although strict compliance with all of the elements of Rule 506 is not necessary to comply with the statutory 412 exemption. Rule 506 has no limit on the dollar amount that can be raised as part of the offering,¹²⁴ but the offering must be sold to no more than 35 purchasers (with the same exclusions as are applicable under rule 505).¹²⁵ As with rule 505, specific affirmatives disclosures must be made to all nonaccredited investors, regardless of whether they become purchasers.¹²⁶ General advertising and solicitation is prohibited.¹²⁷ There are limitations on the ability of purchasers to resell the securities.¹²⁸ In addition, the issuer must reasonably believe that all non-accredited purchasers, alone or with purchaser representative, have such knowledge and experience in financial and business matters that they are capable of evaluating the investment.¹²⁹ There is no counterpart for this requirement in Rule 505. The same advice that applies to 505 offerings probably applies here: the moment nonaccredited investors are included, this exemption becomes complicated enough that experienced securities counsel should probably be consulted.

Rule 507 contains disqualification provisions, and Rule 508 provides that substantial compliance is all that is required to fall within the protection of the regulation. However, the SEC has announced that failure to observe dollar limits or number of purchaser limits precludes a finding of substantial compliance.

2.4.h. The Section 4(6) Exemption

The last potentially important exemption in section 4 of the '33 Act appears in section 4(6), which exempts offers or sales "solely to one or more accredited investors," if the offering price does not exceed \$5 million, there is no advertising or public solicitation, and the issuer files such notice as the Commissioner shall prescribe. Presumably, most issuers would rely on Rule 506 instead of section 4(6), since the rule has no dollar limit and has a six-month safe harbor on integration.

However, to make the parameters of this exemption clear, it is probably worth reviewing the basic requirements for an offeree or purchaser to be considered an "accredited investor." This term, while not defined in the '33 Act itself, is defined in Rule 501, which is part of Reg. D.¹³⁰ This rule defines accredited investor to mean any person in any of the following general categories, or who the issuer reasonably believes to be such a person:

- (1) A bank, savings or loan association, registered broker-dealer, insurance company, registered investment company, licensed small business investment company, a benefits plan established by a state or any of its political subdivisions or agencies so long as it has total assets in excess of \$5 million, or any employee benefit plan under ERISA which is managed by a plan fiduciary or accredited investors and which has assets in excess of \$5 million;
- (2) Any private business development company;

124. This explains why this exemption could not be promulgated under Sec. 3(b), which is strictly limited to offerings not exceeding \$5,000,000 in any 12-month period.

125. 17 C.F.R. Sec. 230.501(e).

126. 17 C.F.R. Sec. 230.506(b)(1), incorporating Sec. 230.502(b) by reference.

127. 17 C.F.R. Sec. 230.506(b)(1), incorporating Sec. 230.502(c) by reference.

128. 17 C.F.R. Sec. 230.506(b)(1), incorporating Sec. 230.502(d) by reference.

129. 17 C.F.R. Sec. 230.506(b)(2)(ii).

130. 17 C.F.R. Sec. 230.501(a).

- (3) Any organization qualified under Internal Revenue Code Sec. 501(c)(3) having assets in excess of \$5 million;
- (4) Any director, executive officer, or general partner of the issuer;
- (5) Any natural person whose net worth (together with that of his or her spouse) exceeds \$1 million;
- (6) Any natural person who had individual income in excess of \$200,000 in each of the last two years, or \$300,000 in such years with the income of that person's spouse, so long as such person has a reasonable expectation of earning the same level in the current year;
- (7) Any trust with assets in excess of \$5 million not formed for the specific purpose of acquiring the specific securities offered if directed by a sophisticated person; and
- (8) Any entity in which all of the equity owners are accredited investors.¹³¹

3. How the Securities Laws Might Apply to Equity Participants in Agricultural Ventures.

This section of the article deals in more detail with particular types of agricultural operations, and the most likely federal securities law consequences that might arise as a result of making certain choices as to business structure. The following is intended neither as a replacement for particularized legal advice, nor as a comprehensive listing of all issues which might arise. Rather, this material should be taken as a general guide to some of the more common issues that may arise.

3.1. The Family Farm

The first general scenario that will be addressed is that of a family farm. The next subsections deal with the issues that may be created when the farm and/or its assets have been conveyed to: (1) a corporation; (2) a limited liability company (LLC); (3) a general partnership, a limited liability partnership (LLP), or joint venture; or (4) a limited partnership or limited liability limited partnership (LLLLP). These materials deal with the transfer of ownership interests; the incurrence of debt will be dealt with later.¹³² Non-traditional transactions are also covered in a later section of this document.¹³³

3.1.a. Setting up a Corporation and Transferring Stock

For any number of reasons, many of which may have had substantially more validity in the not-so-distant past than today, the assets associated with a family farm may have been or may be placed in a corporation. This may be done to provide the members of the family with limited liability against personal debts arising out of the farming operations, to facilitate estate planning considerations, or for a variety of other legal purposes. The end result, however, is that the farm and associated assets are owned by a corporation, and the farmers wind up owning equity in the corporation in the form of stock. Note that for the purposes of the securities laws, it does not matter if the corporation is taxed under subchapter C of the Internal Revenue Code or is an "S Corporation," taxed under subchapter S. In either event, the general consequences under the securities laws will be the same. In addition, although there are some variations in state corporate law, it does not really matter which state's laws apply to the corporation. So long as the corporation is a for-profit entity, the rules regarding the requirement of corporate stock are essentially interchangeable.

131. These are paraphrased. For the exact language of the definition, see 17 C.F.R. Sec. 230.501(a).

132. See part 4 of this document.

133. See part 5 of this document.

As previously discussed, so long as equity interests in a corporation are, in fact, corporate stock, with the traditional characteristics of stock, they will be treated as securities under the '33 Act.¹³⁴ Thus, any time shares of stock are issued to family members, potential investors, creditors, or for any other reason, a security has been transferred, and the transaction should have been structured so as to fit within an exemption from registration under federal and state law.

Sales or gifts to family members are unlikely to cause very many problems. Usually, it will be possible to characterize such transactions as a non-public offering and thus exempt under the federal securities laws. Certainly, donative transfers (gifts) do not seem to raise the kinds of issues that would make it likely that the securities laws have any important role to play. On the other hand, if there are sales of stock to more than a few family members in any given year, or the family members sell their stock outside the family, there are at least potential securities issues, and it would not be a bad idea to at least consult with a securities lawyers about how to minimize potential problems.

The more likely problem arises should the farmers eventually want to sell the farm. Assume that the farm and its assets have been transferred to a corporation, so that the farmers are the owners of the corporation. It may seem simpler to convey the stock in the corporation to a purchaser instead of dissolving the corporation, recognizing gain to the extent of any appreciated assets, then separately conveying each asset and arranging for the assumption or transfer of each liability. The documentation costs of doing a sale in this manner may be quite significant, and there may be tax consequences to dissolving the farm and valuing its assets at market value upon dissolution. It may, therefore, seem simpler for the farmers to sell their stock. Stock is, after all, personal property and does not require the same formalities for transfer that must accompany the sale of real estate. Moreover, if the stock is sold, it will not be necessary to separately list and account for each item of personal property or each debt that is to be transferred. In fact, this may be the only way to transfer indebtedness,¹³⁵ since the corporation would continue to be liable on any debts that it had prior to transfer of the stock, so that in most cases there will be no need to arrange an assignment of any debt or mortgage. If the corporate assets are to be liquidated, banks or other lending institutions may be in a position to refuse to accept the purchaser, forcing the purchaser to arrange alternate financing in order to pay off the existing debts prior to the acquisition. If this means giving up favorable interest rates or other loan terms, this may be less than optimal.

On the other hand, the sale of the farm corporation has potential securities consequences that would not be present if the assets and liabilities associated with that corporation were being sold directly. While it may seem as though there is little to distinguish between the economic consequences of a sale of farm assets and a sale of 100 percent of the stock in a corporation that owns those assets, there are in fact very distinct legal consequences under the securities laws.

The sale of a business through the vehicle of stock transfers involves the sale of securities, even though it is the entire business that it being sold.¹³⁶ Thus, the transaction must either be exempt from

134. See *generally* Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985). For a more detailed discussion of this issue, see section 2.2.b of this document.

135. This discussion is not, of course, intended to suggest that these sorts of arrangements will have any effect on personal guarantees of any such indebtedness. Release of a guarantor will almost certainly require the creditor's consent and in many cases will be conditioned on an acceptable substitute guarantor being found.

136. This was, in fact, the precise question that the Supreme Court addressed in Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985). Some circuit courts had earlier opined that the sale of a business did not involve the sale of securities, and therefore neither the federal rules concerning registration nor the federal anti-fraud provisions were implicated. The Supreme Court rejected this analysis in Landreth.

registration or the shares must be registered. Moreover, even if the transaction is exempt from registration, the federal anti-fraud provisions will still apply.

Finally, it is also worth mentioning that the sale of interests in the corporation will also involve securities transactions. If the farm is running short of funds, and a decision is made to bring in outsiders who, in exchange for a share of profits (as represented by stock), will provide some up-front capital, this involves the sale of securities. If a bank lends credit but insists on having the loan secured by a pledge of the farmers' stock in the corporation, this too involves the "sale" of securities, since a pledge (or mortgage) of securities has been held to be within the ambit of the federal prohibition on the offer or sale of unregistered securities.¹³⁷

3.1.b. Setting up an LLC and Transferring Membership Interests

A more modern approach to business and estate planning issues for the family farmer is likely to involve the establishment of a limited liability company (LLC). An LLC offers the same protection against personal liability that is available with the corporation (and maybe even slightly greater protection, to the extent that failure to observe formalities may not be grounds for "piercing the veil of limited liability" to hold the owners personally liable).¹³⁸ It also offers the potential benefit of avoiding corporate taxation while maximizing flexibility and informality. Thus, ownership of many family farms may have been transferred to an LLC or may be transferred to one in the future. For the purposes of this article, the question that this raises is whether membership interests in such LLCs will be considered to be securities subject to regulation under the '33 Act.

Even before the federal courts entered the debate, commentators were suggesting and evaluating possible approaches to determine whether LLC membership interests should be classified as securities under the federal securities laws.¹³⁹ The majority of such commentators concluded that the most logical method of approaching this determination would be to look at whether the interests in question could properly be classified as investment contracts.¹⁴⁰ Although there was also some discussion of whether the interests could be treated as "stock," or under the family resemblance test originally adopted in the context of promissory notes, or as interests commonly known as securities. The problem is that the statutory language, and indeed the tests that have arisen to aid in interpreting this language, were not written or developed with LLC membership interests in mind. As a consequence, the tests are not easy to apply to these new entities. Because "investment contract" was specifically intended to cover non-traditional interests, most of the few cases have indeed focused on this approach as the appropriate

137. See *Rubin v. United States*, 449 U.S. 424 (1981).

138. For a case mentioning this possibility, see *Hollowell v. Orleans Regional Hospital*, 1998 WL 283298 (E.D. La. 1998). See also David L. Cohen, *Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company*, 51 OKLA. L. REV. 427 (1998), and Steven C. Bahls, *Application of Corporate Common Law Doctrines to Limited Liability Companies*, 55 MONT. L. REV. 43 (1994).

139. See Elaine Welle, *Limited Liability Company Interests as Securities: An Analysis of Federal and State Actions Against Limited Liability Companies Under the Securities Laws*, 73 DENV. U. L. REV. 425 (1996), and Carol Goforth, *Why Limited Liability Company Membership Interests Should Not be Treated as Securities and Possible Steps to Encourage this Results*, 45 HASTINGS L.J. 1223 (1994).

140. This inquiry would be guided by the seminal Supreme Court opinion in *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946), which requires that any interest not otherwise falling within the ambit of the securities laws be characterized as an investment contract if it involves an investment in a common enterprise, with the expectation of profits from the efforts of others.

inquiry in determining the applicability of the federal securities laws to transactions involving LLC membership interests.¹⁴¹

Some of these cases find that the LLC interests in question are securities; some reach the opposite result. The problem is not that the courts do not understand or agree on the proper application of *Howey*; the problem is that there is so much variation between different LLCs, which are popular in large part because of this flexibility in organization and operation.

As mentioned earlier, non-traditional interests are generally likely to be treated as investment contracts when each of four elements are present: (1) an investment of money; (2) in a common enterprise; (3) where the investors expect profits; (4) based on the essential efforts of others. While each of these elements must be present in order for an LLC membership interest to properly be classified as a security under *Howey*, it is the last factor that is typically determinative. This is because each of the first three elements will be present in almost all LLCs.

The first element of the *Howey* test, as currently interpreted, requires only that the purchaser give up some tangible and definable consideration in return for the interest. Most LLC membership interests will undoubtedly be acquired in a way which meets this criteria, regardless of how the LLC is organized or operated. Certainly the test would be present when farm assets are contributed in exchange for membership interests.

The second part of the *Howey* test requires commonality. As mentioned earlier, there are multiple interpretations of what is required to meet this element. The most restrictive approach, which is required in a number of jurisdictions but is acceptable everywhere because it has been recognized by the Supreme Court, requires horizontal commonality, or a pooling of interests by members.¹⁴² If the LLC is to be organized with multiple members, this element is very likely to be met; only with all of their interests pooled together will the farm function as an entity.

The third element, or the requirement of expectation of profits, is also likely to be satisfied in the vast majority of cases. Family farms are generally run in the hopes of a profit, although tax benefits may also play a significant role in making farming operations attractive. While sophisticated planning might be successful in attracting investors in a family farm via unconventional benefits rather than profits, this is not likely to be the case in the vast majority of family farms organized as LLCs. Moreover, it is possible that an expectation of receiving even the more exotic benefits might satisfy this test. Thus, there is unlikely to be a great deal of room for arguing that this element of the investment contract test is missing.

The final requirement is that the expectation of profits must be based on the essential or entrepreneurial efforts of others. As suggested earlier, this is the element which is likely to be determinative in most instances where investment contract analysis is applied to determine if an LLC membership interest is a security. LLCs can be organized with a variety of management models, any of which might be chosen for family farms. One approach is for members to share the management responsibilities, with all members having actual and apparent authority, much as do general partners in

141. SEC v. Parkersburg Wireless LLC, 991 F. Supp. 6 (D.D.C. 1997) (the interests were securities under the *Howey* test for investment contracts); Keith v. Black Diamond Advisors, Inc., 48 F. Supp.2d 326 (S.D.N.Y. 1999) (the interests were not securities under the *Howey* test); Great Lakes Chemical Corporation v. Monsanto Com., 96 F. Supp. 2d 376 (D. De. 2000) (the interests were not securities under the *Howey* test or a variety of other possible approaches considered by the court); KFC Ventures LLC v. Metairie Medical Equipment Leasing Corp., 2000 WL 726877 (E.D. La. 2000) (the interests might be securities under *Howey* and thus the motion to dismiss was denied); Cogniplex Inv. v. Hubbard Ross, LLC, 2001 WL 436210 (N.D. Ill. 2001) (the interests might be securities under *Howey* and thus the motion to dismiss was denied); and (Nelson v. Stahl, 173 F. Supp.2d 153 (S.D.N.Y. 2001) (the interests were not securities under *Howey*).

142. This was, in fact, the type of commonality present in *Howey* itself.

a general partnership. Another approach is for all management authority to be delegated to managers, who need not even be members. In this model, the members delegate both actual and apparent authority to designated managers. A third alternative is for members to delegate actual authority but to retain apparent authority to bind the company, as do general partners who delegate authority to one or more managers. In the manager-managed LLC or the LLC with hybrid management, members may choose to require that only members may serve as managers or may provide that managers need not be otherwise related to the LLC. Each of these possibilities has different ramifications when it comes to applying the *Howey* investment contract analysis.

In the member-managed LLC, it would take very unusual circumstances for members to be able to make the argument that they must rely on the entrepreneurial efforts of others rather than their own management skills. In this model, members have ultimate power over the LLC, and although statutes vary as to how the management authority will be divided among the members, and this is subject to further agreement of the parties, the general framework is essentially antithetical to the notion of member passivity. Because the member-managed LLC so closely resembles the general partnership in the way it allocates partnership authority, it makes sense to evaluate such LLCs in a manner similar to the way in which general partnerships are treated.

Under the analytical framework provided by these cases, ownership interests in a member-managed LLC should not be securities unless there is evidence that:

- (1) an agreement among the parties leaves so little power in the hands of members that the arrangement in fact distributes power as would a limited partnership; or
- (2) the members are so inexperienced and unknowledgeable in business affairs that they are incapable of intelligently exercising management powers; or
- (3) the members are so dependent on some unique entrepreneurial or managerial ability of the promotor or manager that they cannot replace the manager of the enterprise or otherwise exercise meaningful management powers.¹⁴³

On the other hand, in cases involving a manager-managed LLC where members have divested themselves of apparent as well as actual authority, it is likely that the members will be relying on the efforts of the others, unless the members become the managers. If a member is required to become a manager or does in fact become a manager in a manager-managed LLC, that member will probably not be relying on the efforts of others. However, in most cases, members who completely lack authority, either actual or apparent, would appear to be relying on the efforts of others, thus satisfying the fourth prong of the *Howey* test. The exceptions to this would be situations where the powers of members as set out in the operating agreement were so extensive that it would be inaccurate to depict the non-managing member as being a passive investor.

In the hybrid management situation, which involves delegation of actual authority to managers but retention of apparent authority, there is a great deal of room for creative argument about whether the LLC is more like a general partnership or a limited partnership or otherwise meets the *Howey* investment contract text.

The bottom line is that there are potentially very significant securities laws ramifications that may stem from the choice of how to organize an LLC into which a family farm is to be transferred. Speaking very generally, the choice of member-management is more likely to keep the LLC membership interests from being regulated as securities, but of course there may be practical, familial, or business reasons why

143. These are essentially the circumstances recognized by the Fifth Circuit in *Williamson v. Tucker*, 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981), as being sufficient to turn a general partnership interest into a security. See part 3.1.c. of this document for a further discussion of this approach.

this choice may be less than optimal. In any event, because the choice of management structure may be so important in determining the applicability of the federal securities laws, this is one area where the advice of counsel should be sought prior to formation of the LLC itself.

