Cooperatives: An Ownership Model for Digital Networks

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Could a legal structure common to credit unions and rural utilities revitalize blockchain and help realize the web3 vision of a new digital world?

Turbulence in the crypto and blockchain markets over the past year has shed light on a question that has received increasing attention: how web3 companies share ownership in digital networks, including through tokens.

As the industry wrestles with this question, builders and investors should consider an approach that offers several advantages: adding cooperatives to their ownership structures. A handful of web3 projects have done so, but the model is not widely understood in the web3 context.

Credit unions, rural utilities, insurance companies, and agriculture producers often organize as cooperatives. In web3, projects that add cooperatives to their ownership structures could boost participation and reduce regulatory risk while giving users more control of the digital networks they use and a share of the value they create.

The SEC has consistently declined to classify cooperative memberships as securities, enabling cooperatives to distribute ownership to users quickly and easily, while also offering important protections to their members.

We expect a growing number of builders and investors to examine adding cooperatives to existing ownership structures or to organize new ventures in this way. Giving users ownership through cooperatives might even provide builders and investors a better return on investment than if they shared ownership with users through tokens alone. This is because the cooperative structure rewards users in proportion to their participation and consequently may provide a stronger incentive than tokens for users to engage with and strengthen digital networks.

Cooperatives may not be the solution for every project, but they could offer a viable option in cases where existing models of granting ownership fall short. They also offer a promising avenue to fulfill broader web3 aspirations of decentralization and user empowerment.

The Challenges of Ownership in Digital Networks

One imperative runs through many distributed ledger technology projects – changing the status quo to give people more control over the digital networks they use and claims to the value they create. This combination is often called "ownership," though in this context "distributed ownership" is more precise. As the Ethereum Foundation puts it:[1]

> "Centralization has helped onboard billions of people to the World Wide Web and created the stable, robust infrastructure on which it lives. At the same time, a handful of centralized entities have a stronghold on large swathes of the World Wide Web, unilaterally deciding what should and should not be allowed.
>
> Web3 is the answer to this dilemma. Instead of a Web monopolized by large technology companies, web3 embraces decentralization and is being built, operated, and owned by its users. Web3 puts power in the hands of individuals rather than corporations..."

[1] https://ethereum.org/en/web3/

Builders have worked tirelessly to implement distributed ownership of digital networks, but recent failures in the industry show that existing models often fall short. Consider the downsides of two prominent models:

- **Governance tokens:** Many web3 companies issue governance tokens to give users a sense of ownership in a project, often in the form of voting rights. Yet regulators increasingly view[2] these tokens as subject to the same securities laws as stocks. Users may mistakenly believe that governance tokens give them a right to receive profits from a project, which is not usually true. A governance token's value can also swing dramatically, as was clear both before and during 2022.

- **Security tokens:** Less commonly, web3 projects share ownership using security tokens, which confer rights similar to traditional stocks. Sharing ownership this way requires complying with securities laws, rules and regulations - a process that costs time and money. Another disadvantage: The vast majority of users can't purchase security tokens unless the tokens have been registered with regulators, or a valid securities exemption for the issuance of the tokens is used (which can be challenging in the context of a publicly available token).

What's a Cooperative?

A cooperative is a legal entity that gives its owners rights to governance, profits, and liquidation value. Cooperatives also limit owners' liability for the debts of the business.

Cooperatives fall into two main categories: those owned by consumers and those owned by producers. Cooperatives typically allocate economic benefits based on the volume or value of an owner's participation as a "patron" in the business (as opposed to their capital contribution).

People can become owners – more commonly known as "members" – of a cooperative by acquiring one non-transferable membership "share" directly from the cooperative (often for a nominal price but sometimes for free) and signing a membership agreement. By doing so, members become bound by the cooperative's rules, get voting rights, and become eligible to receive profit distributions in proportion to their participation in the business. This bundle of rights constitutes a "cooperative membership."

Occasionally, cooperatives require members to purchase equity in addition to their non-transferable membership shares, but this equity doesn't usually confer any more voting or economic rights than members get from their basic cooperative memberships. The additional equity is normally non-transferable, but the cooperative may redeem the equity at face value if a member leaves the cooperative.

