

Membership Interests v. Securities
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There are a number of U.S. Supreme Court cases that are helpful in defining a basic difference between a membership interest which is not subject to the federal security registration requirements, and an investment interest or security which is potentially subject to registration. The two primary cases in this area are SEC v. W.J. Howey Co., 328 U.S. 293 (1946), and United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975). The Howey case established an expectation of profit test for determining what constitutes a security, stating that a security "involves an investment of money in a common enterprise with profits to come solely from the efforts of others". 328 U.S. at 301. The Forman case involved shares of stock sold to tenants of a housing cooperative in New York City. Although called "stock", the Court in Forman held that the housing cooperative shares did not constitute a security primarily because the tenants were seeking to obtain quality, affordable housing rather than an expectation of a profitable return on investment.

The Forman case based its ruling in part on the conclusion that the cooperative members who purchased stock were motivated primarily by the prospect of affordable housing rather than a profitable return on their funds, and in part on the fact that the cooperative shares had several characteristics not typical of equity stock: (i) the stock did not create an expectation it would appreciate in value, (ii) the stock was subject to substantial transfer restrictions, and (iii) voting of the stock was based on a one vote per member rather than a number of shares voting system.

Under the authority of the Forman and Howey cases, several cases and SEC no action letters have held that membership interests and patronage capital in cooperatives do not constitute securities because they represent economic benefits accruing to members as a result of patronage activities or volume of purchases rather than a return on investment from the efforts of others. See, e.g., Great Rivers Cooperative of Southeastern Iowa v. Farmland Industries, Inc., 198 F.3d 685 (8th Cir. 1999); and B. Rosenberg and Sons, Inc., v. St. James Sugar Cooperative, 447 F. Supp. 1 (E.D. La. 1976).

In a number of no-action letters, the SEC staff has agreed not to recommend any enforcement action to the SEC in circumstances where a cooperative proceeded to issue its stock without registration. In general, in reaching its conclusions, the SEC staff appears to have been influenced by the following factors in these no-action letters, among others:

- Members of the cooperative, as holders of common stock, cannot make a profit on their original investments by selling the stock

(because transferability of the stock is restricted and the potential for appreciation in value, if any, of the stock is not significant), or by reselling the stock to the cooperative (because the repurchase price equals the member's original purchase price).

- The distribution of earnings resulting from transactions with members are not profits but rather reflect a price or cost adjustment for the products purchased or sold by the cooperative. These distributions are commonly referred to as patronage refunds or dividends.
- Distributions of the cooperative's earnings to members, and distributions of net assets to members upon the liquidation of the cooperative, are not made on the basis of the number of shares held or the members' initial investments. Instead, the distributions are made generally based on the quantity or value of business done by members with the cooperative.
- The cooperative purpose and non-profit nature of the enterprise, together with the limitation of membership to those who may benefit from the cooperative relationship, indicate that members acquire and hold their common stock for the purpose of obtaining the benefits of membership in the cooperative, and not with the expectation of making a profit on their purchase and holding of the cooperative's common stock.

The legal framework used in connection with analyzing general and limited partnership interests can also be useful in determining whether cooperative membership interests would be considered to be securities. General partnership interests are typically not considered to be securities because the general partners have control over and active participation in the business; limited partnership interests are usually classified as securities because the limited partners do not actively participate in the business or its management. In one case analyzing this question, a Federal Circuit Court held that general partnership interests could be classified as securities if the partner (or investor, or member) is so dependant on the promoter or on other third parties that the partner is in fact unable to exercise meaningful management powers. Williamson v. Tucker, 645 F.2d 404 (5th Cir. 1981). The Williamson case indicates this could arise in several situations, including a situation where the partner is highly dependent on a unique entrepreneurial or managerial ability of the promoter or manager.

If cooperative membership interests are used as a mechanism to raise funds from cooperative members, it is important to structure the membership interests carefully to make sure they cannot be characterized as securities under the legal precedents that are available. More specifically, it would be desirable to include the following characteristics in the cooperative: (1) membership interests cannot be transferred except in the case of a succession circumstance; (2) the cooperative should have a right to redeem membership interests of a member subject to termination at face

value or original purchase price (without appreciation); and (3) no dividends will be paid on membership interests (but, rather, any margins or profits realized by the cooperative should be allocated to members based on patronage rather than investment amount).

And, finally, a note about “blue sky” or state securities laws: the analysis above focuses on federal securities laws. Each state has its own securities laws, applicable basically to securities offered to residents of the state. Many but not all of the states have exemptions for cooperative interests which are similar to the federal definition of what constitutes a security as described above. But some states (such as California) do not recognize this legal analysis for cooperative memberships. So before embarking on a membership drive, it will be important to identify the residence of the target members and undertake a blue sky analysis.