3.1.c. Setting up a General Partnership or Joint Venture

Another very common form of business enterprise is the general partnership and, under more modern statutes, the limited liability partnership, or LLP. Both the traditional general partnership and the more recent LLP are governed by each state's general partnership laws and ought to be treated as securities under similar circumstances. As a matter of terminology, joint ventures are also covered by this analysis, as for all practical purposes a joint venture is really only a general partnership with a single, limited purpose. Thus, all references in this section to general partners can be understood to include joint venturers (or joint adventurers, as they are sometimes called).

Even a cursory review of the statutory definition of "security" in the '33 Act will reveal that "general partnership interest" is not included in the laundry list of interests that constitute securities. This does not mean, however, that such interests will not be regulated as such. One of the broader categories of interests that will be regulated as securities are "investment contracts," and courts have typically considered whether general partnership interests fit within this category when considering the potential application of the federal securities laws. The investment contract, or *Howey* test, thus forms the general basis on which to determine whether general partnership interests will be treated as securities.

Based upon this approach, most of the earlier judicial opinions concluded that since general partnership law gives all general partners certain management rights and powers as a matter of law, general partners do not rely "solely on the efforts of others" for their profits. Thus the ownership interest which might be purchased by a general partner would not be a security subject to the '33 Act.¹⁴⁴ Not even delegation of authority by general partners to a managing partner or committee would change this result, because of the statutory powers invariably granted to all general partners.¹⁴⁵ There were, however, some cases where a contrary result was reached, and until recently, it was not always easy to predict when a general partnership interest might be treated as a security and thus subject to federal regulation.

The current approach generally follows a presumption that general partnership interests will not be treated as securities, but in circumstances where, for any reason, the general partners are in some way prevented from having any meaningful role in their partnership, their ownership interests will be securities.¹⁴⁶ As a practical matter, this means that in most cases, general partners will not be

144. The following cases stand for the proposition that because general partners do not depend solely on others for their profits, general partnership interests are generally not securities: *Goodwin v. Elkins & Co.*, 730 F.2d 99, 107 (3d Cir.), *cert. denied*, 469 U.S. 831 (1984); *Odom v. Slavik*, 703 F.2d 212, 215-16 (6th Cir. 1983); *Frazier v. Manson*, 651 F.2d 1078, 1081 (5th Cir. 1981); *Slevin v. Pedersen Assocs.*, 540 F. Supp. 437, 441 (S.D.N.Y. 1982); *Elson v. Geiger*, 506 F. Supp. 238, 243 (E.C. Mich. 1980), *aff'd*, 701 F.2d 176 (6th Cir. 1982); *Hirsch v. DuPont*, 396 F. Supp. 1214, 1220-22 (S.D.N.Y. 1975), *aff'd*, 553 F. 2d 750 (2d Cir. 1977); *New York Stock Exch., Inc. v. Sloan*, 394 F. Supp. 1303, 1314 (S.D.N.Y. 1975); *Oxford Fin. Cos. v. Harvey*, 385 F. Supp. 431, 433-34 (E.D. Pa. 1974).

145. See, e.g., *Sloan*, 394 F. Supp at 1314, stating: "The fact that a partner may choose to delegate this day-to-day managerial responsibilities to a committee does not diminish in the least his legal right to a voice in partnership matters, nor his responsibility under state law for acts of the partnership These factors critically distinguish the status of a general partner from that of the purchaser of an investment contract who in law as well as in fact is a 'passive' investor."

146. The leading case in this regard is the opinion of the Fifth Circuit in *Williamson v. Tucker*, 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981). For readers who wish a more detailed analysis of this opinion, see Marc H. Morgenstern, *Real Estate Joint Venture interests as Securities: The Implications of*

purchasing a security when they invest in a partnership. If the particular partner can show that "he was so dependent on the promoter or a third party that he was in fact unable to exercise meaningful partnership powers," this result can be reversed.

Judicial opinions have offered three primary situations when a general partnership interest might properly be classified as a security:

- (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or
- (2) the partner is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership powers; or
- (3) the partner is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership powers.

Even under this approach, however, it is very unusual for a general partnership interest to be treated as a security under the federal securities laws.¹⁴⁷

What are the ramifications of these rules for a family farm set up as a general partnership or LLP? In essence, this choice of business form is likely to mean that the securities laws are not implicated unless the partnership agreement leaves so little actual power in the hands of partners that they are in fact relegated to a passive role, or the partnership interests are transferred to persons who are unable to exercise any meaningful level of participation in the farm operations. In either of these cases, the securities laws will likely apply to any sale or transfer of these interests.

3.1.d. Setting Up a Limited Partnership and Transferring Partnership Interests

Limited partnerships or their more recent offshoot, limited liability limited partnerships (LLLPs), have been popular as an estate-planning tool for family farms for many years. In essence, by transferring the farm and related assets to a limited partnership as part of an estate plan, the original farmers will have accomplished three very useful goals: (1) they will have established a planning scheme where they can transfer interests in the farm while retaining control over decisions related to farming operations; (2) they have made it much simpler to transfer interests in the farm so as to get them (and any subsequent appreciation) out of their estate while still avoiding the possibility of sale to outsiders; and (3) they have minimized the value of what they are transferring for estate and gift tax purposes because limited partnership interests are not freely transferable and lack significant opportunities for control over the underlying assets. All of these characteristics make the limited partnership (and now, the LLLP as well) particularly well-suited as an estate-planning tool.

Williamson v. Tucker, 59 WASH. U. L.Q. 1231 (1982); Leslie J. Levinson, *General Partnership Interests and the Securities Act of 1933: Recent Judicial Developments*, 10 OHIO N.U. L. REV. 463 (1983); Comment, *General Partnership Interests as Securities Under the Federal Securities Laws: Substance Over Form*, 54 FORDHAM L. REV. 303 (1985).

147. See, e.g., Reeves v. Teuscher, 881 F.2d 1495, 1499-1500 (9th Cir. 1989); Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc. Biorhardt, 840 F.2d 236 (4th Cir. 1988); Goodwin v. Elkins & Co., 730 F.2d 99, 107 (3d Cir.), cert. denied, 469 U.S. 831 (1984); Odom v. Slavik, 703 F.2d 212, 215 (6th Cir. 1983); Casablanca Prod, Inc. v. Pace Int'l Research, Inc. 697 F. Supp. 1563, 1567 (D. Or. 1988); Power Petroleum v. P & G Mining Co., 682 F. Supp. 492, 494 (D. Colo. 1988).

Speaking generally, a limited partnership (or LLLP) is a regular partnership that has at least one general partner and at least one limited partner. The general partners in a limited partnership or LLLP have the same rights, responsibilities and liabilities as general partners in a general partnership or LLP. Thus, they have substantial management rights and responsibilities, but general partners in a limited partnership have unlimited personal liability, and in an LLP they may have some degree of personal liability for business debts, depending on the provisions of applicable state law. On the other hand, limited partners generally have no personal liability for the debts of the limited partnership, whether or not it has registered as an LLLP.¹⁴⁸

Typically, when a limited partnership or LLLP is utilized for estate planning purposes, the original farmers retain the general partnership interests in the limited partnership or LLLP, while the limited partnership interests are transferred to their children or other eventual heirs. Not surprisingly, the general partners' interests in a limited partnership or LLLP will usually be treated as being outside the reach of the securities laws for precisely the same reasons applicable to general partnership interests in general partnerships or LLPs.¹⁴⁹ This fact is of limited significance, however, because it is usually the original founders who retain the general partnership interests; most of the ownership interests that will be transferred are limited partnership interests, and these interests are treated very differently from those of the general partners.

One of the primary distinctions between limited partners and general partners is that only the latter have management rights under state law. In fact, a limited partner who participates in control may lose the protection against personal liability generally awarded to limited partners.¹⁵⁰ For this reason, limited partners can generally be said to depend solely on the efforts of others for their share of profits, which in turn means that limited partnership interests have generally been characterized as securities.¹⁵¹ This is also not without exception. Some limited partnership interests have been found not to be securities by virtue of special factors showing involvement of limited partners in management.¹⁵²

The importance of these rules is that securities laws will generally be applicable if a family farm is transferred to a limited partnership or LLLP for estate planning or other purposes, and limited partnership interests are subsequently transferred.

148. There are, of course, exceptions to this statement. A limited partner stands to lose his or her contribution if the limited partnership fails. A limited partner retains personal liability for his or her own misconduct. A limited partner who agrees to assume personal liability, for example, by signing a guaranty, would have personal liability. Additionally, there is at least the possibility that a court might pierce the veil of a limited partnership to impose liability on a limited partner, although this would be very unusual. Finally, a limited partner who participates excessively in control of the business might have personal liability to persons who reasonably believe that he or she is a general partner.

149. See section 3.1.c. of this document.

150. See Rev. Unif. Ltd P'ship Act Sec. 303 (providing that limited partners who assume excessive control will have unlimited personal liability as to persons who deal with the limited partnership believing the limited partner to be a general partner.)

151. See *Mayer v. Oil Field Sys. Corp.*, 721 F.2d 59 (2d Cir. 1983); *SEC v. Holschuh*, 694 F.2d 130, 137 (7th Cir. 1982); *SEC v. Murphy*, 626 F.2d 633, 640 (9th Cir. 1980); *Goodman v. Epstein*, 582 F.2d 388, 408-09 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979); *Hirsch v. DuPont*, 396 F. Supp. 1214, 1227-28 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2d Cir. 1977).

152. See *Bank of America Nat'l Trust & Savings Ass'n v. Rittenhouse Assoc.*, 595 F. Supp. 800 (E.D. Pa. 1984); *Frazier v. Mason*, 484 F. Supp. 449 (N.D. Tex. 1980), *aff'd* 651 F.2d 1078 (5th Cir. 1981).

3.2. Agri-Businesses

3.2.a. The Publicly Held Enterprise

The primary focus of this document is on securities issues that are likely to arise in the context of smaller, agriculturally-based enterprises. The reason for this emphasis is not that larger businesses will face fewer securities issues--quite the contrary. However, it is almost inconceivable that any modern business would seek to go public¹⁵³ or become large enough for its securities to become publicly traded¹⁵⁴ under circumstances where the need for experienced securities counsel has not yet been recognized.

Conventional wisdom suggests that in order to be a "good candidate" for a public offering, the company in question should be in a position to generate \$75-100 million in annual sales in the near future.¹⁵⁵ Of course there are exceptions to this, as evidenced by the relatively recent "dot.com" phenomenon, but generally speaking, only companies of sufficient size and economic prospects will voluntarily seek to raise capital through a public offering. Although there are benefits from going public, including an enhanced ability to raise capital, increased liquidity for owners, and a certain prestige associated with being publicly traded, there are also costs. First and foremost, there are the high initial expenses associated with a public offering, which will almost always cost hundreds of thousands of dollars and take months of time.¹⁵⁶ Thereafter, there are increased record-keeping and reporting requirements, an increase in the likelihood of being sued in securities actions, a loss of flexibility, and exposure to the risk of takeovers.¹⁵⁷

As a company grows, the other limits to keep in mind are approached when a company has assets of at least \$10 million and a class of equity securities held by 500 or more persons.¹⁵⁸ Current law

153. "Going public" usually refers to the process pursuant to which a company makes a public offering pursuant to a registration statement filed with the SEC, and thereafter becomes a reporting company. For a more detailed analysis of "going public," see Harold S. Bloomenthal, *GOING PUBLIC AND THE PUBLIC CORPORATION* (West 1997-2000).

154. In addition to the process of a public offering, certain companies become reporting companies because of their size. See Section 12(g)(1) and Exchange Act Rule 12g-1 15 U.S.C. Sec. 78l and 17 C.F.R. Sec. 240.12g-1. These provisions impose registration and reporting requirements on issuers with assets exceeding \$10 million when any class of equity securities is held of record by more than 500 persons. There are exemptions in the statute, including an exemption for securities issued by a "cooperative association" as defined in the Agricultural Marketing Act, and securities issued by certain other cooperative organizations. See Sections 12(g)(2)(E) & (F), 15 U.S.C. Secs. 78l (2)(E) & (F). These exemptions are discussed further in the text at part 3.2.b.

155. John F. Olson & Daniel W. Nelson, *What Makes a Company a Good Candidate for Going Public? Criteria, Advantages, and Disadvantages Related to Going Public*, SF05 ALI-ABA 155, 157 (Aug. 4, 2000).

156. Alan J. Berkely, *Pre-Planning for a Public Offering: Issues and Answers to be Considered Before Making a Commitment*, SF43 ALI-ABA 139, 148-49 (2001) (estimating a six to twelve month process and expenses exclusive of commissions and underwriting expenses of \$250,000-\$400,000).

157. These disadvantages are described in considerably more detail in John F. Olson & Daniel W. Nelson, *What Makes a Company a Good Candidate for Going Public? Criteria, Advantages, and Disadvantages Related to Going Public*, SF05 ALI-ABA 155, 163-65 (Aug. 4, 2000).

158. Section 12(g)(1) of the '34 Act, read with Rule 12g-1 promulgated pursuant to the '34 Act, requires an issuer to register a class of equity securities when the securities are held of record by at least 500 persons and the issuer has total assets in excess of \$10 million. See 15 U.S.C. Sec. 78l and 17 C.F.R. Sec. 240.12g-1. The statute provides that the dollar amount is \$1 million, but Rule 12g-1 exempts issuers having not more than \$10 million in total assets on the last day of its most recent fiscal year (except for certain foreign

requires the issuer to register that class of securities unless the securities are exempt under the terms of the statute.¹⁵⁹ Only two of the exemptions appear to have special application to agriculturally-based companies, and these exemptions are discussed in the following section of this document.

This information on public and reporting companies is not intended as anything more than the briefest of introductions to the issue of reporting companies and the obligations that they face.¹⁶⁰ The point here is that any company considering a public offering or on the verge of becoming publicly held by virtue of size and number of owners should consult with experienced securities experts.

3.2.b. Special Securities Laws Limiting the Obligation of Agricultural Enterprises to Register under the '34 Act

The '34 Act includes two possible exemptions from the registration requirement for "public" companies that have an agricultural bent, both of which apply to cooperatives. One possibility is that the cooperative in question fits within the definition of a "cooperative association" as defined in the Agricultural Marketing Act.¹⁶¹ This Act, in turn, defines cooperative association to mean:

any association in which farmers act together in processing, preparing for market, handling, and/or marketing the farm products of persons so engaged, and also means any association in which farmers act together in purchasing, testing, grading, processing, distributing, and/or furnishing farm supplies and/or farm business services: Provided, however, that such associations are operated for the mutual benefit of the members thereof as such producers or purchasers and conform to one or both of the following requirements:

First. That no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own therein; and

Second. That the association does not pay dividends on stock or membership capital in excess of eight per cent per annum.

And in any case to the following:

Third. That the association shall not deal in farm products, farm supplies, and farm business services with or for nonmembers in an amount greater

private issuers).

159. Section 12(g)(1) for "exempted securities," which are in turn defined in section 3(a)(12) of the '34 Act (15 U.S.C. Sec. 78c) to be government and municipal securities and certain other specialized securities. Section 12(g)(2) also includes an exemption for the securities of certain specialized issuers. One of these exemptions is for securities issued by a "cooperative association" as defined in the Agricultural Marketing Act. This exemption is discussed further in the text at part 3.2.b.

160. For a more in-depth overview of this topic, see Larry D. Soderquist, *Understanding Sec. Law Sec. 9:3 PLI-Ref-SECLAW* (2001) (materials dealing with registration of securities under the '34 Act); Robert J. Haft, *2A Venture Cap. & Bus. Fin. Sec. 5A.01* (1997-2000) (dealing with the practice, procedure and consequences of going public).

161. 15 U.S.C.A. Sec. 78l(g)(2)(E), which exempts "any security of an issuer which is a 'cooperative association' as defined in the Agricultural Marketing Act, approved June 15, 1929, as amended, [12 U.S.C.A. 1141 et seq.], or a federation of such cooperative associations, if such federation possesses no greater powers or purposes than cooperative associations so defined."

in value than the total amount of such business transacted by it with or for members. All business transacted by any cooperative association for or on behalf of the United States or any agency or instrumentality thereof shall be disregarded in determining the volume of member and nonmember business transacted by such association.¹⁶²

The other possibility under the '34 Act is for the security to meet the following requirements: any security issued by a mutual or cooperative organization which supplies a commodity or service primarily for the benefit of its members and operates not for pecuniary profit, but only if the security is part of a class issuable only to persons who purchase commodities or services from the issuer; the security is transferable only to a successor in interest or occupancy of premises serviced or to be served by the issuer; and no dividends are payable to the holder of the security.¹⁶³

The fact that the exemption for cooperatives is so limited is quite significant. At one time, most agricultural cooperatives were organized so as to comply with the requirements of section 521 of the Internal Revenue Code. These cooperatives also operated in a manner consistent with the Agricultural Marketing Act. However, this is no longer the case. The restrictions imposed by these federal statutes are so limiting, especially as the number of farmers has shrunk over the years, that it has become increasingly impracticable for all cooperatives to fit within these strictures.¹⁶⁴

However, for the purposes of these materials, it is worth emphasizing the potential availability of these exemptions, since even an experienced securities lawyer may be less familiar with these particular provisions. The following materials describe in some detail the ways in which cooperatives function, and may therefore be helpful to counsel trying to understand the way in which securities laws may apply to interests issued by such enterprises.

3.3. Participation in Traditional Marketing Cooperatives

3.3.a. What is a Traditional Cooperative?

Traditional cooperatives are often compared to corporations, perhaps because co-ops were typically incorporated under state law.¹⁶⁵ In order to describe the way in which a traditional cooperative operates, it may make sense to start with a review of the structure of a typical business corporation, because these are the more familiar form of business enterprise. Persons wishing to become equity participants in a corporation buy stock. This stock gives the owners the right to elect directors, generally

162. 12 U.S.C.A. Sec. 1141j.