What Would a Cooperative Look Like in a Web3 Project?

For new web3 projects, cooperatives provide a way to give users voting and economic rights without issuing tokens, though new projects could also choose to issue utility tokens and digital collectibles (like NFTs) in addition to giving people ownership in the project through cooperative memberships.

In the case of an existing web3 company that previously issued tokens, adding a cooperative to the company structure would not automatically result in those tokens being deemed to be non-securities in the eyes of the SEC. The cooperative structure could clarify, however, that utility tokens and digital collectibles are consumptive goods that do not provide rights to control or receive distributions from the project, in contrast to what stocks typically do.

When it comes to previously issued tokens that confer governance rights, builders and investors should speak with legal counsel to determine how to integrate those rights most effectively into the cooperative governance structure.

[2] https://www.sec.gov/news/speech/gensler-sec-speaks-090822

How Do Cooperatives Compare with Corporations, LLCs, and Partnerships?

Cooperatives have several features in common with other business entities like corporations, LLCs, and partnerships, though cooperatives tie governance and economic rights to active participation in a way that corporations, LLCs, and partnerships do not.

Question	Cooperatives	Corporations and LLCs	Partnerships
Who owns the business?	Customers or producers, typically called the cooperative's "members."	Investors, typically called the corporation's "shareholders" or the LLC's "members."	Investors, typically called the partnership's "partners."
How do you become a member?	Meet membership requirements set forth in bylaws, sign membership agreement and acquire a membership share. Members may also be required to purchase non-transferable, non-interest-bearing equity in cooperative to raise additional capital. This equity may be redeemed by the cooperative, as specified in the cooperative's articles and bylaws.	Purchase shares or units in the corporation or LLC. Employees and consultants may also receive shares or units as compensation for services.	Contribute cash, property and/or services to the partnership. Employees and consultants may also receive partnership interests as compensation for services.
Are owners liable for debts of the business?	No.	No.	Possibly, depending on the type of indebtedness, partnership and partner.
Who makes strategic decisions for the business?	Members vote on certain decisions as provided by statute and bylaws and elect board of directors. Board of directors makes most key decisions.	Shareholders or members vote on certain decisions as provided by statute and bylaws or operating agreement and elect the board of directors/managers. Board of directors/managers makes most key decisions.	Partners vote on key decisions.
Who manages the business?	Officers appointed by board of directors manage everyday affairs of the business.	Officers appointed by board of directors typically manage everyday affairs of the business.	General partners usually manage everyday affairs of the business.
How is voting power allocated?	One-member, one-vote, though voting is sometimes weighted by participation.	Shareholders or members have number of votes corresponding to number of voting shares or units held. Preferred shareholders or members may have special voting rights.	Voting power may be shared between general and limited partners, where applicable.
How are profits distributed?	Profits distributed to members based on their patronage, i.e., the volume or value of goods and services member purchased from or sold through the cooperative. Non-patronage earnings are retained, used to fund limited dividends on preferred equity or allocated to members based on their patronage.	Profits distributed to shareholders or members based on number of shares or units held. Preferred shareholders or members may have special rights to distributions.	Profits allocated and distributed according to the profit (and loss) sharing percentages specified in the partnership agreement.
How are distributions made upon sale or liquidation of company?	Sale or liquidation proceeds distributed to members based on formula included in bylaws or approved by the board of directors. Typically distributions made to members are a function of their patronage during a period prior to sale or liquidation.	Sale or liquidation proceeds distributed to shareholders or members based on the number of shares or units held. Preferred shareholders or members may have special rights to distributions.	Sale or liquidation proceeds distributed according to sharing percentages specified in the partnership agreement.

The features that make cooperatives unique make them useful for web3. By distributing profits to members in proportion to their participation, cooperatives give members a powerful incentive to engage with and grow the networks they use. And by giving each member one vote or a participation-weighted vote – instead of giving the most votes to those who buy the most shares or governance tokens – cooperatives help prevent the concentration of power that decentralized organizations are supposed to mitigate.

Are Cooperative Memberships Securities?

