Law in Brief: Intro to Co-op Formation: New Hampshire

What is a co-op?

A cooperative ("co-op") is a type of for-profit business that is communally owned and democratically managed by its members. Co-ops follow a one person-one vote principle, where each member gets an equal say in the co-op's governance (in a traditional corporation, shareholders are able to exert influence in proportion to their initial financial investment or ownership share).

The International Cooperative Alliance has established seven guiding principles that distinguish cooperative entities:

1. Voluntary and Open Membership: Cooperatives are voluntary organizations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political or religious discrimination.
2. Democratic Member Control: Cooperatives are democratic organizations controlled by their members, who actively participate in setting policies and making decisions.
3. Member Economic Participation: Members contribute equitably to, and democratically control, the capital of their cooperative.
4. Autonomy and Independence: Cooperatives are autonomous, self-help organizations controlled by their members. If they enter into agreements with other organizations or raise capital, they do so on terms that ensure democratic control by their members and maintain their cooperative autonomy.
5. Education, Training, and Information: Cooperatives provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of their co-operatives.
6. Cooperation among Cooperatives: Cooperatives serve their members most effectively and strengthen the cooperative movement by working together through local, national, regional and international structures.
7. Concern for Community: Cooperatives work for the sustainable development of their communities through member-approved policies.

Co-op structures can accommodate many kinds of group enterprise. For example, a co-op grocery store's customers could be co-op members, whose investment in the co-op grants them discounts on products and profit dividends. Or, a group of small, independent dairy producers could band together as a co-op to access a new market or to collectively invest in expensive processing infrastructure.

Co-ops are incorporated under state law, and each state has slightly different statutory requirements for "co-op." The legal business structure of a co-op can take a number of different forms. In most states, any type of business entity (like an LLC, an S-Corp or non-profit) can be incorporated as a co-op. In New Hampshire, state law lays out guidelines for two types of co-ops: **marketing co-ops**, which are generally made up of groups of agricultural producers, and **consumer co-ops**. (N.H. Rev. Stat. Ann. § 301)

This can seem a little confusing, but the basic principles to grasp are that operating a business as a co-op is primarily a matter of choosing (i) your preferred manner of corporate governance (how do you want to make business decisions?), and (ii) how your business's income and appreciation in value are allocated – i.e., they are allocated based on use, or "patronage," not in proportion to financial investment. These choices may also have implications for entity structure and tax liability. An attorney or a co-op consultant can help you sort through these distinctions as you begin the co-op formation process.

What are the most common types of co-op?

- **Consumer co-op**: Consumer co-ops are businesses owned by their customers, who elect a board, make organizational decisions democratically, and receive benefits in the form of reduced price on goods and dividends from the co-op's profits. The outdoor store REI is a consumer co-op and most housing co-ops and credit unions are consumer co-ops.

- **Producer co-op:** Producer co-ops are owned and operated by producers of a tangible product. Producer co-ops are also sometimes known as "supplier" or "marketing" co-ops. Producer co-ops can help their members gain access to larger markets, pool processing or infrastructure costs, and collectively bargain for more favorable contract terms. Agricultural co-ops like Ocean Spray Cranberries are producer co-ops.

- **Worker co-op**: Worker co-ops are businesses that are owned by their workers. The business's profits are generally returned to its worker-owners in proportion to the amount of labor they contribute to the business. In some states, any business entity type can incorporate as a worker co-op (e.g., in New Hampshire, an LLC can also be a worker co-op). Equal Exchange, the coffee and food company, is an example of a worker co-op.

- **Multi-stakeholder/hybrid co-op**: A hybrid co-op is a co-op that combines two or more types of co-op, most commonly worker and consumer co-ops. Each stakeholder group holds seats on the co-op's board, and voting power is distributed proportionally between the stakeholder groups. For example, in a co-op grocery store, both consumer members and worker members would be represented on the board. Fedco Seeds is an example of a hybrid co-op, and many co-op grocery stores are also structured as hybrid co-ops.

Are there any tax benefits available to co-ops?

The Internal Revenue Service (IRS) grants special federal tax benefits to most types of co-ops listed above under a section of the federal tax code called "Subchapter T." The primary benefit under "Subchapter T" is that a co-op's income is only taxed once when distributed to shareholders, rather than as corporate income and then as personal income. (I.R.C. §1381) A co-op qualifies for these benefits when it meets the following criteria:

(1) affords democratic control by the members;
(2) vests in and allocates among the members all net profits from member usage ("patronage");
(3) complies with certain detailed rules – (a) establishes a pre-existing obligation to allocate income on a cooperative basis, (b) distributes net income to members within 8.5 months after the end of the fiscal year, and (c) pays at least 20% of the net income to members annually in cash (as opposed to patronage equity); and
(4) promotes subordination of capital (i.e., power and control are not allocated based on the amount of capital invested).