163. 15 U.S.C.A. Sec. 78l(g)(2)(F).

164. For a discussion of the waning importance and prevalence of section 521 cooperatives, see generally Donald A. Frederick, *Income Tax Treatment of Cooperatives: Internal Revenue Code Section 521*, USDA, Rural Bus.-Coop. Serv., Coop. Info. Rept. 44, pt. 4, (June 1996) *Accord* James R. Baarda, UNITED STATES COOPERATIVES AND INCOME TAX POLICY 111 (1997) ("A decreasing number of cooperatives are attempting to qualify for section 521 exempt status because the burdens of meeting the qualifications outweigh the benefits received from 'exemption.'"); and David W. Cobia, Ed., COOPERATIVES IN AGRICULTURE 295 (National Council of Farmer Cooperatives, 1989) ("Changing economic conditions affecting the operation of cooperatives have decreased the number of cooperatives holding section 521 status.")

165. USDA, COOPERATIVE PRINCIPLES AND LEGAL FOUNDATIONS 1 (1977) (citing Evans & Stokdyk, THE LAW OF AGRICULTURAL MARKETING (1937)).

on the basis of the number of shares owned.¹⁶⁶ Share ownership also entitles the equity participants to share in earnings on a pro rata basis.¹⁶⁷ Absent agreement among the shareholders to the contrary, shares are freely transferable and capable of appreciating in value. These are, in fact, the essential attributes of corporate "stock" identified by the U.S. Supreme Court in the context of determining when "stock" will be considered to be a security.¹⁶⁸

Cooperatives do not generally work in quite this way. First, cooperatives may or may not issue "stock" to their members; equity participation in a co-op can take many different forms. In addition, while members may be required to buy some sort of "membership interest" as a condition to joining the cooperative, the majority of a traditional cooperative's equity comes from retained patronage dividends rather than external "investment." Finally, even where "stock" is purchased, its function is typically only to give members the right to use the co-op's services and facilities. It generally does not determine voting rights or the right to share in profits from the venture, if any. Cooperatives generally operate on a one-vote per member basis, regardless of the relative investment of the members or the number of shares or membership interests owned.¹⁶⁹ Similarly, although members generally have equal voting rights in the cooperative, member income is based on patronage rather than equity investment and ownership.¹⁷⁰ Distributions upon dissolution are also based on patronage rather than the members' proportionate capital investment.¹⁷¹ In addition, membership rights (however denominated) are not usually freely transferable and typically do not have the potential for appreciation.

For these reasons, even though co-ops may be "incorporated" under state law, they are functionally very different entities. In evaluating the characteristics of a cooperative, it has been said that:

Any definition of a cooperative must account for four operationally-unique cooperative principles. First, cooperatives are owned and democratically controlled by the producers who use their services. Second, the cooperative

166. Corporations may also issue non-voting shares, but at least one class of shares must have voting rights.

167. Again, it is possible that the corporation will issue multiple classes of shares, each with different participation rights. However, every share in the same class must entitle its owner to the same rights as are attributable to every other share in the same class.

168. Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985), identifying the characteristics "usually associated with common stock as (i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value." *Id.* at 686, citing United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 851 (1975).

169. James Baarda, *State Incorporation Statutes for Farmer Cooperatives*, USDA/ACS, Cooperative Information Rep. No. 30, Sec. 11.01 and Table 11.01 (Oct. 1982).

170. Thus, when a cooperative desires to return some of its net earnings to its patrons, it generally pays out patronage "dividends" (in cash or other property). Earnings returned to persons using the cooperative may also be known as patronage refunds, but are labeled "patronage dividends" in the Internal Revenue Code. I.R.C. Sec. 1388(a) (1976). For convenience, the term patronage dividend will be used in this document.

However, the cooperative often does not pay out all of its earnings when they are earned; rather, the typical traditional cooperative will retain at least a portion of each member's patronage dividends until a later date. Patronage dividends that are allocated to patrons but retained by the cooperative are generally known as patronage retain or retained equities.

171. Statutes addressing the distribution of assets by an agricultural cooperative at dissolution apportion them in three ways: 1) according to property interests; 2) according to stock ownership; or 3) according to past patronage. See James Baarda, *State Incorporation Statutes for Farmer Cooperatives*, USDA/ACS, Cooperative Information Rep. No. 30, Sec. 17.03.02 and Table 17.03.02 (Oct. 1982).

distributes its net income to producers in proportion to their use of the cooperative. Third, returns on ownership capital are limited. Fourth, producers who use the cooperative substantially finance its operation.¹⁷²

This litany of attributes makes for ready comparison with the traditional, for-profit corporate form. In the case of a corporation, shareholder-owners generally have one vote per share, meaning that voting rights are held proportionately to each shareholder's equity investment in the enterprise. In addition, a shareholder's equity interest is typically acquired through investment in the stock itself, although the stock may (and hopefully will) appreciate in value. The investment may be recouped through dividends or upon sale of the appreciated stock on the open market. Most stock is not redeemable, nor is redemption the typical way in which the value of an investment in corporate stock is realized. In general, therefore, a stockholder's income is generally based on stock ownership, as is the stockholder's right to participate in distributions upon dissolution and liquidation. The shares are generally freely transferable, unless the shareholders have agreed to limit this right. Moreover, there is generally no requirement that the owners of a business corporation "use" the corporation's facilities or products.

None of the essential attributes of the cooperative form of business fit the traditional corporate model. This fact explains why some commentators have complained that "viewing a co-operative as a corporation distorts its true nature because an ordinary corporation may exist and operate independent from its own detached power base whereas a co-operative cannot exist apart from a body of people who are its members."¹⁷³

3.3.b. Application of the Securities Laws to Traditional Cooperatives

Generally speaking, members in a cooperative are required to make a limited financial investment upon joining the cooperative.¹⁷⁴ For agricultural cooperatives, membership is limited to those who produce the agricultural products which are the focus of the cooperative venture.¹⁷⁵ Often, a relatively small initial investment in the venture is required of members. For cooperatives with stock, this investment often takes the form of a mandatory purchase of common stock.¹⁷⁶ On the other hand, because cooperatives may be formed on a stock or non-stock basis, the initial investment by members may not result in the issuance of "stock" and instead may take the form of a membership or initiation fee.¹⁷⁷ Even for cooperatives organized on a stock basis, membership or initiation fees may be required in lieu of a mandatory purchase of stock or in addition to it. However, for the most part, these fees give

172. Sharlene F. Roberts-Caudle, *Agricultural Cooperative Member Equity: You Don't Have to Die for It!* 7 SAN JOAQUIN AGRIC. L. REV. 1, 6 (1997) (footnotes omitted).

173. Stuart Bailey, Univ. of Saskatchewan Centre for the Study of Cooperatives, ENCOURAGING DEMOCRACY IN CONSUMER AND PRODUCER COOPERATIVES 1 (1986), cited in Sharlene F. Roberts-Caudle, *Agricultural Cooperative Member Equity: You Don't Have to Die for It!* 7 SAN JOAQUIN AGRIC. L. REV. 1, 2 (1997).

174. Lewis D. Soloman & Melissa B. Kirgis, *Business Cooperatives: A Primer*, 6 DEPAUL BUS. L.J. 233, 242 (1994).

175. Jon K. Lauck & Edward S. Adams, *Farmer Cooperatives and the Federal Securities Laws: The Case for Non-Application*, 45 S.D. L. REV. 62, 69 (2000) (noting that "the purchase of equity is often limited by statute to the cooperative's member-patrons . . .").

176. See generally Neil E. Harl, 14 Agricultural Law Sec. 136.01[1] at 136-4, n.23 (Matthew Bender, Nov. 1996).

177. Lewis D. Soloman & Melissa B. Kirgis, *Business Cooperatives: A Primer*, 6 DEPAUL BUS. L.J. 233, 239-45 (1994).

rise to the same rights as purchasers obtain upon buying membership interests in the form of stock and under the federal securities laws should not be subject to significantly different analysis, regardless of what the fee is called or whether membership interest is documented through the issuance of something called "stock."¹⁷⁸

Regardless of whether or not the initial purchase results in the issuance of stock, most of the equity¹⁷⁹ in a traditional cooperative is generated by the cooperative's retention of a portion of the sales price of goods sold through the cooperative or a portion of any savings realized as a result of purchases through the cooperative.¹⁸⁰ Members in the cooperative are normally entitled to receive shares of the cooperative's profit, based on how much they use the cooperative's facilities or services.¹⁸¹ Many agricultural cooperatives simply retain a portion of the amount which would otherwise be paid to the members for their product on a per unit basis.¹⁸² This form of "investment" is often referred to as a patronage retain, and may or may not be represented by certificates.¹⁸³

The prevalence of this as a method of financing is attributable to a number of factors. First, although cooperatives are required by federal tax laws and state incorporation laws to pay patronage

178. It is clear that the mere fact of calling an interest "stock" will not be determinative. See, e.g., *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 (1975).

In addition to this authority, several no-action no-action requests from cooperatives have specifically referenced such fees rather than stock purchases. See generally *AMSI Travel Alliance, Inc.* (avail. Feb. 7, 1980); *Southland Dealers Corp.* (avail. Oct. 22, 1979); and *Yellow Cab Cooperative Assn.* (avail. Apr. 6, 1979). Some cooperatives have also received favorable no action responses for member financing through annual dues payments in addition to the initial membership fee. *Wine Spirits Shippers Cooperative, Inc.* (avail. Mar. 8, 1981); *Yellow Cab Cooperative Assn.* (avail. Apr. 6, 1979); *Rural Television Cooperative Assn.* (avail July 22, 1977).

179. There are a number of reasons why farmers' cooperatives may be unable to raise sufficient capital by selling membership interests. "Since the purchase of equity is often limited by statute to the cooperative's member-patrons, ...this financing option can be limited. This option is especially limited in times of economic distress when farmers have very little working capital." Jon K. Lauck & Edward S. Adams, *Farmer Cooperatives and the Federal Securities Laws: The Case for Non-Application*, 45 S.D. L. REV. 62, 69 (2000).

In addition, the greater the capital needs of the cooperative, the less satisfactory equity financing may be as a source of operating funds. See Ralph W. Dutrow et al., *United States Dep't of Agric., Financial Profile of 15 New Agricultural Marketing Cooperatives 7* (1981) (Agricultural Cooperative Service, ACS Service Report No. 27, May 1981).

One obvious alternative to equity financing is debt. Financing through debt can also raise difficult issues for cooperatives under the federal securities laws. One problem is that there are so many kinds of debt that may be used by such enterprises. For example, in addition to loans from commercial sources, members may make advance payments for supplies to be purchased later or outright cash loans evidenced by promissory notes. There are relatively few authorities dealing with the appropriate treatment of debt issued by cooperatives under the federal securities laws. For at least some kinds of debt, the Staff of the SEC has apparently taken the position that the securities laws should apply. See *Southland Dealers Co-Op, Inc.* (avail. Oct. 22, 1979) (membership interests would not require registration, but proposed offering of preferred stock and debt securities "would involve the offering of securities."). Debt is discussed more fully in part 4 of this document.

180. Farmer Coop. Service, USDA, *Legal Phases of Farmer Cooperatives* 471-80 (1976).

181. *Id.*

182. *Id.* at Sec. 62, at 252-53.

183. See generally Mary Beth Matthews, *Current Developments in the Law Regarding Agricultural Cooperatives*, 1 DRAKE. J. AGRIC. L. 173, 174 n.10 (1996), citing Mary Beth Matthews, *Financial Instruments Issued by Agricultural Cooperatives*, USDA/ACS, Cooperative Information Rep. No. 68, March 1988. Accord Neil E. Harl, 14 *Agricultural Law Sec.* 136.01[1] at 136-5 to -6 (Matthew Bender, Nov. 1996).

dividends each year to their members,¹⁸⁴ they are not required to pay the entire dividend in cash. Federal tax laws require at least 20 percent be paid in money or by qualified check in order for the entire patronage dividend to be a deductible expense for the cooperative.¹⁸⁵ The amount not paid in cash is kept by the cooperative and credited to the member in one of several ways. For example, a member may receive "stock," credit on a capital account, an equity certificate, or some other evidence of his or her retained patronage in the cooperative.¹⁸⁶ Retained patronage dividends (however denominated) thus provide an easy way for members to contribute equity capital to the cooperative.¹⁸⁷ The principal manner of recouping these types of equity investment is through redemption of these interests by the cooperative, rather than by sale of the interests in a market.¹⁸⁸

Unfortunately, there are relatively few authorities addressing when such equity interests¹⁸⁹ are properly classified as securities.¹⁹⁰ It seems that some of these interests will be classified as securities while other interests will not be subject to such regulation.¹⁹¹ A more detailed review of the applicable definitions of the term "security" indicates why both of these possibilities exist.

The definitions section of the '33 Act does not specifically reference membership interests in cooperatives, agricultural or otherwise. Some commentators have opined that, because of the absence of a profit motive in many such ventures, the securities laws should generally not apply to such interests

184. See, e.g., I.R.C. Sec. 1388.

For a general discussion of patronage dividends, see Irving Clark & Phillip L. Erickson, *Taxation of Cooperatives*, 229-2nd Tax Mgmt. (BNA); Donald A. Frederick & John D. Reilly, *Income Tax Treatment of Cooperatives: Background*, USDA, Agric. Coop. Serv., Info. Rept. No. 44, pt. 1 (Nov. 1993); Donald A. Frederick & John D. Reilly, *Income Tax Treatment of Cooperatives: Patronage Refunds*, USDA, Agric. Coop. Serv., Info. Rept. No. 44, pt. 2 (Dec. 1993); and John E. Noakes, *Taxation of Agricultural Cooperatives* in 14 Neil E. Harl, *Agricultural Law*, ch. 135 (1996).

185. I.R.C. Sec. 1388(c)(1).

186. See Terence J. Centner, *Retained Equities of Agricultural Cooperatives and the Federal securities Acts*, 31 U. KAN. L. REV. 245, 246 (1982).

187. *Id.* at 247.

188. See generally *Equity Redemption--Issues and Alternatives for Farmer Cooperatives*, USDA/ACS, Cooperative Information Rep. No. 23, 1982.

189. There are a number of no-action determinations from the SEC concerning the status of revolving equity plans designed to retire "retained dividends." See, e.g., *American Crystal Sugar Co.* (avail. Feb. 19, 1984); *Yellow Cab Cooperative Assn.* (avail. Apr. 6, 1979); *Mississippi Chemical Corp.* (avail. Nov. 14, 1977); *Mid-America Dairyman, Inc.* (avail. Mar. 3, 1977).

190. Not all patronage retains have been classified as "equity" for all purposes. See, i.e., *In re Schauer*, 62 Bankr. 526, 531-32 (D. Minn. 1986) (noting that while "patronage dividends may be distributed in the form of capital stock or equity securities," the patronage dividends at issue in that case were "not in themselves equity securities" under Minnesota law).

191. One particularly well-respected commentator has observed that, in his opinion: Stock or a membership in a business cooperative may or may not be a security. Where a nominal amount is paid for a non-transferable interest with no appreciation potential, and where earnings are distributed in accordance with patronage volume rather than shareholdings, no security would be involved. But some cooperative stock has sufficient profit/loss potential to be a security.

Richard W. Jennings et al., *SECURITIES REGULATION: CASES AND MATERIALS* 341 (8th ed. 1998) (noting that most of the available authorities are non-binding no-action letters from the SEC).

at all.¹⁹² However, as described in the introductory sections of this document, the securities laws were broadly drafted, and there are certainly sections of the definitions section that could arguably apply to cooperatives.

The applicable definition in the '33 Act provides in pertinent part: "[U]nless the context otherwise requires--the term 'security' means any note, stock . . . certificate of interest or participation in any profit-sharing agreement . . . investment contract . . . or, in general, any interest or instrument commonly known as a 'security' . . ." ¹⁹³ Membership interests in an agricultural cooperative might be treated as falling within any one or more of these categories.

One possibility is that membership interests might constitute "stock," as such term is used in the federal securities acts. This possibility has some inherent plausibility, since cooperative membership interests are often evidenced by shares of "stock" and technically represent equity participation in a corporate entity. On the other hand, this type of membership interest does differ fundamentally from typical "corporate stock."¹⁹⁴ Alternatively, these interests, if certificated, might be seen as evidence of participation in a profit-sharing agreement. An even more likely alternative is that such interests, whether or not represented by certificates, might qualify as "investment contracts," as such term is meant in the federal securities acts. Finally, it is also possible that the interests might be "commonly understood," to be securities because of public perceptions.

Perhaps not surprisingly, the leading authorities in the area of when interests in cooperatives should be regulated as securities do not involve agricultural cooperatives. In fact, most of the cases appear to involve housing cooperatives. The leading case is *United Housing Foundation, Inc. v. Forman*,¹⁹⁵ a U.S. Supreme Court opinion issued in 1975. This case involved securities fraud claims by the shareholder-residents of a low- and moderate-income cooperative housing development. The opinion focused on whether the ownership interests in that case, which were called stock, were securities.

The "stock" in that case essentially entitled the purchasers to residence in the cooperative housing project. The shares reflected a number of principles characteristic of cooperative membership interests: (1) ownership of shares entitled the holder to occupy a residential apartment in the project, and only share-owners could occupy an apartment; (2) the required capital contribution was based on the size of the apartment; (3) regardless of the number of shares owned, each share-owner had a single vote in electing directors and deciding cooperative issues; (4) transfer of shares was restricted;¹⁹⁶ and (5) no dividends were paid and the stock could not appreciate in value. The two primary arguments in favor of treating

192. See 1 Louis Loss, *SECURITIES REGULATION* 492-94 (2d ed. 1961) (claiming that investments in cooperatives are made "to finance the provision of low cost quality goods and services used by members or the group marketing of goods produced by them"); I. Packel, *ORGANIZATION AND OPERATION OF COOPERATIVES* 285-86 (4th ed. 1970); Miller, *Cooperative Apartments: Real Estate or Securities?* 45 B.U. L. REV. 465, 496 (1965). "So long as profit does not mean benefit (as it has not) and so long as profit is the often unspoken but essential element of motivation in securities sales and purchases, federal securities law should not apply. The problem is: no one is absolutely certain." *Id.* at 496 (citing Professor Loss).