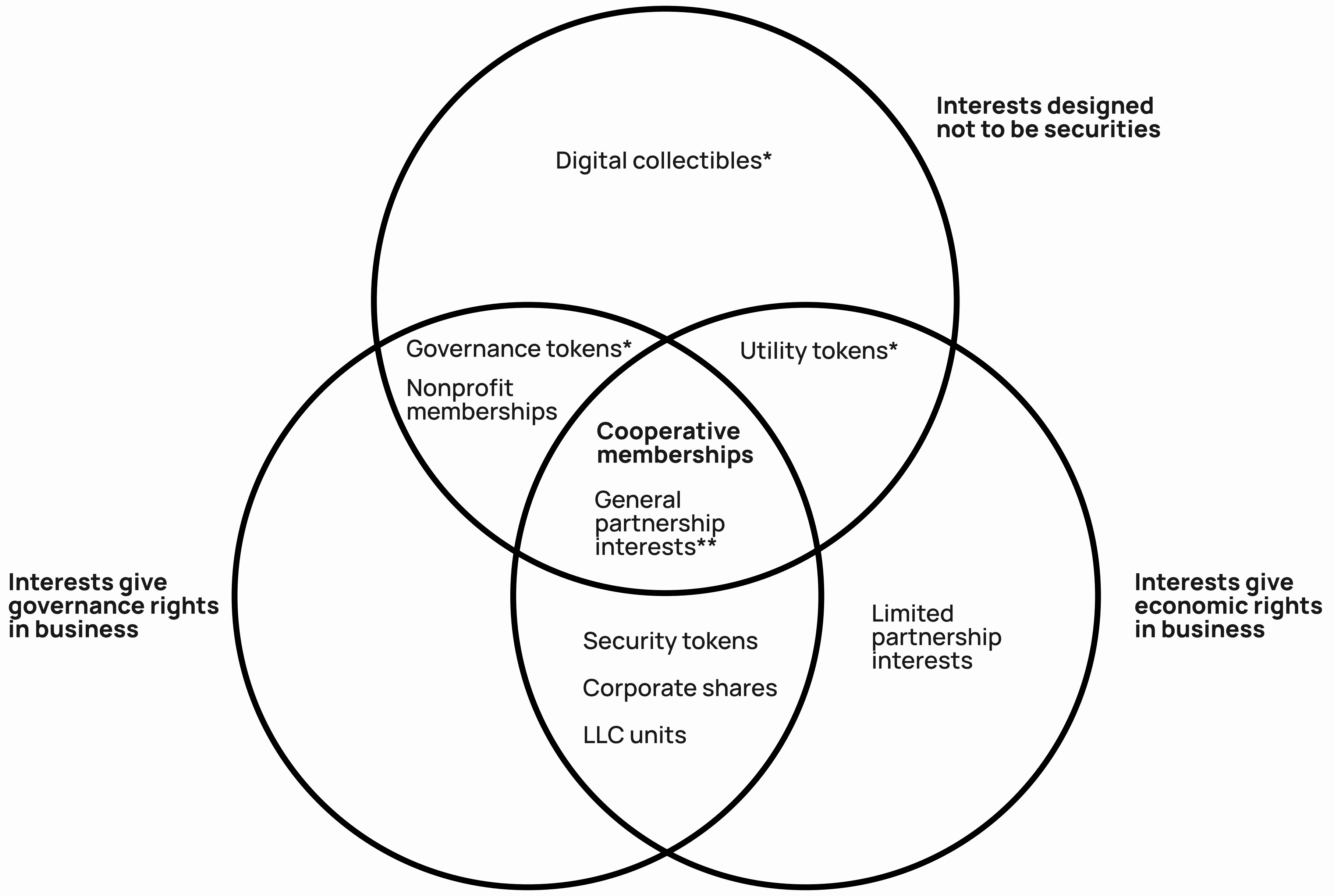
U.S. regulators have consistently signaled that cooperative memberships are not subject to federal securities laws.

In dozens of instances, cooperatives have argued that their members join to benefit from their participation in the enterprise, without an expectation to reap profits from the efforts of others. As a result, they have said, cooperatives should not be subject to federal securities laws. The SEC has agreed with this position (subject to case-specific nuances) regarding organizations as diverse as a residential water company,[3] a cooperative for audiologists,[4] and a sugarbeet processing cooperative.[5] Nonprofits, including the Green Bay Packers, Inc. and a Los Angeles Rams fan club,[6] have relied on similar logic to argue their stocks and memberships are not securities.