Other types of co-ops, such as credit unions, rural electric co-ops and mutual insurance co-ops, are governed under different tax rules; an accountant can help you determine which tax benefits apply to your co-op.

Who should form a co-op?

Co-ops are well-suited to those interested in building businesses founded on democratic values and equal participation, and who desire profits and risks to be equally distributed. Co-op governance requires a serious commitment to group deliberation, collaborative thinking and decision making, and intensive planning and communication.

Aspiring co-op groups should prepare themselves for a lot of meetings, negotiations, and compromise; additionally, the beginning phases of co-op development will necessitate maintaining group momentum while working through the not-always-glamorous nitty-gritty of starting a business. Cooperative governance can be applied to a number of familiar business types: a group of farmers who purchase fertilizer together can be a co-op, a farmers' market can be a co-op, a fine dining restaurant can be a co-op.

What are the benefits and risks of forming a co-op?

Benefits:

- Democratic ownership and proportional distribution of risks and benefits: meaning all members have equal incentive to participate in the business, without any one member assuming greater risk than any other member.
- Co-ops are accountable to their members, not investors, so decisions can be made for the benefit of members rather than purely to maximize profit.
- Co-ops are generally eligible for special, lower tax rates than non-cooperative corporations.
- Some special funding and grants are available for co-op start-ups or businesses converting to co-ops.
- Co-ops can access a network of co-operative businesses, and co-ops are more likely to work with other co-ops.
- Purchasing for a group allows for co-op members to access volume discounts that are inaccessible to independent business owners.
- Co-ops operate according to shared values, democratically agreed upon. These values can be as simple as "lower prices for agricultural inputs," or a co-op's bylaws and governing principles can more explicitly address issues such as environmental impact, gender parity, or racial equity.
- Worker ownership and profit sharing can lead to lower turnover and higher rates of worker satisfaction. (https://fortune.com/2021/05/19/worker-cooperatives-employee-owned-businesses/)

Risks:

- Democratic control requires group decision making and more elaborate governance structures, which can slow the speed of change or adaptation.
- Large investors may be less attracted to co-ops, since voting power is allocated on a per-person basis, rather than by amount of money invested.

- If members decline to participate in co-op governance or otherwise shirk their membership duties, it can be difficult for the co-op to operate at full capacity.

How do I form a co-op?

What are the basic steps to forming a co-op?

- **Determine what type of co-op you will start and clarify its goals.** Are you trying to organize a producer co-op to market a product with a group of small businesses? Are you trying to start a worker-owned restaurant? Determine what your business will do and what kind of co-op ownership and governance structure make the most sense.
- **Form an organizing/steering committee**. This committee is a group of future members who guide the entity formation process, meet with consultants and attorneys, and make decisions necessary to establish your new co-op.
- **Work out the details**. Define the scope of your business plan, choose a legal structure, draft co-op bylaws in accordance with state law, and establish a board (if needed – some co-ops may be small enough that the membership body essentially doubles as the board) to govern your co-op moving forward.
- **Make it official.** Name your co-op in accordance with state naming laws (in New Hampshire, consumer co-ops must include the word "cooperative" in their legal business name), draft articles of incorporation, and incorporate your co-op with the state.
- **Launch your co-op!** Obtain all necessary zoning clearances, permits, and licenses; register your business with all relevant state agencies (for instance, New Hampshire requires you to register with the New Hampshire Employment Security agency if you plan to hire employees) and execute your business plan.

When will I need to consult an attorney?

Although an attorney can be a valuable resource at any step in the process, legal assistance is crucial while crafting your by-laws; an attorney may also be a useful resource when you are initially deciding between entity types. At most other stages of the co-op formation process, a professional mediator, dedicated co-op consultant, or other business coach is sufficient to keep you on track.

Where can I find more resources?

- Cooperative Development Institute
- Columinate
- Democracy at Work Institute
- New Hampshire Secretary of State
- Legal Food Hub

This guide was prepared by Liz Turner, Legal Intern, Conservation Law Foundation.

Looking for legal help?
Contact the Legal Food Hub to see if you qualify for ***free*** *legal assistance!*
legalfoodhub.org
legalfoodhub@clf.org
1-844-LAW-GROW (1-844-529-4769)