193. 1933 Act, Sec. 2(1), codified at 15 U.S.C.A. Sec. 77b(1).

194. For a more detailed discussion of how corporations and cooperatives differ, see part 3.3.a of this document.

195. 421 U.S. 837 (1975).

196. The shares could not be transferred, pledged, or encumbered to a non-tenant. In addition, they could descend at death only to a surviving spouse. Upon termination of occupancy, the cooperative possessed a right of first refusal to repurchase the shares. If the cooperative did not repurchase the shares, sale could only be made to an eligible prospective tenant. *Id.* at 842-43.

these interests as securities were that (1) they constituted shares of "stock," which is explicitly included in the statutory definition of "security" and/or (2) the shares represented investment contracts under the test articulated in *S.E.C. v. W. J. Howey*.¹⁹⁷

Although the membership interests in *Forman* were called "stock," the Supreme Court declined to apply a mechanistic approach to the issue, concluding that "Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto."¹⁹⁸ In finding that the "stock" used in that case did not involve the type of investment usually associated with corporate stock, the Court explained the transaction as follows:

Common sense suggests that people who intend to acquire only a residential apartment in a state-subsidized cooperative, for their personal use, are not likely to believe that in reality they are purchasing investment securities simply because the transaction is evidenced by something called a share of stock.¹⁹⁹

Examining the economic realities of the transaction, the Court concluded that the cooperative shares possessed none of the characteristics typical of corporate stock. The shares lacked: (1) the right to receive dividends contingent upon an apportionment of profits, (2) negotiability, (3) the ability to be pledged or hypothecated, (4) voting rights in proportion to the number of shares owned, and (5) the possibility of appreciation in value.²⁰⁰

Similarly, it was also determined that the shares of stock could not properly be categorized as investment contracts. As described earlier in this document, an interest will generally be regulated as an investment contract only if the following four elements are present: (1) an investment, (2) in a common enterprise, (3) with the expectation of profits, (4) solely from the efforts of others.²⁰¹ A cooperative clearly involves a common enterprise, but the Supreme Court concluded that none of the other elements were present: the interests did not involve any investment;²⁰² there was no "expectation of profits";²⁰³ and any possible economic benefits would not result from the managerial efforts of others.²⁰⁴

197. 328 U.S. 293 (1946). [A]n investment contract for purposes of the Securities Act means a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party *Id.* at 298-99.

198. 421 U.S. at 849.

199. 421 U.S. at 851. The Court noted that in the case before it, "the inducement to purchase was solely to acquire subsidized low-cost living space; it was not to invest for profit." *Id.*

200. *Id.*

201. *Howey*, 328 U.S. at 299.

202. The Court observed that the purchases of cooperative shares were not intended as an investment, but were intended to provide essential services for the residents of the cooperative. 421 U.S. at 857.

203. 421 U.S. at 852. The Court recognized some potential economic benefits that might accrue to purchasers of the cooperative shares, but determined that, on the facts before it, the possibility of such income was 'far too speculative and insubstantial' to bring the transaction within the securities laws. *Id.* at 856.

204. 421 U.S. at 852-58.

The *Howey* requirement that profits arise solely through the efforts of others would not normally be satisfied in the case of cooperatives for three reasons: (1) because there are no profits paid on capital, the benefits of cooperative membership can arise only through use of the cooperative by the member (through direct

Although commentators originally suggested that this case might be narrowly construed,²⁰⁵ it is now clear that this is not going to be the case. Generally speaking, equity interests in traditional cooperatives will be outside the scope of the securities laws so long as the motivation behind the purchase is to enable the purchaser to use or participate in the use of the purchased item.²⁰⁶

This is also the approach which governs in the context of interests in agricultural cooperatives.²⁰⁷ The fact that membership interests may be called stock is not a sufficient justification for the application of the securities laws.²⁰⁸ In addition, the absence of a profit motive also precludes a determination that the interests in question are investment contracts.²⁰⁹ Because earnings in a traditional cooperative are based on patronage rather than the level of up-front investment, it is relatively easy to distinguish this type of enterprise from a venture involving investment contracts.²¹⁰ Finally, it is unlikely that members in a

patronage); (2) the economic savings to cooperative members arise primarily as a consequence of the nonprofit relation between the co-op and its members, rather than through the managerial efforts of others; and (3) where, as is often the case, cooperative members retain control over important decisions and participate in its business affairs, the 'solely through the efforts of others' test could not be met. *Id.* at 848-51.

205. See, e.g., authorities cited in Note, Shares in Privately Financed Cooperative Apartment Corporations and the Federal Securities Laws After *Grenader v. Spitz*, 30 Rutgers L. Rev. 432, 433 n.10 (1977). Commentators seeking to apply the federal securities laws to cooperative housing projects generally contended that the facts of *Forman* were unique. Not only was the cooperative project in *Forman* a non-profit organization, publicly financed under state supervision; the shares possessed no possibility of capital appreciation on resale. Arguably, this could be materially different from projects where capital appreciation is possible.

206. See *Grenader v. Spitz* 537 F.2d 612 (2d Cir. 1976), *cert. denied*, 429 U.S. 1009 (1977). See also *B. Rosenberg & Sons, Inc. v. St. James Sugar Coop.*, 447 F. Supp. 1 (E.D. La. 1976), *aff'd without opinion*, 565 F.2d 1213 (5th Cir. 1977).

Characteristics of the *Grenader* situation which could have distinguished it from the facts of *Forman* included all of the following: (1) the project was privately sponsored; (2) the cooperative's bylaws permitted the payment of dividend distributions; (3) shareholder voting power was proportional to the number of shares owned; (4) there was potential for capital gains, and (5) reserve funds of the cooperative were invested in financial markets, arguably resulting in a participation in earnings from the use of investors' funds. Nonetheless, the Second Circuit confirmed that the critical inquiry is whether the purchasers are motivated by a desire to use or consume the item purchased, or to develop it themselves. If either of these statements is accurate, the federal securities laws will not apply. *Grenader*, 537 F.2d at 617-619.

207. See, e.g., *B. Rosenberg & Sons, Inc. v. St. James Sugar Coop.*, 447 F. Supp. 1 (E.D. La. 1976), *aff'd without opinion*, 565 F.2d 1213 (5th Cir. 1977).

208. In *Rosenberg*, the court held that membership stock in a cooperative sugar marketing association was not a "security" within the meaning of the federal securities laws:

The stock certificate here denotes nothing more than membership in the cooperative. It has none of the characteristics associated with the concept of a security. It is non-negotiable, bears no dividends, can only be owned by a member, and can only be transferred with approval of the board of directors.

565 F.2d at 3.

209. *Id.* at 4.

210. "Equity credits or patronage dividends are not profits similar to income from ordinary stock investments but are rebates or refunds to members based solely on patronage and not on the amount of money invested in the stock. A member accrues no equity credits if he produces no cane or if the association sustains a loss . . ." *Id.*

traditional agricultural cooperative believe that they are buying a security rather than simply paying for the privilege of belonging to the cooperative.²¹¹

One way of documenting how entrenched this position has become is to consider what the Securities Exchange Commission itself has to say about investments in traditional cooperatives. Because this is an area of some uncertainty, it is not uncommon for securities practitioners to request an opinion from the SEC as to whether the Commission agrees that a particular type of interest will be outside the scope of the securities laws. These requests come in the form of requests for "no-action letters," and while particular determinations do not have any precedential value in and of themselves and are not binding on the courts, they do provide significant guidance from the staff at the regulatory agency charged with administration of the securities laws as to what they believe to be the appropriate scope of such regulation.²¹²

The SEC has generally granted²¹³ the no-action requests made by or on behalf of traditional cooperatives requesting determinations that the SEC will not recommend enforcement of the federal securities laws on the grounds that the co-op has illegally sold securities without complying with federal law.²¹⁴ In these no-action letters, the SEC's staff most commonly notes that the cooperative's stock or other membership interests merely evidences a membership interest in the cooperative and do not possess most of the characteristics of a security, such as: (1) ordinary dividend rights, (2) unrestricted transferability, or (3) the potential for significant appreciation in value.²¹⁵ However, in at least some cases

211. The *Rosenberg* court explained this as follows:

It is readily apparent that local sugar cane farmers purchasing shares of stock in the defendant cooperative did not believe that they were purchasing investment securities. The inducement to purchase was membership in an association that would provide the sugar cane farmer with services he might not otherwise obtain--that is, the assurance of a place to process and market the fruits of his labor. The cooperative member did not participate for the purpose of obtaining profits from investment securities.

Id.

212. "No action" determinations do not constitute the formal position of the SEC, but rather represent the views of the Commission's staff. They are informal rulings under 17 C.F.R. Sec. 202.1(d), and provide assurance that a contemplated action will not lead to an enforcement proceeding by the Commission.

213. This was not the case prior to *Forman*. "Prior to . . . [Forman] the S.E.C.'s Division of Corporation Finance generally took the position in no-action letters that cooperatives which allowed their members to share in their earnings or savings were issuers of securities." Neil E. Harl, 14 *Agricultural Law Sec.* 136.01[3] at 136-19 (Matthew Bender, Nov. 1996).

214. See, e.g., *Veterinary Products, Inc.* (avail. Feb. 6, 1998); *NBF Acquisition, Inc.* (avail. April 1, 1997); *Cap Rock Telephone Co., Inc.* (avail. Nov. 4, 1994); *Peer Marketing Associates, Inc.* (Feb. 3, 1993); *Kentucky Pharmacy Services Corp.* (avail. June 6, 1991); *Producers Feed Co.* (avail. July 30, 1990); *Associated Grocers, Inc.* (avail. Feb. 12, 1988); *American Crystal Sugar Co.* (avail. Feb. 19, 1984); *California Ammonia Co.* (avail. May 27, 1983); *AMSI Travel Alliance, Inc.* (avail. Feb. 7, 1980); *Salon Owners' Cooperative* (avail. Aug. 4, 1980); *It Co-op* (avail. Oct. 1, 1979); *Mid-America Dairymen, Inc.* (avail. Mar. 3, 1977).

215. *Id.* See also the discussion of the SEC's general position on this issue in Steve F. Brault, *Equity Financing of Cooperatives: Advantageous Federal Securities Law and Tax Treatment*, 21 *WILLAMETTE L. REV.* 225, 243-49 (1985).

where one or more of these enumerated characteristics are present, the SEC has acquiesced in the view that the interests are securities.²¹⁶

On the other hand, the absence of other traditional hallmarks of the cooperative form of enterprise has not deterred the SEC from granting no-action requests. For example, the SEC has not generally required co-ops to abide by the traditional principle of one vote per member. In fact, the Commission has issued several no-action letters concerning membership shares in "cooperatives" where membership rights were not shared equally, but rather were allocated on the basis of capital contributions²¹⁷ or the number of shares held.²¹⁸ Similarly, the SEC has also taken a no-action position with regard to a cooperative which allocated the right to purchase fertilizer products on the basis of the amount of stock owned by each member.²¹⁹

There has, however, never been any guarantee that courts will follow the rather limited approach taken by the SEC in these no-action letters rather than the inquiry into investment intent suggested by the *Forman* court.²²⁰ The most recent federal court opinion suggests that the federal courts are still inclined

216. In *Calavo Growers of California*, (avail. Oct. 23, 1996), one of the cooperative's subsidiaries began doing a substantial portion of its business with non-members. That subsidiary earned substantial profits, which were in turn distributed to the cooperative's members. The cooperative treated those payments as the equivalent of taxable dividends, and further acknowledged that these payments meant that members had an expectation of receiving distributions which would not be dependent upon the efforts of the members. The cooperative relied on these facts in claiming an exemption from the securities laws based upon an exchange of securities solely to existing security holders (1933 Act, Sec. 3(a)(9), codified at 15 U.S.C.A. Sec. 77c(a)(9)), and the Staff acquiesced, issuing the requested no-action letter.

Similarly, in *Associated Grocers Co-Op, Inc.* (avail. June 8, 1984), each member of a cooperative that supplied groceries and other products to its members purchased shares of stock and a buying deposit. The price of a buying deposit was based upon the number of stores owned by the member which were supplied by the cooperative and the amount of business that the member transacted with the cooperative. The buying deposits obligated the cooperative to pay interest at the rate of five percent per annum without any regard to the member's own efforts. When the cooperative proposed to exchange new stock for the existing shares, counsel asserted that the 5% annual interest converted the shares into securities, thus rendering the proposed transfer exempt under section 3(a)(9) of the 1933 Act. The exemption would only apply if the shares were in fact securities. The SEC issued the requested no-action letter.

217. In *Independent Producers Marketing Corp.* (avail. Dec. 18, 1981), there were two classes of shares, M and E. Class M shareholders were entitled to elect one-third of the board of directors. The remaining directors were elected by Class E shareholders. Class E shareholders held some Class M stock, but had also "contributed substantial additional capital in order to acquire their Class E [shares]." Class E shareholders possessed sole voting power over transactions such as mergers, sales of assets, liquidations, and other matters, as well as having exclusive rights to dividends declared from non-patronage earnings of the business. The no action letter was requested only with regard to the Class M stock.

In *AMSI Travel Alliance, Inc.* (avail. Feb. 7, 1980), majority control of the board of directors was retained by the incorporating "parent" trade organization which issued to itself all of the common stock of the cooperative. "Members" of the cooperative purchased preferred shares, which entitled them to elect one less than a majority of the board of directors.

In *California Ammonia Co.* (avail. May 27, 1983), there were also two classes of owners. Farmers owned class A stock while ammonia producers owned class B shares. The farmers, as class A shareholders, were entitled to elect a majority of the board of directors, while the bylaws guaranteed to the owners of class B stock the right to elect at least one director.

218. American Hardware Supply Co. (avail. Jan. 9, 1984).

219. Mississippi Chemical Corp. (avail. Nov. 14, 1977).

220. Consider the Second Circuit's opinion in *Grenader*, 537 F.2d 612 (2d Cir. 1976), *cert. denied*, 429 U.S. 1009 (1977). In that case, none of the SEC's three conditions were met: the shares were transferable, dividends on capital were not prohibited, and capital gain on resale of the membership interest was permitted.

to emphasize the question of whether the purchasers bought their cooperative membership interests as an investment and, in connection with that inquiry, are likely to weigh a variety of relevant factors.²²¹ The case in question actually involved the issuance of interests which were called "capital credits" rather than "stock," but clearly the credits represented a type of interest in the cooperative.

The court in that decision considered both the "family resemblance" test, which had originally been used to determine whether promissory notes should be regulated as securities,²²² and the *Howey* investment contract test.²²³ The parties who argued that the securities laws should apply to the "capital credits" in question pointed to the following characteristics as supporting the application of the '33 Act:

(1) the capital credits were transferable; (2) the capital credits represented retained equities and were issued in an effort to raise, or retain, capital; (3) members gave value for the capital credits either in the form of equities given up or in the form of a deferred-cash, dollar-valued entitlement that the capital credits represented; (4) capital credit holders expected and received distributions of earnings; (5) profits that benefitted equity holders, including capital credit holders, were derived from the managerial efforts of others; (6) capital credits gave the owner the right to purchase common stock; (7) capital credits evidenced retention of monies ultimately owed to the members--which was a debt; (8) a majority of the capital credit holders had the credits because their common stock had been converted to capital credits; and (9) there was no other regulatory scheme to protect holders of capital credits, other than the federal security laws.²²⁴

In rejecting this argument, the court observed that while Congress intended a "broad" definition of the term "security," it had never intended to cover all fraud claims within the ambit of the federal securities laws. The court first rejected application of the family resemblance test, and instead turned to a consideration of whether the capital credits at issue could be properly characterized as investment contracts.²²⁵ In concluding that the federal securities laws should not apply, the court began by noting that "the class members enter into the cooperative relationship not in expectation of the profits . . . but instead to reap the benefits of that relationship." The court also concluded that there was no "valuable return on an investment normally expected from the purchase of a security," since the credits were not interest

537 F.2d at 617. Nonetheless, the court found that the membership shares in that case were not securities.

221. As of this writing, the most recent judicial pronouncement on the issue of the appropriate treatment of membership interests in agricultural cooperatives under the federal securities laws appears to be *Great Rivers Cooperative of Southeastern Iowa v. Farmland Industries, Inc.*, 198 F.3d 685 (8th Cir. 1999). The case involved an attempt by Farmland Industries, the nation's largest cooperative, to amend its bylaws to authorize the conversion of outstanding shares of common stock owned by inactive or ineligible members into "capital credits," a form of non-voting equity. Once this bylaw provision was in place, Farmland converted a number of shares of common stock held by persons ineligible to be members in the cooperative into capital credits. This eventually led to the filing of a class action alleging securities fraud and a variety of related claims. The district court dismissed the federal securities claims "on the grounds that the capital credits [were] not 'securities' within the meaning of the federal securities laws."

222. The family resemblance test as currently applied is based on the Supreme Court's opinion in *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990).

223. *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293 (1946).

224. *Farmland*, 198 F.3d at 697-98.

225. *Id.* at 699 ("The *Reves* approach is not applicable here because "capital credits" are not specifically included in the statutory definition of "security.").

bearing and were not readily convertible into cash.²²⁶ The court then considered a number of specific characteristics applicable to the credits: all credits represented equity interest originally obtained as an incident of membership in the cooperative; the credits were not issued by Farmland out of any intent to raise money for general business operations; there was no common trading of the interests for speculation and "the capital credits are not fundamentally an investment." Applying the investment contract analysis to these specific facts lead the court to conclude that the capital interests were not investment contracts because there was "no investment of money in the traditional sense," and no expectation of profits from the efforts of others. This latter conclusion was compelled because, under Farmland's co-operative structure, any distributions would be in the form of "patronage refunds, i.e., a price or cost adjustment, resulting from the member's own transactions."²²⁷ The one countervailing factor emphasized by the plaintiff class (that at least some of the owners believed the capital credits represented an investment covered by the securities laws) was not enough to change the opinion of the court on the result.