The fact that cooperative memberships and the membership "shares" that represent them are non-transferrable also distinguishes them from transferable equity in a corporation, LLC or partnership, which are generally subject to federal securities laws.

These attributes naturally protect cooperative members from the kind of harms that securities regulators seek to prevent. Because cooperative memberships are not transferable, they are rarely the subject of financial speculation. Information asymmetries between management and owners may also be less common in cooperatives than in other business forms. That's because consumers and producers – rather than passive investors – own a cooperative, and they can judge the quality of the cooperative's goods, services, and management based on their own participation in the business.

Here's a look at how various business ownership interests and tokens compare to cooperative memberships with respect to governance rights, economic rights and their status as securities:



* The SEC may consider interests to be securities under Howey test in some circumstances, particularly if interests are purchased or held for investment and not for consumption.
** General Partners have unlimited liability for the debts and obligations of the partnership.

[3] https://www.sec.gov/divisions/corpfin/cf-noaction/2018/tesoro-viejo-master-mutual-water-company-102418-2a1.htm
[4] https://www.sec.gov/divisions/corpfin/cf-noaction/2014/entheos-audiology-060214-12g3.htm
[5] https://www.sec.gov/divisions/corpfin/cf-noaction/2013/american-crystal-sugar-company-071713-2a1.htm
[6] https://www.sec.gov/divisions/corpfin/cf-noaction/2017/la-fan-club-062817-2a1.htm

One important note: While many states follow U.S. federal standards to decide if cooperative memberships and other assets are securities, some states use different standards, like the "risk capital" test in California. Cooperative interests that aren't securities under federal law often aren't securities under state law either, but builders should always confirm this with legal counsel, especially if they intend to use the proceeds of selling cooperative memberships to fund the development of new products or services.

Adding Cooperatives to an Ownership Structure: 7 Things for Builders to Do

There are many ways builders can use cooperatives to enhance participation and give ownership in a web3 project to users in compliance with securities laws. One of the most effective approaches involves holding or consolidating the productive assets of the project under a parent company and allowing a cooperative to join the cap table. This method ensures that builders, investors and users can access the profits and governance of the entire business on equal footing.

After adding a cooperative to the cap table, builders and investors could maintain control over the business through their equity in the parent company until the user network is strong enough, and the valuation of the project is high enough, to permit a successful exit. Concurrently, users could gain increasing control over the project as the network grows and the cooperative earns or buys more equity in the parent company.

Here are seven steps builders could take to employ cooperatives in their digital network structures:

1. For Existing Projects: Consolidate Productive Assets

- Some projects give control over certain assets (like the project treasury) to users through governance tokens. Meanwhile, builders and investors may retain control over other productive assets (like intellectual property or third-party contracts) through a combination of governance tokens and their equity in the corporation or other entity developing the project.
- If an existing project has divided control of productive assets in this way, builders can consolidate the project's assets in a parent company and its subsidiaries.
- By holding assets within a single family of entities, builders ensure that equity owners have complementary incentives to grow the value of the business.

2. Form a Cooperative to Join the Parent Company's Cap Table

- Adopt governing documents outlining membership requirements, voting procedures, board composition, patronage allocation units or pools, patronage capital programs and distribution mechanics.
- Many jurisdictions have statutes for forming and governing cooperatives
  - One of the more flexible regimes is based on the Uniform Limited Cooperative Association Act published by the Uniform Law Commission.
  - Colorado, Kentucky, Nebraska, Oklahoma, Utah, Vermont, Washington and Washington, D.C. have adopted laws based on this Act. Much like corporations formed in Delaware, despite being headquartered elsewhere, a cooperative can organize under the laws of one state and maintain its presence elsewhere.

3. Invite Users to Join the Cooperative

- Decide whether users will acquire their membership "share" for a fee or at no additional cost.
- Potential members would have to enter a membership agreement and meet some conditions to join. Conditions for a user to become a member of the cooperative could include:
  - Ownership of NFTs or tokens that builders previously issued.
  - Verification of the user's identity.
  - Active and ongoing participation in the project.
- The cooperative could continue to add members even after the first group of members has joined.