This result was reached even though the interests in question did not fully comport with the traditional way in which ownership of agricultural cooperatives has been documented. Nonetheless, the court appeared to be relatively firm in holding that investment in a cooperative, when motivated by a desire to participate in the cooperative endeavor rather than simply to expect profits in a passive manner, should not be regulated as securities.

This result means that the entire transaction will be outside the ambit of the federal securities laws. State law will still prohibit the use of fraudulent and deceptive practices, but the cause of action will be based on state law rather than the federal securities laws. However, because there is at least the possibility that even traditional agricultural cooperatives may choose to do business in non-traditional ways or to issue non-traditional interests, it is also worth considering the specific provision of the '33 Act available as an exemption to farmers' cooperatives.

3.3.c. The Agricultural Cooperative Exemption

The '33 Act specifically exempts from the registration requirements securities issued by certain farmers' cooperatives.²²⁸ The availability of this exemption turns on whether the cooperative under consideration qualifies as tax exempt under section 521 of the Internal Revenue Code (the Code).²²⁹

Section 521 of the Code requires a farmers' cooperative to be "organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses."²³⁰ In addition, if the organization issues capital stock,

226. *Id.*, citing *Co-Operative Grain & Supply Co. v. Commissioner of Internal Revenue*, 407 F.2d 1158, 1163 (8th Cir. 1969) ("Advantages which accrue to a member of a cooperative accrue primarily because of his patronage with the association and not because of any financial investment . . .").

227. This discussion appears in the case at pages 700-701.

228. 15 U.S.C.A. Sec. 77c(a)(5)(B)(i).

229. This provision exempts securities issued by any "farmer's cooperative organization exempt from tax under section 521 of [the Internal Revenue Code]." *Id.*

230. 21 U.S.C.A. Sec. 521(b)(1).

the interest rate may not exceed the greater of "the legal rate of interest in the State of incorporation or 8 percent per annum . . . on the value of the consideration for which the stock was issued," and substantially all stock "(other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) . . . [must be] owned by producers who market their products or purchase their supplies and equipment through the association."²³¹ Finally, the cooperative is limited in the amount of business it can conduct for non-members and non-producers. The exemption will be available so long as the association does not market the products of, or purchase supplies and equipment for, nonmembers in an amount exceeding "the value of the products marketed [or supplies and equipment purchased] for members," provided also that "the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases."²³²

At one time, most agricultural cooperatives were organized so as to comply with the requirements of section 521 of the Internal Revenue Code. These cooperatives also operated in a manner consistent with the Agricultural Marketing Act. However, this is no longer the case. The restrictions imposed by these federal statutes are so limiting, especially as the number of farmers has shrunk over the years, that it has become increasingly impracticable for all cooperatives to fit within these strictures.²³³

This analysis simply emphasizes the potential importance of structuring equity interests in agricultural cooperatives in such a way that the securities laws never apply at the outset. If the interests in question are not securities, no exemption is necessary. If an exemption is required, section 3(a)(5) of the '33 Act will be available only to a limited number of co-ops.

3.4 Participation in New Value-Added Cooperatives

3.4.a. What is a New Value-Added Cooperative?

Beginning in the early 1990's, commentators began to report on the spread of value-added cooperatives, sometimes referring to these operations as new wave or new generation cooperatives.²³⁴ In actuality, there were two different, albeit related, developments that were taking place in the context of agricultural cooperatives.

The first of these trends involved an increasing concentration on the production and marketing of value-added products, rather than the raw agricultural produce that was historically at the heart of most traditional agricultural cooperatives. The purpose of these cooperatives is clear--to develop new products

231. *Id.* at Sec. 521(b)(2).

232. *Id.* at Sec. 521(b)(4).

233. "A decreasing number of cooperatives are attempting to qualify for section 521 exempt status because the burdens of meeting the qualifications outweigh the benefits received from 'exemption.'" James R. Baarda, UNITED STATES COOPERATIVES AND INCOME TAX POLICY 111 (1997). "Changing economic conditions affecting the operation of cooperatives have decreased the number of cooperatives holding section 521 status." David W. Cobia, Ed., COOPERATIVES IN AGRICULTURE 295 (National Council of Farmer Cooperatives, 1989)." In 1970, 62 of the 100 largest U.S. farmer cooperatives held section 521 status. In 1986, only 21 of the 100 largest cooperatives held section 521 status." *Id.* at 111. For a more detailed discussion of section 521 cooperatives, see generally Donald A. Frederick, *Income Tax Treatment of Cooperatives: Internal Revenue Code Section 521*, USDA, Rural Bus.-Coop. Serv., Coop. Info. Rept. 44, pt. 4, (June 1996).

234. The USDA has published a "guide" to creating next generation cooperatives: William Patrie, *Creating 'Co-op Fever': A Rural Developer's Guide to Forming Cooperatives*, USDA, Rural Bus.-Coop. Serv., Rept. No. 54, (July 1998). So has the Illinois Institute for Rural Affairs: Mark J. Hanson, *Starting a Value-Added Agribusiness: The Legal Perspective* (Ill. Inst. for Rural Affairs, Jan. 2000).

which add value to raw agricultural produce and thereby gain access to an increased share of the ultimate consumers' food dollars. These "value-added co-ops" have appeared in virtually every area of agricultural production, including so-called "niche markets" like bison processing, and more traditional arenas such as corn sweetener production, sugar beet processing and pasta production.

The second trend involved a new way of doing business in the cooperative format, primarily in order to respond to a need for a significant influx of up-front capital to enter new markets. The traditional method of cooperative financing depended upon retained equity accounts, which required years to accumulate rather than being available at the outset. Because value-added ventures often require significant start-up capital, the value-added trend added impetus for a change in structure away from the traditional principles of cooperative operations.

This article discusses value-added cooperatives as if they all have adopted the newer methods of financing operations, while in reality this is not completely accurate. In fact, it may have been more technically accurate to have framed this discussion in term of "new wave" or "new generation" cooperatives. However, these "new wave" cooperatives are only the latest modification to traditional cooperative operations, and undoubtedly in the not-to-distant future, the next new thing will come along. At that point, the labels "new wave" or "new generation" will be misleading and out of date. Moreover, even now they are completely uninformative. Therefore, because the bulk of new value-added cooperatives are organizing along these "new wave" designs, and because it is the value-added phenomenon that seems to have given a significant impetus to the development of these new financing techniques, these materials will speak of the newer cooperatives as value-added cooperatives.²³⁵

It is probably worth emphasizing from the outset that there are several characteristics shared by both traditional and the new value-added co-ops. Like traditional cooperatives, these value-added ventures typically operate on the traditional cooperative principle of one-member, one-vote.²³⁶ Similarly, a very significant motivating factor in the decision to participate in a value-added cooperative is the desire to gain the benefits of membership--typically a guaranteed market for a particular commodity. In fact, membership in such ventures is usually limited to a single commodity, such as grain or eggs or a certain type of livestock. Finally, as with traditional cooperatives, earnings in a value-added enterprise are generally distributed to members on the basis of patronage.

The differences between traditional and value-added co-ops, however, may be very significant. First, membership in new generation cooperatives is generally "closed" or "restricted," with total membership based on the volume of raw product that the cooperative can adequately process or refine.

235. This is not a completely idiosyncratic choice. A number of sources have called such value-added enterprises the "new generation" of agricultural cooperatives. *E.g.*, Andrea Harris et al., *New Generation Cooperatives and Cooperative Theory*, 1996 J. OF COOPERATIVES 15 (1996). This terminology has also been adopted in the popular press. *E.g.*, Perkins Jerry, *Golden Eggs? Co-ops Unite Farmers*, DES MOINES REGISTER 3 (Apr. 16 2000) ("Value-added, farmer owned enterprises also are known as 'New Generation Cooperatives.'") (available online 2000 WL 4955217); Perkins Jerry, *Pork Farmers May Try Processing*, DES MOINES REGISTER 1 (June 11, 1999) ("A growing number of so-called "new generation" producer-owned cooperatives have been formed in the past 10 years to slaughter and process the livestock or crops of their member owners.") (available online 1999 WL 7211094); Traci Carl, *Farmers Grow into the Food-Processing Business*, J. REC. (Okla. City) (Mar. 11, 1977) (quoting University of Missouri Professor Mike Cook as saying that "[a]bout 100 of the 'new generation' cooperatives have sprung up across the nation.") (available online 1997 WL 14388141). It has also been used in Congressional Testimony. *See, i.e.*, Remarks of Charles E. Kruse, President of Missouri Farm Bureau, on the Agricultural Assistance Bill, Cong. Testimony (March 15, 2000) (available online 2000 WL 11069472).

236. *E.g.*, Robert Cropp, *New Generation Cooperatives Defined*, notes from presentation to the New Generation Cooperatives Conference at the University of Wisconsin (Apr. 1, 1996) (available online at <http://www.wisc.edu/uwcc/info/bob.html>).

The attributes of membership also differ from that in a traditional co-op because a member's equity in a value-added enterprise will be completely proportionate to that member's patronage, since a member is generally required to purchase not only a membership interest but also delivery rights. These "rights" (which both include the privilege of delivering a specified volume of the applicable commodity and an obligation to do so) may be assigned on the basis of the number of shares of common stock or may depend on the purchase of preferred shares. The delivery rights and obligations may attach as a result of ownership of the stock pursuant to the terms of the cooperative's organizational documents or may be separate from the stock, as part of a contract entered into between the member and the co-op. In any event, the extent of each member's delivery obligations are generally tied to that member's up-front investment. Thus, while it is true that a member in a value-added cooperative will share in profits on the basis of patronage, it is equally accurate to say that the members' sharing ratios are fixed by the members' relative up-front investments.

This difference is also reflected in the nature of a member's investment in a value-added co-op. Because processing most agricultural commodities is an expensive, capital-intensive proposition, minimum capital requirements for membership in such ventures is often high. In exchange for a greater initial capital investment, farmers hope for a greater rate of return. Thus, successful value-added co-ops pay out much of their profits on an annual basis rather than retaining significant amounts. In fact, expansion is typically funded by the issuance of additional delivery or membership rights in exchange for new or additional investment in the venture, rather than through retained patronage dividends.

To attract more funds up-front, value-added deals are generally structured so that the delivery or membership rights have value which can be recognized upon sale. With this framework, there is no necessity to wait for redemption by the cooperative in order to recover the initial investment. The market will determine the value of the interests, and members have the potential to benefit from appreciation in value. On the other hand, just as there is an increased potential for profits, there is also increased risk.

To recap, there are several characteristics that can be used to distinguish between traditional and value-added cooperatives. One possible list²³⁷ of the distinguishing characteristics of such value-added enterprises is as follows:

1. Substantial equity investment by members;
2. Closed or restricted membership;
3. Delivery rights or obligations tied to equity investment;
4. Recognition of the transferability of delivery rights;
5. Value-added payments made to members as they are earned; and
6. Expansion funded by new investment rather than patronage retains.

These characteristics create a very different type of equity investment than that usually made in connection with traditional cooperatives.

237. The list is an amalgamation of items taken from lists of distinguishing characteristics suggested by Ralph K. Morris, Esq., of Doherty, Rumble & Butle in Minnesota, and Dennis A. Johnson, President and CEO of the St. Paul Bank for Cooperatives. See Ralph K. Morris, *Legal and Financial Aspects of new Generation Cooperatives: Legal Implications*, notes from presentation to the New Generation Cooperatives Conference at the University of Wisconsin (Apr. 1, 1996) (available online at <http://www.wisc.edu/uwcc/info/morris.html>); and Dennis A. Johnson, *Surfing the New-Wave Cooperatives*, 62 no.7 FARMER COOPERATIVES (Oct. 1995) (available online at <http://www.wisc.edu/uwcc/info/farmer/627surf.html>) (Citing "[d]efined or selected membership rather than open membership" as a characteristic of new-wave cooperatives).

First, there is the dollar amount at stake. Value-added cooperatives face potentially significant problems in raising sufficient equity, since modern agricultural processing and marketing facilities require significant sums of money to get started. Because lenders expect equity investors in such enterprises to contribute approximately 50 percent of the total capital requirements of the venture,²³⁸ initial investments in value-added cooperatives must often be quite substantial.²³⁹

Second, because delivery rights or obligations are tied to equity investment, this means that the member's earnings will depend on the total investment in the enterprise. A value-added cooperative typically ties the delivery rights and obligations of each member to the number of shares acquired by that member. Thus, although payments to the member may be on the basis of patronage (i.e., the volume of commodities delivered), the payments will also reflect the dollar investment made in the business. This makes the payments look much more like traditional dividends, which are tied only to the amount invested and not at all to the level of patronage. Contrast this with the traditional co-op, where payments reflect the level of patronage and are unrelated to the level of initial investment.

Third, there is a general recognition that the delivery rights in a value-added co-op have a value. This value comes about because membership in a value-added enterprise is generally "closed," or in other words limited to a pre-determined number of investors. The number of investors is determined by the total volume of crops or other agricultural goods that can be processed by the co-op. Once investors have purchased the right to deliver that volume of the relevant commodity, the only way to join the cooperative is if an existing member agrees to sell delivery rights or if the cooperative decides in the future to expand and sell additional membership (and delivery) rights at that time. If a particular enterprise is successful, the right to have a guaranteed market for produce and the right to receive value-added payments may be quite valuable. Allowing these delivery rights to be sold on the open market means that there is the possibility of appreciation over the initial cost of investment.

238. One source has estimated that "most financial institutions will require at least 40 to 60 percent equity from the owners." Cindy Thyfault, *Developing New Generation Co-ops: Getting Started on the Path to Success*, 63 No.4 RURAL COOPERATIVES (July/Aug. 1996) (available online at <http://www.wisc.edu/uwcc/info/develngen.html>).

Another source suggests that most value-added cooperatives "raise between 30 and 50 percent of their total capital requirements" by selling such shares. Andrea Harris et al., *New Generation Cooperatives and Cooperative Theory*, 1996 J. OF COOPERATIVES 15 (1996). The same source suggests that "[r]emaining capital requirement are met through debt or the issue of preferred shares." *Id.*

239. Consider, for example, Mountain View Harvest, a value-added cooperative designed to assist wheat growers by purchasing a bakery and transforming the produce "into a value-added food." Dan Campbell, *Show Me the Dough*, RURAL COOPERATIVES 24-26 (May/June 1997) (available online at http://www.wisc.edu/uwcc/info/farmer/64_2_24.html). "To join Mountain View Harvest, a grower had to purchase at least one share in the co-op for \$12,500. They also had to pay a \$500 membership fee and agree to deliver 900 bushels of wheat to the co-op for each share purchased." *Id.*

Similarly, Dakota Growers Pasta Company set an initial share price of \$3.90, and members were required to purchase a "minimum of fifteen hundred shares at the initial share price during the cooperative's equity drive." Andrea Harris et al., *New Generation Cooperatives and Cooperative Theory*, 1996 J. OF COOPERATIVES 15, 17 (1996). This translates to a minimum equity investment of \$5850 for wheat growers wishing to participate. An equivalent minimum investment of \$5000 was required for investment in 21st Century Alliance Inc. by wheat farmers looking for the opportunity to sell their product as flour. Traci Carl, *Farmers Grow into the Food-Processing Business*, J. REC. (Okla City) (Mar. 11, 1997) (available from Westlaw at 1997 WL 14388141).

The New Horizon Cooperative permits members to deliver corn to the co-op, which is then fed to chicken that lay eggs which are sold on the market. Shares in this co-op were first offered in February of 1999 at \$3,000. Perkins Jerry, *Golden Eggs? Co-ops United Farms*, DES MOINES REG. 3 (Apr. 16, 2000) (available on Westlaw at 2000 WL 4955217).

Further enhancing the possibility of appreciation is the fact that most value-added co-ops do, in fact, pay out profits as they are earned. Unlike traditional cooperatives, where the bulk of equity financing comes from patronage retainers, a value-added co-op runs primarily on paid-in capital. If the co-op decides to expand, these operations are financed by selling additional equity interests rather than retaining a significant portion of the business' earnings. This practice makes purchase of an interest in a value-added enterprise more attractive and, if the enterprise is profitable, enhances the price that interest will bring on the market.

With these attributes in mind, how are the securities laws likely to apply to equity interests in such ventures? This is not an easy question to answer because there is so little in the way of legal precedent applicable to such operations. Over time, of course, this will change as value-added cooperatives become even more prevalent, so readers should be especially careful to consider developments that may have occurred after the date of this document's publication.

3.4.b. Application of the Securities Laws to Value-Added Cooperatives.

Assuming that the framework applied by the courts to interests in traditional cooperatives will also be applied to membership interests in value-added co-ops, the primary inquiry will be whether the interests were purchased as an investment.²⁴⁰ This is admittedly a difficult question to answer.

First, it is clear that the purchase of such equity interests does include the present right to membership in the cooperative enterprise. In the case of an agricultural co-op, the obvious benefit of this membership is that the purchaser will acquire a guaranteed market for the agricultural product used by that co-op. Thus, if the purpose of the co-op is to turn raw corn into corn meal, membership in the co-op carries with it a guaranteed market for a certain amount of corn. If the co-op is involved in converting durham into pasta, membership includes the right to sell the durham to the enterprise.

The significance of these membership benefits should not be underestimated. After all, the question of whether the securities laws apply to traditional cooperatives turns on the question of whether the purchaser "is motivated by a desire to use or consume the item purchased," because in that case the securities laws will not apply.²⁴¹ However, it is clearly possible that in some transactions the investor will be offered and interested in both something for use and an expectation of profits.²⁴² In such a case, the application of the federal securities laws may raise difficult questions that have yet to be fully addressed by the courts.