4. For Projects That Previously Issued Tokens: Determine How to Treat the Tokens

- In the case of a project that issued utility tokens or digital collectibles, those tokens can remain in use after the project adds a cooperative to its ownership structure. People holding those tokens could continue to trade them with anyone, subject to applicable laws.
- When utility tokens or digital collectibles are traded only among active members of the cooperative subject to project policies, SEC precedents regarding American Crystal Sugar's preferred stock[7] and seat licenses for the San Francisco Giants[8] suggest the Agency might not view those assets as securities. Some projects may choose to impose reasonable restrictions on token transfers to take advantage of these precedents.
- Because cooperative memberships give users governance rights, it might be duplicative if users also hold tokens conferring voting or other control rights in a project. If a project has already issued governance tokens, builders and investors should speak with legal counsel to determine how to integrate those rights into the cooperative voting structure.

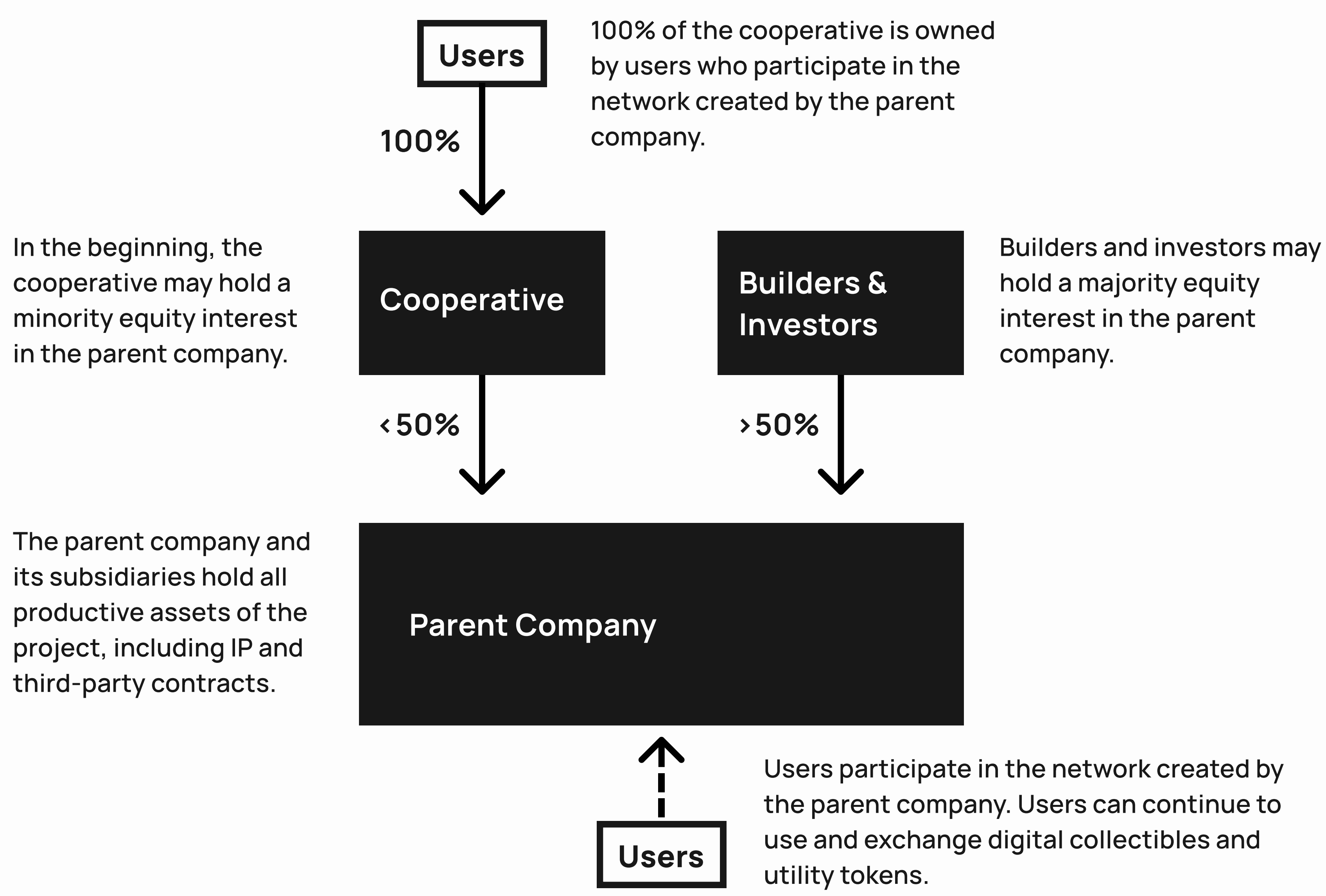