Because there is unlikely to be an absolutely clear answer to the question of whether such purchases are motivated by a desire to "invest," courts are likely to turn to the specific factors which have been explicitly considered in the few opinions that have been decided to date dealing with traditional

240. The two primary authorities for this position are the Supreme Court's opinion in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), and the Eighth Circuit decision in *Great Rivers Cooperative of Southeastern Iowa v. Farmland Industries, Inc.*, 198 F.3d 685 (8th Cir. 1999). Not all authorities agree that this is an appropriate choice. For an analysis of public policy justifications supporting the conclusion that interests in value-added cooperatives should not be regulated as securities, see Jon K. Lauck & Edward S. Adams, *Farmer Cooperatives and the Federal Securities Laws: The Case for Non-Application*, 45 S.D. L. REV. 62, 64-99 (2000).

241. *Forman*, 421 U.S. at 852-53.

242. This was expressly recognized by the U.S. Supreme Court in the *Forman* decision. 421 U.S. at 853, n.17.

cooperatives.²⁴³ Factors which have been articulated as potentially relevant to this inquiry include all of the following:

1. Are the interests required for participation in the cooperative?
2. Are the interests sold to raise money for general operations?
3. Is there common trading of interests for speculation?
4. Are the interests "fundamentally" an investment?
5. Is there an expectation of profits?
6. Are the interests governed by an alternate scheme of regulation?
7. Are the purchasers likely to believe they have purchased a security?²⁴⁴

Unfortunately, a consideration of such factors does not lead to a consistent or certain result.

Some factors, for example, suggest that most interests in a value-added co-op should not be treated as securities under the federal laws. For example, the first factor listed above asks whether the initial purchase was required in order for the purchaser to obtain the benefits of membership in the cooperative. Certainly most co-ops require such a purchase, including value-added cooperatives.

Other factors may require a closer examination of the nature of the interest at issue. For example, one of the questions asks whether the interest is expected to generate an expectation of "profits." At least one court considered the fact that the interests in question (which although non-traditional were issued by a traditional cooperative) did not bear interest to indicate the absence of the "valuable return on an investment normally expected from the purchase of a security."²⁴⁵ Equity interests in a value-added co-op can be set up so that they do not carry any right to interest or dividend payments, and it is certainly true that a member's return in a value-added cooperative will depend on patronage just as in a traditional co-op. Thus this factor might suggest that equity interests in a value-added cooperative should not be classified as securities. On the other hand, the economic reality is that patronage returns in such co-ops are tied to the level of investment, as well as the level of patronage, because delivery rights are tied to investment. Thus, a court might conclude that a profit motive is inextricably linked to equity investment in such ventures. How these facts will be weighed by the courts has not yet been settled.

243. There is at least one reported case dealing with the appropriate securities classification of equity interests in a value-added cooperative. In *Ripplemeyer v. National Grape Cooperative Association*, 807 F. Supp. 1439 (W.D. Ar. 1992), the court considered a lawsuit brought by grape growers against two non-stock agricultural cooperatives, National Grape Cooperative Association ("National") and Welch Foods, Inc. ("Welch"). The plaintiffs had all entered into membership and marketing agreements with National "in order to gain access to a nationwide market" for their grapes, typically after processing by Welch, a wholly owned subsidiary of National. After National terminated the membership agreements in question, a group of growers sued on a number of theories, including claims under the 1934 Act. The defendants responded that the marketing agreements were not securities. The court applied the *Howey* test, and concluded as follows:

The court does not believe the marketing agreements themselves constitute investment contracts within the meaning of *Howey*. National is run for the mutual benefit of its members as producers not as investors. Advantages accrue to a member because of his patronage and not because of any financial investment he has made.

Id. at 1453. Unfortunately, the case does not describe whether patronage was tied to investment in a manner that appears to be typical of value-added cooperatives. Nor does the court focus on the value-added nature of the cooperative venture, apart from noting that Welch "processed grapes grown by National's members . . . into finished goods such as Welch's Grape Jelly." Thus, the case is of limited predictive value.

244. This list essentially comes from *Great Rivers Cooperative of Southeastern Iowa v. Farmland Industries, Inc.*, 198 F.3d 685 (8th Cir. 1999), which mentioned all of these factors in one form or another.

245. *Great Rivers*, 198 F.3d 685 (8th Cir. 1999)

There are other factors which appear to support the conclusion that interests in value-added cooperatives are likely to be classified as securities under the federal laws. For example, a value-added co-op frequently raises funds for general business operations by selling equity interests. This factor, or more accurately its absence, has been found to be very important in determining whether the interests issued by traditional cooperatives are securities.²⁴⁶

Similarly, it is often important to consider whether the interests are "readily convertible into cash."²⁴⁷ In a typical value-added cooperative, equity interests can be converted to cash by sale on the open market. This is in rather stark contrast to interests in traditional cooperatives, which were generally convertible to cash only upon redemption by the cooperative. Thus, this factor might also make it look like the interests in such a cooperative are securities.

Finally, free transferability of the interests might also make it appear that equity interests in value-added co-ops are securities. Although membership in traditional cooperatives was generally not transferable, it may be impossible for a value-added cooperative to raise sufficient funds unless it sets up a scheme whereby the membership or delivery rights are freely transferable. The usual practice is for the board in such ventures to retain the right to approve or disapprove the transfer of interests, and certainly only persons who meet the eligibility requirements for membership in the co-op will be allowed to purchase the interests.²⁴⁸ Thus, an argument could be made that such interests are not "freely transferable." This would mean that the interests in question look less like a security. On the other hand, if the interests are in fact readily traded, and if the purchasers are led to "invest" based on the expectation that a market will develop, this might lead a court to conclude that the interests should be regulated as securities. For these reasons, the question of whether equity interests in a value-added co-op are freely transferable is therefore likely to be highly fact-specific, and is unlikely to provide a clear resolution to the issue of whether such interests are securities.

Because arguments can be made both ways about whether equity investment in a value-added co-op should be classified as a security, it is not surprising that such interests are often registered with the SEC.²⁴⁹ This fact alone, however, should not be taken as proof that the interests are in fact securities. There are cases where interests have been registered by the issuer out of an abundance of caution, yet the court ultimately concludes that they were not securities.²⁵⁰

246. The court in *Great Rivers* focused on the fact that the capital credits in that case were not "issued to raise money for the general business use of Farmland or to finance substantial investments." *Id.* at 699-700.

247. This was also an issue in *Great Rivers*. See *Great Rivers*, 198 F.3d at 700.

248. Of course, since delivery rights for a given commodity are generally tied to the equity interests in one form or another, it is unlikely that anyone not appropriately involved in agriculture would be interested in investing in the enterprise.

249. See, e.g., American Crystal Sugar Co., Form S-1, Registration Statement filed July 28, 1997 (available online from Westlaw, filing 97646544); Harvest States Cooperatives, Form S-1, Registration Statement filed January 24, 1997 (available online from Westlaw, filing 97510798). See also Minn Dak Farmers Cooperative, Form 10-K filed November 30, 1998 (available online from Westlaw, filing 98760782) (incorporating by reference Form S-1 Registration Statement declared effective Sept. 11, 1995); Dakota Growers Pasta Co, Form 10-k, filed Oct. 28, 1998 (available online from Westlaw, filing 98731933).

In some instances, value-added co-ops have apparently decided to de-register some of their equity interests. For example, National Grape Cooperative Association, Inc. requested a no-action determination from the SEC when it sought to de-register its membership interests and marketing agreements. National Grape Cooperative Association, Inc. (avail. Jan. 21, 1985).

250. This was actually the situation in *Great Rivers*. See discussion at 198 F.3d at 701.

There are, of course, a few cases dealing with the securities classification of equity interests issued by agricultural cooperatives. For the most part, however, these opinions are not particularly helpful in predicting how equity interests in value-added co-ops will be treated under the securities laws.²⁵¹ While the SEC has received a limited number of no-action requests from value-added agricultural cooperatives, these no-action determinations are similarly unhelpful in providing guidance as to how the securities laws are likely to be applied.²⁵²

3.4.c. Policy Considerations Relative to the Securities Laws Treatment of Interests in Value-Added Cooperatives.

In deciding how the securities laws are likely to be applied to equity interests in value-added cooperatives, it makes some sense to consider congressional objectives in enacting the securities laws and in providing exemptions for some farmers' cooperatives. The primary justification for enactment of the federal securities laws was apparently a need to respond to perceived abuses in the capital markets.²⁵³ As explained by the Supreme Court:

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.²⁵⁴

The solution posed by both the 1933 and 1934 Acts was to provide mandatory disclosures and penalties for material misstatements and omissions. Because of this focus, it seems logical to make sure that the securities laws apply when the purpose of a particular transaction is to raise capital for a profit-making enterprise, particularly where investors are induced to participate in the venture on speculation that the efforts of others will produce a profitable return on that investment.²⁵⁵

251. Many cases involving agricultural cooperatives contain statements which simply offer very little in the way of future guidance. For example, the United States District Court of Colorado considered whether Farmland Industry's capital credits should be classified as securities in *Consumers Gas & Oil, Inc. v. Farmland Industries, Inc.*, 815 F. Supp. 1403 (D. Colo. 1992). The court concluded that because Farmland had registered its capital credits, the co-op had "admitted" that the interests were securities. In addition, the court concluded that "[e]ven if Defendant's admission is insufficient, we believe that the capital credits involve in this case fall within the broad definition of 'security'" *Id.* at 1410. No further analysis was supplied.

However, for researchers interested in reviewing the case law involving the application of the federal securities laws to agricultural cooperatives, the following cases may offer at least some minimal guidance: *Great Rivers Cooperative of Southeastern Iowa v. Farmland Industries, Inc.*, 198 F.3d 685 (8th Cir. 1999); *B. Rosenberg & Sons, Inc. v. St. James Sugar Coop.*, 447 F.Supp. 1 (E.D. La. 1976), *aff'd without opinion*, 565 F.2d 1213 (5th Cir. 1977); *American Grain Association v. Canfield, Burch & Mancuso*, 530 F. Supp. 1339 (W.D. La. 1982); *Van Huss v. Associated Milk Producers, Inc.*, 415 F. Supp. 356 (N.D. Tex. 1976).

252. See, e.g., *National Grape Cooperative Association, Inc.* (avail. Jan. 21, 1985); *American Crystal Sugar Company* (avail. Feb. 19, 1984); *North Mississippi Paper Mill* (avail. March 14, 1981); *Minn-Dak Farmers Cooperative* (avail. Oct. 20, 1972).

253. Thomas Lee Hazen, *THE LAW OF SECURITIES REGULATION* Sec. 1.2 (1996).

254. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 (1975).

255. This comports fully with the approach of the U.S. Supreme Court in cases like *S.E.C. v. W. J. Howey Co.*, 328 U.S. 293 (1946), which focused on the meaning of the phrase "investment contract" in the statutory definition of the word "security." Although the *Howey* test, which asked whether a particular transaction involved an investment premised on the expectation of profits from the efforts of others, was originally proposed only in this limited context, the Court has also suggested that this focus may be appropriate

It has been suggested that the purchase of equity interests in traditional agricultural cooperatives is far different from investment in securities, and that these differences explain why the securities laws should not apply to co-op financing.²⁵⁶ This approach does, indeed, seem viable in the case of traditional co-ops. One such difference is that farmers usually buy into a traditional agricultural co-op not because they expect the co-op to produce of profit for them, but because they want a guaranteed market for their agricultural produce. The market produces "profits," if any, not the co-op managers. A second difference between membership interests in a traditional cooperative and typical securities is that co-ops reward patronage rather than investment. A good argument can be made that there is no need to protect persons who choose to participate in a joint business enterprise in the same way that there is a need to protect passive players in the capital markets.

These differences help explain why membership interests in such co-ops are not usually treated as securities--they lack the essential attributes of an "investment" seeking "profits" and instead are more in the nature of a purchase for use. A consideration of these differences, however, also points to the potential problems posed by the case of value-added co-ops, where the distinctions between investment and purchase for use are blurred.

A value-added co-op often does seek substantial sums of money in the form of equity contributions. The purpose of such fund-raising is to finance operations out of which a profit is expected. Farmers may decide to join such a co-op out of a desire to share in those potential profits, in addition to the desire to gain a market for their produce. Although the farmers' earnings are technically tied to patronage, the rate of return will also be proportionate to their total investments and dependent to a large extent on the efforts of others. For example, in a value-added co-op that turns sugar beets into processed sugar, the efforts of the co-op's managers in operating the processing plant and marketing the refined product will determine whether the venture is ultimately successful or an economic failure. Thus, ownership interests in this kind of venture have, to some extent, the hallmarks of securities.

The question of how the securities laws are to be applied in such situations may come down to whether, in a given case, farmers who make a decision to participate in such a venture need or could benefit from the protection of the securities laws. To answer this question, it will be important to look at how the co-op has marketed its membership interests and the rights that ownership gives the farmers. The reality is that value-added co-ops have certain choices which should make it more or less likely that membership interests will be securities to which the federal laws apply. It is therefore important to consider the ways in which value-added cooperatives might be organized to make it more or less likely that the securities laws will apply.

3.4.d. Potentially Significant Variations in the Way of Organizing Operations

A cooperative that wishes to avoid application of the federal securities laws will probably have taken care to encourage farmers to buy into the business in order to obtain the usual benefits of cooperative membership. Promoters will have emphasized the various benefits of participation in the cooperative, including having a guaranteed market for a specified amount of agricultural produce and

whenever there is a question about the applicability of the federal securities laws.

This test [the Howey 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.

Forman, 421 U.S. at 852.

256. Professor Neil Harl has suggested that there are specific factors which explain why the federal securities laws exempt securities issued by at least some agricultural co-ops. See Neil E. Harl, 14 Agricultural Law Sec. 136.01[3] at 136-12 to -14 (Matthew Bender, Nov. 1996).

related benefits which will flow from acting with other farmers. Such benefits could include any economies of scale which might arise if farmers store their products together or increased bargaining power as sellers or purchasers for farm supplies. The potential for value-added profits would not be used as the primary inducement for farmers to participate.²⁵⁷ The reason that this may be a helpful strategy is that courts have traditionally focused on whether participants have had investment intent in determining whether a security has been acquired.

The actual importance of this choice may vary depending on the relative importance of the potential benefits of value-added productions. Farmers who choose to invest in a value-added cooperative are likely to be thinking of the possibility of appreciation, as well as the potential benefits of guaranteeing a ready market for their agricultural produce. Even if this interest is not expressed, it is always likely to be within the private contemplation of the parties. On the other hand, if the potential benefits of appreciation have been made paramount in the marketing efforts, it is much more likely that a decision to participate will be viewed as tantamount to "investing" in the enterprise and that much more likely to be treated as a security.

In addition, if it is understood that the participants will not even be marketing their own produce to the cooperative, but instead will be supplying the cooperative with raw materials purchased elsewhere, the only viable motive becomes desire to participate in the anticipated profits from the venture. In this case, it would be much harder to argue against the conclusion that the securities laws, as currently written and interpreted, are likely to require such interests to be treated as investment contracts. Thus, the way in which the interests are marketed can be quite significant to the issue of whether the securities laws should apply to the transaction.

A second way in which value-added cooperatives may have attempted to avoid application of the federal securities laws is to have taken steps to unlink a member's return from the investment. While value-added co-ops typically require participants to buy delivery rights stock as a form of capital contribution to the enterprise, it may be possible to require members to buy "membership stock" (as distinguished from "delivery rights stock") for more than a nominal price. For example, suppose a value-added co-op requires a relatively significant membership fee (or purchase of membership stock) which would entitle but not obligate members to buy delivery rights (in the form of stock or otherwise). First, the cost of the membership fee would itself be completely independent of the farmer's level of patronage (and therefore the farmer's ultimate share of any profits). Second, depending on the relative cost of the membership fee as compared with the cost of acquiring delivery rights, a member's share of profits would not necessarily be proportionate to that member's total investment in the enterprise.²⁵⁸ This type of arrangement could therefore distinguish participation in this type of venture from a typical investment in securities.

On the other hand, this alternative also involves some potentially significant drawbacks. Researchers at the Centre for the Study of Co-operatives at the University of Saskatchewan have outlined some advantages derived from the unique structure of new generation cooperatives and the sale of delivery rights in particular.²⁵⁹ For example, they have explained how this type of structure facilitates

257. Not only should promoters be cautioned to take this tack when discussing the benefits of joining the cooperative with potential members, but any promotional literature should follow the same approach.

258. Of course, if every member purchases an equal volume of delivery rights, there would be no disparity between each member's total investment and his or her eventual share of profits. This option does, however, provide at least the possibility that investment in a value-added cooperative would not be directly tied to the level of investment.

259. Andrea Harris et al., *New Generation Cooperatives and Cooperative Theory*, 1996 J. OF COOPERATIVES 15 (1996).

capital acquisition by providing economic incentives to investment, including investment in long-term projects.²⁶⁰ This benefit is achieved first and foremost by linking a member's return to the total investment, the very attribute which makes this type of interest resemble a security. It is also achieved by allowing appreciation of the interests once purchased, which allows the enterprise to raise money for long-term projects--an economically essential characteristic which also makes the underlying interest look more like a security. For these reasons, unlinking investment from the ultimate rate of return may have economic costs that make this option undesirable and therefore uncommon, even at the risk of rendering the sale of interests in the enterprise subject to regulation as securities.

A third choice that some value-added cooperatives may have taken might be to limit the transferability of whatever interests are being sold. While delivery rights in a value-added co-op may have intrinsic value, allowing free trading in such interests is likely to make them look a lot like securities. Thus, steps to limit the resales of such interests might make a court hesitate about classifying the interests as securities. To achieve this result, the co-op's board might retain full power to approve or disapprove transfers, and the cooperative's organizational documents might limit the purchase to persons who are either already members in the cooperative or persons who are eligible for membership and willing to purchase a membership (either from the co-op or a selling member). While this will not necessarily prevent trading from happening,²⁶¹ it is likely to be considered by any court faced with the issue of whether the interests in question should be regulated as securities.

Again, however, this strategy has potentially negative economic consequences. If the restrictions of transferability are so significant that they actually place a meaningful limitation on the ability of participants to sell their interests at an appreciated price, then the interests will be significantly less attractive at the outset. One of the intrinsic benefits to participation in a new generation cooperation is that participants are able to realize a return on their investment through the sale of appreciated interests; without this potential advantage, there is little economic incentive for the type of long-term projects required in order to make value-added processing economically viable.

Another possibility, and one with fewer immediately obvious adverse economic consequences, is that a co-op may have taken steps to encourage members to participate in management decisions as a *sine qua non* of membership. To the extent that the farmers who join the cooperative are active in making decisions about how the co-operative is to proceed, an argument can be made that even if they have "invested" in the enterprise, they are not expecting profits from the managerial efforts of others, as distinguished from their own involvement. However, there are practical problems with this option that make it unlikely to be a popular choice, at least with larger ventures. As a cooperative grows in size, active participation by participants in day-to-day management becomes less and less feasible because at some point, the group of members will simply become too disperse and too unwieldy to function efficiently. Moreover, while it may be reasonable to expect farmers to be "experts" on issues such as ordinary farm management, they may not be particularly experienced at operating a processing facility or in handling the marketing and distribution end of a value-added business.

The inevitable conclusion which must be drawn is that, once the structure of a new value-added cooperative has been reviewed, the legal advisor should take a careful look to see how closely any equity interests in the enterprise will resemble investment contracts on one end of the spectrum or interests in

260. *Id.* at 18-19.

261. For example, a limited market for the interests at issue ("base") existed in *Van Huss v. Associated Milk Producers, Inc.*, 415 F. Supp. 356 (N.D. Tex. 1976). However, the significant restrictions on transferability in that case helped the court decide that the securities laws did not apply to the sales in question.

traditional cooperatives on the other end. Is it reasonable to believe that the primary reason for joining the enterprise is the desire to recoup profits from the processing operations? Will a member's eventual return be directly linked to the dollar amount of that member's contributions? Do the organizers believe that a substantial secondary market will develop for the equity interests? Is the nature of the enterprise such that most participants will essentially be passive participants? If the answers to these questions are in the affirmative, a prudent advisor is likely to suggest compliance with the securities laws. This means registration or compliance with an appropriate exemption.

In connection with any such decision, it is worth reiterating that a decision to register or treat equity interests as securities may or may not be viewed by the court as a binding admission that the securities laws should apply.²⁶² Finally, it should again be emphasized that once a determination has been made that the securities laws are likely to apply, compliance with the registration or exemption requirements will not insulate the cooperative from claims of securities fraud. The civil liability provisions for material misstatements and omissions apply even if the issuer has complied with the requirements of one or more exemptions or if the security has been registered with the SEC.

4. The Need to Borrow Funds

4.1 General Rules Applicable to Debt

As mentioned earlier in this document, the '33 Act includes within the definitions of "security" any "note," as well as an "evidence of indebtedness."²⁶³ However, it is clear that Congress never intended for all promissory notes to be regulated as securities under the '33 Act.²⁶⁴

The current test that governs whether a particular note is subject to the federal securities laws was announced by the U.S. Supreme Court in *Reves v Ernst & Young*.²⁶⁵ The test, which asks whether the note in question bears a "family resemblance" to notes that are clearly not within the ambit of the federal securities laws, starts out with a presumption that a note is a security. This presumption may be rebutted only by a showing that the note bears a strong resemblance to one of six enumerated categories of instruments. The categories are:

- (1) a note delivered in consumer financing;
- (2) a note secured by a mortgage on a home;
- (3) a short-term note secured by a lien on a small business or some of its assets;
- (4) a notice evidencing a "character" loan to a bank customer;

262. Compare *Great Rivers Cooperative of Southeastern Iowa v. Farmland Industries, Inc.*, 198 F.3d 685 (8th Cir. 1999) (registration found not to amount to an admission that the capital interests in question were securities) with *Consumers Gas & Oil, Inc. v. Farmland Industries, Inc.*, 815 F. Supp. 1403 (D. Colo. 1992) (decision to treat interests as securities was binding).

263. See *supra* part 2.2.a of this document.

264. For a general discussion of this issue, see *Promissory Notes as Securities* under Sec. 2(1) of Securities Act of 1933 (15 U.S.C.A. Sec. 77b(1)), and Sec. 3(a)(10) of Securities Exchange Act of 1934 (15 U.S.C.A. Sec. 78c(a)(10)), 39 A.L.R. Fed. 357. See also William E. Aiken, Jr., et al, *Securities Regulation--Federal*, 69 Am. Jur. 2d Secs. 28-35 (1993).

265. 494 U.S. 56 (1990). For a discussion of case law developments since this decision was handed down, see *Notes Qualifying as Securities in the Wake of Reves: Recent Developments* [*Reves v. Ernst & Young* 494 U.S. 56 (1990)], 31 Rev. Securit & Commod Reg 1:1 (1999).

- (5) a short term note secured by an assignment of accounts receivable; or
- (6) a note that simply formalizes an open-account debt incurred in the ordinary course of business, particularly if, as in the case of the customer of a broker, it is collateralized.²⁶⁶

Under the family resemblance test as adopted by the Supreme Court, the question of whether a particular note shows a sufficiently strong resemblance to any of these categories is to be answered by examining the following four factors:

- (1) whether the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer's interest primarily is in the profit the note is expected to generate, in which case the instrument is likely to be a "security" or whether the note is exchanged to facilitate the purchase of any sale of a minor asset or consumer good, to correct for the seller's cash flow difficulties, or to advance some other commercial or consumer purpose, in which case the note is less likely to be a "security";
- (2) whether, in examining the plan of distribution of the note, it is determined that it is an instrument in which there is a common trading for speculation or investment, with the understanding that the wider distribution of the notes, the greater a likelihood that the securities laws will apply;
- (3) the expectations of the investing public and in particular whether they believe they are purchasing a security; and
- (4) whether some factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument, thereby rendering application of the federal securities acts unnecessary.²⁶⁷

The cases make it clear that one of the critical inquiries is the purpose for which the note has been given. Generally speaking, if the note is given as part of a business transaction, it is really just a "cash substitute," and not a security.²⁶⁸ On the other hand, the cases are divided if the facts show that the note was given in exchange for an interest in a business or its assets. In some of these cases such notes have been held to be securities, while in other cases they have not.²⁶⁹ If the promissory note is evidence of

^{266.} *Reves v. Ernst & Young*, 494 U.S. 56 (1990), *reh'g denied*, 494 U.S. 1092 and *on remand* 937 F.2d 1310 (8th Cir.).

^{267.} *Id.*

^{268.} *Sea Pines of Virginia, Inc. v PLD, Ltd.*, 399 F. Supp. 708 (MD Fla 1975); *Lino v City Investing Co.*, 487 F.2d 689 (3rd Cir. 1973); *Joseph v Norman's Health Club, Inc.*, (ED Mo) 336 F. Supp. 307 (E.D.Mo. 1971). See also *Williamson v Tucker*, 645 F.2d 404 (5th Cir. 1981). *cert denied*, 454 US 897 (notes given to purchase real estate are commercial in nature); *Danner v Himmelfarb*, 858 F.2d 515 (9th Cir. 1988), *cert denied*, 490 U.S. 1067 (purchase of Mexican pesos for promissory notes securities by deed of trust on realty did not convert notes into securities).

^{269.} Compare *Alberto-Culver Co. v Scherk* (CA7 Ill) 484 F.2d 611 (7th Cir. 1973), *rev'd on other grounds* 417 U.S. 506 (notes were securities); and *Shults v Henderson* 625 F. Supp. 1419 (WDNY), *aff'd without opinion*, 805 F.2d 391 (2d Cir.) (notes received in exchange for assets of a radio station were securities), with *C.N.S. Enterprises, Inc. v G. & G. Enterprises, Inc.*, 508 F.2d 1354 (7th Cir 1975) *cert denied*, 423 U.S. 825 (not securities); *Altman v Knight*, 431 F. Supp. 309 (SDNY 1977) (not securities); *Sea Pines of Virginia, Inc. v PLD, Ltd.*, 399 F. Supp. 708 (MD Fla 1975) (not securities); *Van Arsdale v Claxton*, 391 F. Supp. 538 (SD Cal 1975) (not securities); and *Ahern v Gaussoin*, 611 F. Supp. 1465 (DC Or 1985) (not securities).

a loan, it is the purpose for which the loan proceeds are to be used that is the relevant consideration.²⁷⁰ For example, if the loan proceeds are used to purchase consumer goods or services, the loan has a commercial nature that precludes characterization as a security. On the other hand, proceeds which are used to promote business operations have a business purpose and may be treated as securities.²⁷¹

The mere fact that loan proceeds are to be used to purchase securities does not render a promissory note, given in return for the loan, a security.²⁷² On the other hand, notes issued to raise capital for the general business operations of the issuer may be securities, particularly where other factors indicate an investment nature for the transaction, such as interest rates slightly above commercial norms. For example, in *Reves*, the notes (which were found to constitute securities) were issued by an agricultural cooperative where: (1) the notes were issued in an effort to raise capital for its general business operations, (2) purchasers bought the notes in order to earn a profit in the form of interest, (3) one of the primary inducements offered purchasers was an interest rate constantly revised to keep it slightly above the rate paid by local banks and savings and loan institutions, (4) although the notes were not traded on an exchange, they were offered over an extended period to the cooperative's 23,000 members, as well as to nonmembers, and were ultimately held by more than 1,600 people.²⁷³

What does this analysis suggest with regard to agriculturally-based enterprises? First and foremost, there should be little concern with the issuance of debt instruments in the ordinary course of business. While it is true that every check written to pay for supplies or services might literally be a note or other evidence of indebtedness, there is simply nothing in such a transaction that should give cause for concern. In fact all of the following are expressly recognized in the family resemblance test as being outside the scope of the securities laws:

- (1) short-term notes secured by a lien on the business or some of its assets;
- (2) short term notes secured by an assignment of accounts receivable; and
- (3) notes that simply formalize an open-account debt incurred in the ordinary course of business, particularly if it is collateralized.

However, if a business seeks to raise general operating funds by issuing promissory notes, the family resemblance test offers no such assurances.

4.2. Special Considerations Applicable to Debt in the Agricultural Sector

There is not that much to distinguish between agriculturally-based enterprises and other types of for-profit businesses when it comes to the question of whether a particular issuance of debt will be regulated as a security. The specific exemption in the '33 Act for securities issued by qualified agricultural

270. *Reves v. Ernst & Young*, 494 U.S. 56 (1990), *reh'g denied*, 494 U.S. 1092 and *on remand* 937 F.2d 1310 (8th Cir.). *Accord* *Ahern v Gaussoin*, 611 F. Supp. 1465 (DC Or 1985).

271. *Zabriskie v Lewis*, 507 F.2d 546 (10th Cir. 1974) (the court noting that the fact that proceeds are to be used for a business purpose does not mean that an investment note necessarily is involved, the court noting that making the distinction between commercial and investment notes when proceeds are to be used for a business purpose often is difficult); *Kansas State Bank v Citizens Bank of Windsor*, 737 F.2d 1490 (8th Cir. 1984).

272. *See, e.g., Davis v Avco Financial Services, Inc.*, 739 F.2d 1057 (6th Cir 1984), *cert. denied*, 470 U.S. 1005.

273. *Reves v. Ernst & Young*, 494 U.S. 56 (1990), *reh'g denied*, 494 U.S. 1092 and *on remand* 937 F.2d 1310 (8th Cir.).

cooperatives might be available,²⁷⁴ but as discussed in preceding sections of this document, it applies only if the cooperative qualifies as tax exempt under section 521 of the Internal Revenue Code.²⁷⁵ Fewer and fewer cooperatives fit this restrictive model. There are similar exemptions under the '34 Act,²⁷⁶ but they are also available only to a relatively small and declining number of cooperatives.

As mentioned in the preceding section, it is the speculative or unusual financing transaction that is most likely to involve the sale of a security. The cases involving the financing of agricultural enterprises generally confirms this.

Thus, a lending institution that insists on an unusual degree of control, or the receipt of profits, may find that the transaction has been converted into one involving securities.²⁷⁷ Similarly, an agricultural business that issues unusually speculative debt, especially to a broad segment of the public, may find that the notes in question are securities.²⁷⁸

5. Non-Traditional Transactions

Perhaps one of the most helpful ways of looking at the way that securities laws apply to agricultural enterprises is to examine those areas of dispute where the courts have actually been called upon to resolve the issue of whether the securities laws apply to particular types of transactions. These materials address some of those cases.

5.1 Application of General Rules to Businesses that Happen to be Based on Agriculture

It is clear that the fact that an enterprise is agriculturally based will not change the way in which the securities laws typically apply. There are numerous cases involving agriculturally-based companies that reflect this reality. Thus, a corporation that issues stock will be found to have issued a security, even if the corporation operates an agriculturally-based business. Similarly, the fact that a partnership runs an agricultural operation will not prevent the *Howey* investment contract test from applying.²⁷⁹ This analysis

274. See *supra* part 2.4.b. of this document.

275. *Id.*

276. See *supra* part 3.2.b. of this document.

277. For example, in *Hector v. Wiens*, 533 F.2d 429 (9th Cir. 1976), there was at least a material issue of fact as to whether the bank in question had participated in a common enterprise with a grain farmer, thereby converting the loan transaction into one involving the sale of a security.

278. This was the fact pattern and result in *Reves v. Ernst & Young*, 494 U.S. 56 (1990), *reh'g denied*, 494 U.S. 1092 and *on remand* 937 F.2d 1310 (8th Cir.).

279. See, *i.e.*, *Koch v. Hankins*, 928 F.2d 1471 (9th Cir. 1991) (partnership interest in jojoba farm was at least potentially an investment contract); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875 (1st Cir. 1991) (horse breeding partnership). In fact, *Howey* itself involved the sale of interests in a citrus operation. *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946).

is equally applicable to the sale of debt.²⁸⁰ Willful violations of the securities laws by agricultural operations can result in the imposition of criminal penalties.²⁸¹

5.2 Unusual or Highly Speculative Ventures

Some of the cases applying the federal securities laws to agricultural operations are unusual because of the nature of the underlying enterprise. Sometimes the way in which the operation is to be run or is promoted is what makes the enterprise more susceptible to being classified as one which involves the sale of securities. For example, an early case held that when promoters sought contributions in an agricultural enterprise by claiming participants would earn 30 percent profit per annum by utilizing “intensive scientific methods” to grow crops, they had converted their operation into one involving the sale of securities.²⁸² A much more recent case found that ownership interests in two thoroughbred stallions became securities when marketed along with breeding rights that could be sold at a profit.²⁸³ In this case, it was the terms of the ownership interests that resulted in application of the securities laws.

Alternatively, sometimes the particular product involved in the proposed farming venture is itself such that participants can only be found by soliciting involvement in terms which insure that the securities laws will apply. For example, it may come as no surprise to find that the inducement to invest in earthworm farming on the basis of “guaranteed profitability” was found to involve the sale of securities.²⁸⁴ Inducements to investors to participate in jojoba bean farming were found to at least potentially raise the issue of whether the securities laws applied.²⁸⁵

These cases should not be taken as evidence that every unusual or distinctive agricultural operation will require the issuance of securities. Rather, in the case of such operations, it is likely that the speculative nature of the venture will make it difficult to attract sources of operating funds, and this is what may make it more likely that promoters will be found to have issued securities in the attempt to obtain necessary capital.

5.3. Cattle-Based Operations

280. In fact, the U.S. Supreme Court case which adopted the family resemblance test involved the issuance of promissory notes by an agricultural cooperative. *Reves v. Ernst & Young*, 494 U.S. 56 (1990), *reh'g denied*, 494 U.S. 1092 and *on remand* 937 F.2d 1310 (8th Cir.). As with the sale of equity interests, the issue of whether the underlying business is agricultural or not is irrelevant to the question of whether a particular form of debt is a security. See *Bellah v. First Nat. Bank of Hereford*, 495 F.2d 1109 (5th Cir. 1974 (discussing difference between commercial and investment paper without considering fact that business in question involved livestock operation). See also *supra* part 4.2. of this document.

281. See *Davis v. S.E.C.*, 109 F.2d 6 (7th Cir. 1940) (secretary guilty of criminal contempt for failing to adhere to injunction against issuing memberships in agricultural enterprise).

282. *SEC v. Universal Service Ass'n*, 106 F.2d 232 (7th Cir. 1939).

283. *Sheets v. Dziabis*, 738 F. Supp. 307 (N.D.Ill. 1990).

284. *Smith v. Gross*, 604 F.2d 639 (9th Cir. 1979).

285. *Koch v. Hankins*, 928 F.2d 1471 (9th Cir. 1991). The Ninth Circuit actually found that there were sufficient fact questions so that summary judgment should not have been ordered in favor of the defendants. However, on remand, the plaintiffs voluntarily dismissed the action in favor of proceeding in state court. See *Koch v. Hankins*, 8 F.3d 650 (9th Cir. 1994), involving the appeal after remand.

It appears from a review of published decisions that the federal securities laws have been most often raised in connection with cattle operations. There is certainly nothing inherently unusual about cattle operations, and the very popularity of cattle farming may be one reason for the number of securities issues that have been raised. Cattle operations can be very capital intensive, and profits are not always certain, making the pressures to develop innovative financing techniques particularly acute.

Most of the securities cases involving the cattle industry involve one of four different fact patterns: (1) the sale of cattle together with maintenance and feeding contracts, or the sale of such maintenance and feeding contracts separately; (2) the sale of cattle embryos or other cattle breeding plans; (3) cattle leasing programs; and (4) investment in cattle operations. Each of these possibilities will be examined separately.

5.3.a. Maintenance and Feeding

There are several cases that deal with the issue of whether the sale of cattle maintenance and feeding obligations involves the sale of securities.²⁸⁶ In general, these cases dealt with the issue of whether the securities laws apply to someone who sells maintenance and feeding contracts to cattle owners (either with or without cattle).