5. Join Parent Company Cap Table

A cooperative can acquire equity in the parent company in two main ways:

- The cooperative could provide services to the parent company in exchange for equity in stock or restricted stock units.
- The cooperative could purchase equity from builders, investors or the parent company using funds raised from the sale of memberships, retained earnings or other sources.

The cooperative could acquire equity in the parent company subject to exemptions from securities registration requirements for "accredited" or sophisticated investors. Builders and investors should consult with attorneys and tax advisors to ensure these exemptions are available and properly apply in each case, and that any equity purchases are tax efficient for the cooperative and the parent company.

This chart shows a typical model for adding a cooperative to a company's ownership structure:



[7] https://www.sec.gov/divisions/corpfin/cf-noaction/2013/american-crystal-sugar-company-071713-2a1.htm
[8] https://www.sec.gov/divisions/corpfin/cf-noaction/sfba022406.htm

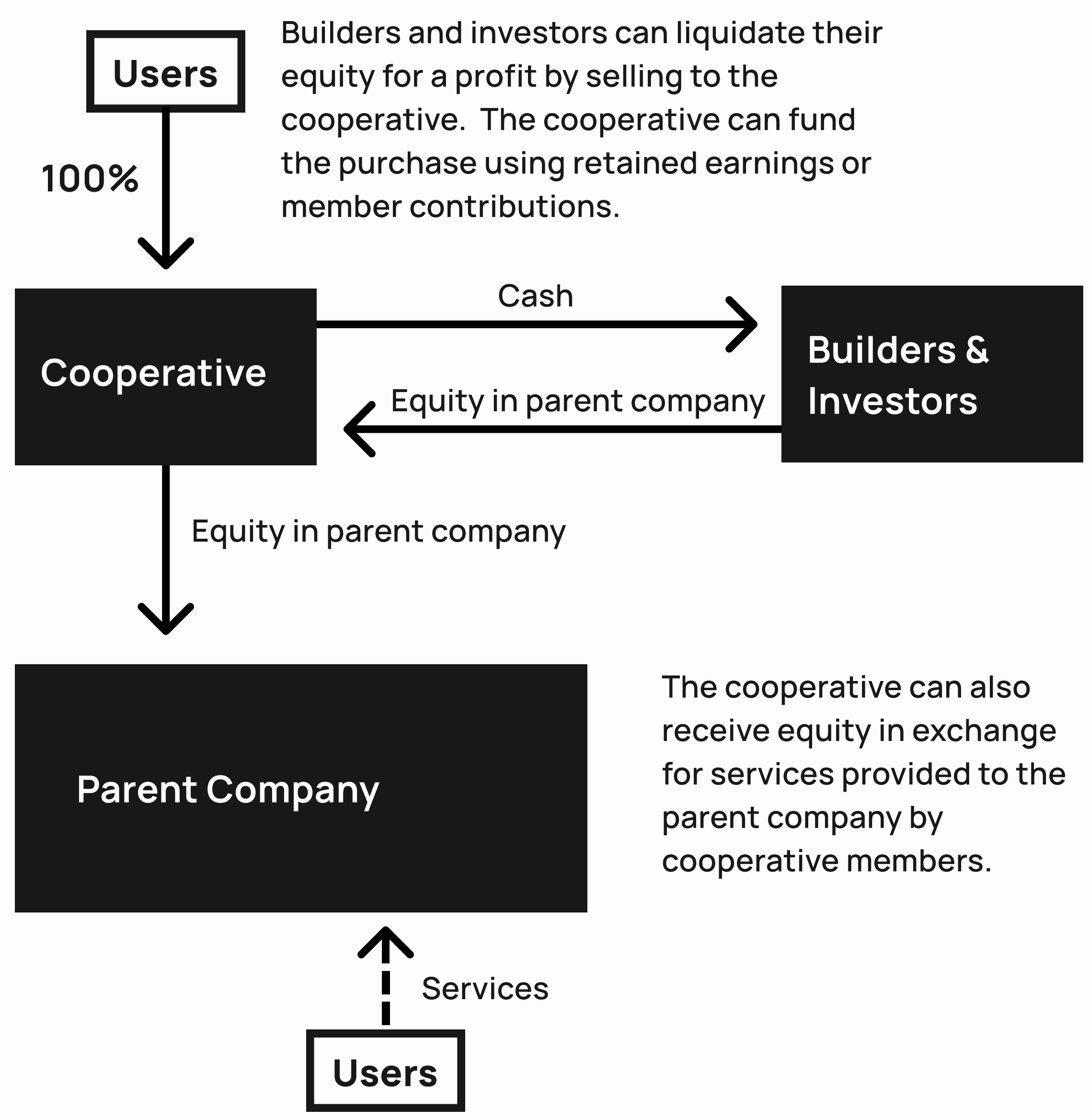
6. Participate in Parent Company Governance and Economics

- Users could elect members of the cooperative's board of directors.
- The cooperative's board of directors could vote the cooperative's shares in the parent company to elect directors and take shareholder actions.
- If builders want users to have more say in project governance, they could also give the cooperative and its users rights to vote on parent company affairs.
- In the early days of a project, it's unlikely a parent company would distribute profits to builders, investors and users.
  - Parent companies that would like to share profits, though, could make distributions to the cooperative in proportion to its equity interest in the parent company (or as otherwise agreed by the cooperative and parent company).
  - Profits distributed to the cooperative would be allocated to each user based on participation, usually calculated based on the value of users' transactions with the parent company and its subsidiaries, or with some other measure of patronage. For example, this could be a scoring algorithm that measures participation using variables other than currency such as the number of comments, likes and shares that a user contributes on a particular social media platform.
  - Profits would be distributed in accordance with Subchapter T of the Internal Revenue Code, which gives special tax advantages to cooperatives. Under Subchapter T, profits derived from patronage (i.e., transactions in goods and services between members and the cooperative or parent company) distributed to members are generally tax-deductible to the cooperative.
  - Tax-deductible distributions to members can be in cash, cryptocurrency, "qualified written notices of allocation" (a kind of IOU particular to cooperatives) or other property. For cash patronage refunds and qualified written notices of allocation, the amount of cash distributed, the face amount of the qualified written notices of allocation, and/or the cash distributed in redemption of non-qualified written notices of allocation must be reported to members on Form 1099-PATR. For cryptocurrency or other property, the cooperative would need to establish its fair market value in order to report it to members on Form 1099-PATR.
  - Distributions are generally taxable to members who receive them, though members may not need to pay tax on distributions representing refunds from purchases for personal, living or family use.

7. Exit

- Periodic equity sales by the parent company to the cooperative could provide liquidity for builders and investors as a web3 project grows while allowing the cooperative to increase its overall ownership of the parent company, resulting in more control over and economic exposure to the project. The cooperative could fund these acquisitions using fees from the sale of memberships, utility tokens or collectibles, retained earnings or other capital raised by the users.
- Builders and investors could sell tokens to community members for consumptive use within the project, subject to applicable laws.
- If a parent company were acquired, the cooperative would likely receive sale proceeds in proportion to its equity in the parent company, and these proceeds would be distributed to cooperative members in proportion to their participation.

Builders and investors can liquidate their equity for a profit by selling to the cooperative, as shown below.



Cooperatives Could Benefit Builders, Investors, Regulators and Users

Cooperatives are not a panacea for web3 - and they come with tax and legal questions that require counsel, consideration, and planning to answer.

For many builders and investors, though, a cooperative offers a path toward greater user participation, transparency, and regulatory certainty. Additionally, regulators can gain greater comfort around the protections and rights afforded to community members through the cooperative structure.

Ultimately, cooperatives could allow users and communities that build value to participate in the economic returns of the project. As such, the cooperative may be tailor-made for the decentralized and user-empowered world of web3.

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