In those cases finding that the securities laws do apply to such transactions, the general approach has been for the courts to apply the investment contract analysis of *Howey*.²⁸⁷ This requires the courts to find an investment in a “common enterprise” with the expectation of the profits from the efforts of others.²⁸⁸ In at least some jurisdictions, the common enterprise requirement can be satisfied by showing a sufficient link between the investor and promoter.²⁸⁹ Thus, such commonality can exist if the “fortuity

286. These cases found that such cattle-feeding or maintenance contracts did or could constitute securities: *Long v. Shultz Cattle Company, Inc.*, 881 F.2d 129 (5th Cir. 1989); *Seale v. Miller*, 698 F. Supp. 883 (N.D. Ga. 1988); *Babst v. Morgan Keegan & Co.*, 687 F. Supp. 255 (E.D. La. 1988); *Waterman v. Alta Verde Indus., Inc.*, 643 F.Supp. 797 (E.D.N.C.1986), *aff'd mem.*, 833 F.2d 1006 (4th Cir.1987); *McLish v. Harris Farms, Inc.*, 507 F.Supp. 1075 (E.D.Cal.1980); *Barry v. Ceres Land Co., Inc.*, Fed. Sec. L. Rep. ¶ 99,008 (D.Minn.1978); *Plunkett v. Francisco*, 430 F.Supp. 235 (N.D.Ga.1977); *Boone v. GLS Livestock Mgmt., Inc.*, Fed. Sec. L. Rep. ¶ 97,174 (D.Utah 1976); *Ingenito v. Bernec Corp.*, 376 F. Supp. 1154 (S.D.N.Y. 1974). These cases found that the transaction in question did not involve the sale of securities: *DeWit v. Firstar Corp.*, 904 F. Supp. 1476 (N.D. Iowa 1995); *Nichols Charolais Ranch Inc. v. Barton*, 460 F. Supp. 228 (M.D. Fla. 1975).

287. *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946). See *supra* part 2.2.c. of this document for a more detailed discussion of the *Howey* test.

288. See, e.g., *Long v. Shultz Cattle Company, Inc.*, 881 F.2d 129 (5th Cir.1989). Accord *Waterman v. Alta Verde Indus., Inc.*, 643 F.Supp. 797 (E.D.N.C.1986), *aff'd mem.*, 833 F.2d 1006 (4th Cir.1987) (cattle-feeding program was investment contract); *McLish v. Harris Farms, Inc.*, 507 F.Supp. 1075 (E.D.Cal.1980) (cattle-feeding program was investment contract); *Barry v. Ceres Land Co., Inc.*, Fed. Sec. L. Rep. ¶ 99,008 (D.Minn.1978) (cattle-feeding program was investment contract); *Plunkett v. Francisco*, 430 F.Supp. 235 (N.D.Ga.1977) (cattle lease and calf maintenance program was investment contract); *Boone v. GLS Livestock Mgmt., Inc.*, Fed. Sec. L. Rep. ¶ 97,174 (D.Utah 1976) (cattle breeding and feeding program was investment contract).

289. *Long*, 881 F.2d at 140, noting that the Fifth, Ninth and Eleventh Circuits have all recognized vertical commonality as sufficient under *Howey*. There is an extensive citation of authorities from the various circuits in the *Long* case, as well as references to the Supreme Court's frequent decisions to avoid certiorari on this issue.

of the investments collectively is essentially dependent upon promoter expertise.²⁹⁰ In others, a pooling of the cattle might be sufficient to find commonality or a sliding pay scale for the promoter depending upon the success of the feeding or maintenance regimen. With regard to the “efforts of others” element, this may depend on the nature of the promoter’s contractual control over the venture or the practical ability of participants to make important decisions.²⁹¹

On the other hand, the absence of horizontal commonality or pooling of interests between the various investors has also been found to be a sufficient justification for declining to apply the securities laws in at least some cases.²⁹² Knowledgeable investors who have the right to and actually do participate in the cattle operation are also unlikely to be afforded any protection under the securities laws.²⁹³

5.3.b. Breeding and Embryos

Another relatively recent innovation in cattle farming has involved the sale of cattle embryos as one way to help reduce the risks of an unprofitable investment in the cattle business. There have been several cases dealing with the issue of whether the sale of such embryos are securities,²⁹⁴ again typically applying the standard investment contract analysis.

An embryo purchase plan exists where a promoter seeks a fee or other remuneration for arranging the purchase of certain cattle embryos for a cattle farmer. The cases appear to hold that if the promoter maintains practical control over the essential elements of the program, the securities laws will apply.²⁹⁵ Sophistication of the purchasers in the sense of whether they would be able to exercise meaningful control over the program is relevant in determining whether the securities laws apply.²⁹⁶

5.3.c. Leasing

290. Long, 881 F.2d at 140, citing Securities & Exchange Comm'n v. Continental Commodities Corp., 497 F.2d 516, 522 (5th Cir.1974).

291. For example, in *Seale v. Miller*, 698 F. Supp. 883 (N.D. Ga. 1988), the fact that the investors had the theoretical right to participate in control did not prevent a finding that the contracts were investment contracts where “nothing indicated the investor ever intended to become involved” or that the seller “had the least expectation” the investor would do so.

292. See *DeWit v. Firstar Corp.*, 904 F. Supp. 1476 (N.D. Iowa 1995).

293. *E.g.*, *Nichols Charolais Ranch, Inc. v. Barton*, 460 F. Supp. 228 (M.D. Fla. 1975).

294. See *Bailey v. J.W.K Properties, Inc.* 904 F.2d 918 (4th Cir. 1990) (cattle breeding program involving selection and purchase of cattle embryos was an investment contract); *Eberhardt v. Waters*, 901 F.2d 1578 (11th Cir. 1990) (the sale of cattle embryos did involve an investment contract); *Tanenbaum v. Agri-Capital, Inc.* 885 F.2d 464 (8th Cir. 1989) (upholding jury verdict finding that purchaser had sufficient expertise to control his own investment, precluding a finding of an investment contract).

295. See *Bailey v. J.W.K Properties, Inc.* 904 F.2d 918 (4th Cir. 1990); *Eberhardt v. Waters*, 901 F.2d 1578 (11th Cir. 1990).

296. Compare *Bailey v. J.W.K Properties, Inc.* 904 F.2d 918 (4th Cir. 1990) (even though purchasers were sophisticated, they had no expertise in cattle embryos and very limited access to information) with *Tanenbaum v. Agri-Capital, Inc.* 885 F.2d 464 (8th Cir. 1989) (there was sufficient evidence to support jury finding that sophisticated investors did retain ultimate control over the embryo program).

Yet another non-traditional form of cattle farming and financing involves the leasing of cattle. This, too, has raised various securities issues.²⁹⁷ Most of these cases appear to assume that the transactions have involved the sale of securities, without discussing in detail the reasoning that supports this conclusion. Presumably, however, the appropriate analysis would be much the same as for the cattle operations described in the preceding two sections. In other words, a cattle leasing program is likely to involve the sale of securities if it seeks the investment of money from investors who are to participate in a common enterprise (as that concept is defined in the relevant jurisdiction), and who are led to expect profits from the essential efforts of others, either because of contractual limitations on their ability to manage or because of practical problems with such a role.²⁹⁸

The preceding materials should not be taken as an indication that the cattle industry is the only type of agricultural operation to develop new financing techniques and arrangements which might implicate the federal securities laws.²⁹⁹ It is merely that this appears to be a kind of farming operation where such innovations are particularly popular.

6. A Final Note on Futures and Commodity Trading

The preceding materials do not address any of the issues raised by commodities and futures trading, both activities that are intimately connected with agriculture. Congress has long recognized this relationship,³⁰⁰ and farmers were among the earliest advocates of regulation for commodity futures and options trading.³⁰¹ Early suggestions for dealing with the problem of commodities futures and options trading ranged from banning futures trading altogether, to prohibiting the use of mails for futures trading,

297. See *Renovitch v. Kaufman*, 905 F.2d 1040 (7th Cir. 1990); *Mertel v. Livestock Breeders Intern. of N.J., Inc.*, 1988 WL 66864 (D.N.J. 1988); *S.E.C. v. Great Western Leasing Corp.*, 1985 WL 1677 (N.D. Ill. 1985); *Plunkett v. Francisco*, 430 F. Supp. 235 (D.C. Ga. 1977).

298. See *In re North American Cattle Co.*, 512 Bankr. 822 (W.D.Mich. Bankr. 1985) (suggesting that the most likely analysis for a cattle leasing program would be under the *Howey* investment contract test, but declining to decide the issue).

299. In fact, some of the types of arrangements specifically discussed in the text in the context of cattle have also been tried with other kinds of livestock. See, e.g., *Continental Mktg. Corp. v. Securities & Exchange Comm'n*, 387 F.2d 466 (10th Cir.1967), *cert. denied*, 391 U.S. 905 (1968) (beaver breeding program found to be investment contract); *Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414 (8th Cir.1974) (chinchilla breeding program involved investment contract).

300. In fact, Congress has been expressly concerned about the adverse effect that commodity futures trading can have on the agricultural industry and the economy since at least the 19th century. See Jerry W. Markham, *The History of Commodity Futures Trading and its Regulation* 10, 257 n.16 (1987) (describing 1866 to 1896 as "one of the longest periods of continuous decline in agricultural prices in [American] history"). Erratic changes in commodity prices led to economic decline and impoverishment for many farmers, which sparked the "populist revolt." *Id.* at 10.

301. In the late 19th century, there were increasing requests for such regulation by farmers, who were particularly concerned that commodity futures and options trading on the Chicago Board of Trade contributed to the price volatility that precluded them from getting an adequate price for their crops. Markham, *supra* note 300 at 10. "Between 1880 and 1920 there were some 200 bills introduced in Congress to regulate futures and options trading." *Id.*

to levying a prohibitive tax on trading in certain commodities.³⁰² The regulation of commodity transactions, however, was politically contentious and legislation was not actually enacted until 1921.³⁰³

In 1921, Congress passed the Futures Trading Act (FTA)³⁰⁴ to protect against the "evils of futures trading" by imposing a prohibitive tax on futures transactions not conducted on a "contract market."³⁰⁵ The FTA was, however, short-lived. In *Hill v. Wallace*,³⁰⁶ the Supreme Court overturned the FTA on the grounds the tax it imposed violated the Commerce Clause.³⁰⁷

In response to this decision, Congress essentially re-enacted the FTA in the Grain Futures Act of 1922 (the GFA).³⁰⁸ By adding the purpose of regulating futures exchanges through the prevention and removal of "obstructions and burdens upon interstate commerce," Congress apparently created a record that enabled this act to withstand a constitutional challenge,³⁰⁹ despite retaining the same prohibitive tax on the seller of off-exchange futures transaction while continuing to exempt forward transactions.

However, the stock market crash of 1929 provided a clear indication that the essentially self-regulatory approach of the GFA did not adequately protect the economy from the adverse effects of

302. See Markham, *supra* note 300 at 10. But see Roberta Romano, *The Political Dynamics of Derivative Securities Regulation*, 14 YALE J. ON REG. 279, 296 (1997) (arguing that as legislative negotiating progressed, revisions were made to get votes rather than protect benefits of futures trading).

303. See The Future Trading Act, Ch. 86, 42 Stat. 187 (1921). But see Cotton Futures Act, ch. 313, 39 Stat. 476 (1916). Although the Cotton Futures Act dealt with futures, it did not expansively regulate cotton futures trading. The Act merely established a commercial pricing system and federal grading system for cotton. See *Id.*

304. Ch. 86, 42 Stat. 187 (1921).

305. See *Id.* Sec.5, 42 Stat. at 188. The FTA levied a tax of \$.20 per bushel involved in any futures contract except where the contract was executed on a board of trade or where the seller of the grain was (i) the owner of the property on which the grain was grown or (ii) the grower of such grain, or (iii) where either party to the contract was a cooperative. See Sec. 4(a)-(b), 42 Stat. at 187; see also *Competitive Strategies for Agric.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 48,683 (citations omitted).

306. 259 U.S. 44 (1922).

307. See *Id.* at 66-67.

308. Ch. 369, 42 Stat. 998 (1922).

309. The GFA withstood a challenge to its constitutionality in *Board of Trade v. Olson*, 262 U.S. 1 (1923).

futures trading.³¹⁰ Congress responded³¹¹ with the Commodity Exchange Act of 1936 (the CEA).³¹² In essence, the CEA expansively amended the GFA by broadening its scope and regulatory reach.³¹³

More recently, economic pressures have also lead Congress to strengthen the regulation of futures markets.³¹⁴ The response was the Commodity Futures Trading Commission Act of 1974, which created the CFTC as an independent agency to enforce the CEA.³¹⁵ The CEA has since been amended to confer upon the CFTC exclusive jurisdiction over contracts for future delivery.³¹⁶

The regulation of commodities futures and options trading is itself a subject worthy of extensive consideration. In the agricultural context, for example, the relatively recent proliferation of hedge-to-arrive financing arrangements has led to extensive debate about the appropriate scope of such regulation.³¹⁷

310. See H.R. Rep. No. 74-421, at 2 (1935); cf. Anne M. Khademian, *The SEC and Capital Market Regulation: The Politics of Expertise* 25-26 (1992) (citing stock market crash of 1929 as impetus for enactment of comprehensive federal securities legislation).

311. There was considerable pressure to strengthen the regulation of commodities futures and options trading. See H.R. Rep. No. 73-1522, pt. 2 (1934) (discussing pressure to strengthen GFA). "Since 1925, every Secretary of Agriculture has recommended that the act be strengthened." H.R. Rep. No. 73-1637, at 3 (1934). President Roosevelt had also asked Congress to enact such legislation, complaining that "unregulated speculation in securities and in commodities was one of the most important contributing factors in the artificial and unwarranted 'boom' which had so much to do with the terrible conditions of the years following 1929. ... 'It should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations.'" H.R. Rep. No. 74-421, at 2 (citing letter from President Roosevelt to Chairman, House Comm. on Interstate and Foreign Commerce, March 26, 1934).

312. Ch. 369, 42 Stat. 998 (1922) (codified as amended at 7 U.S.C. Sec. (1994)). The enactment of the Securities Exchange Act of 1934 placed added pressures on Congress to adopt new regulations applicable to the commodities markets, because professional speculators were transferring their activities from the newly regulated securities trade into the virtually unregulated commodities markets. See Securities Exchange Act of 1934, ch. 404, 48 Stat. 881; H.R. Rep. No. 74- 421, at 2.

313. As stated by Secretary of Agriculture Henry A. Wallace in a letter to the Chairman of the Committee on Agriculture and Forestry:

This act is so modified as to be readily applicable to any commodity and becomes a vehicle for effective regulation of commodity exchanges. [The Act] vests in a commission ... power to fix limitations upon purely speculative trading. [The Act] prohibits ... certain practices involving cheating and fraud in connection with the handling of customers' orders ... [and] provides for the licensing of commission firms engaged in soliciting orders for future delivery and outlaws certain kinds of transactions

H.R. Rep. No. 73-1637, at 2.

314. For a discussion of these pressures, see Markham, *supra* note 300 at 61, and Christina Barone, Comment, *The Hedge-to-Arrive Controversy: Conflicting Outcomes in Administrative and Judicial Proceedings*, 52 ADMIN. L. REV. 1423, 1430 n.36 (2000).

315. See 7 U.S.C. Sec. 6(a) (1994) (granting the CFTC exclusive jurisdiction over transactions involving "contract[s] for the purchase or sale of a commodity for future delivery").

316. U.S.C. Sec. 1(a)(11) (1994).

317. The following list includes some of the many sources that deal with aspects of this issue: Jerry W. Markhan, *Hedge-to-Arrive Contracts*, 13A Commodities Reg. Sec. 27:15 (database updated April 2002); Christina A. Barone, Comment, *The Hedge-to-Arrive Controversy: Conflicting Outcomes in Administrative and Judicial Proceedings*, 52 ADMIN. L. REV. 1423 (2000); Charles F. Reid, Note, *Risky Business: HTAs, the Cash*

This article does not deal with commodities regulation or the special problems associated with novel and developing forward financing arrangements. This limitation should not, however, be taken as an indication that there are no regulatory issues associated with such activities. It is merely that this topic is beyond the scope of this article. The preceding discussion gives some very general background, and perhaps some places to start if a research issue involving these types of arrangements presents itself. As with many of the issues discussed in this article, there is often no safe substitute for the advice of experienced counsel.

This article was prepared in May 2002.

This material is based on work supported by the U.S. Department of Agriculture under Agreement No. 59-8201-9-115. Any opinions, findings, conclusions or recommendations expressed in this article are those of the author and do not necessarily reflect the view of the U.S. Department of Agriculture.

NCALRI is a federally funded research institution located at the University of Arkansas School of Law
Web site: www.NationalAgLawCenter.org • Phone: (479)575-7646 • Email: NatAgLaw@uark.edu

Forward Exclusion and Top of Iowa Cooperative v. Schewe, 44 VILL. L. REV. 125 (1999); Glenn L. Norris, *Hedge to Arrive Contracts and the Commodity Exchange Act: a Textual Alternative*, 47 DRAKE L. REV. 319 (1999); Jennifer Durham King, *Hedge-to-arrive Contracts: Jurisdictional Issues Under the Commodity Exchange Act*, 18 N. ILL. U. L. REV. 481 (1998); Erik Asklesen, *Hedge-to-Arrive Contracts and the Commodity Exchange Act*, 7-Spg. KAN. J.L. & PUB. POL'Y 122 (1998); Nicholas P. Iavarone, *Understanding the Hedge-to-arrive Controversy*, 2 DRAKE J. AGRIC. L. 371 (1997); Paul J. Pantano, Jr., *Hybrid Hedge-to-arrive Contracts: Are They Exempt from CFTC Jurisdiction?* 16 NO. 8 FUTURES & DERIVATIVES L. REP. 1 (Oct. 1996).