

**SENATE JUDICIARY COMMITTEE**  
**Senator Thomas Umberg, Chair**  
**2021-2022 Regular Session**

AB 283 (Chen)  
Version: January 21, 2021  
Hearing Date: June 22, 2021  
Fiscal: Yes  
Urgency: No  
AWM

**SUBJECT**

Corporate securities: exemption from requirements

**DIGEST**

This bill exempts equity-related securities or credits issued by a cooperative corporation as patronage distributions from securities qualification requirements, as specified.

**EXECUTIVE SUMMARY**

While most securities transactions are governed by federal law, the Corporate Securities Law of 1968 requires certain securities offered or sold within the state to be qualified for sale by the Department of Financial Protection and Innovation (DPFI). The qualification process requires the issuing corporation to pay a fee to DPFI, and the corporation will likely incur filing-related legal costs.

Cooperative corporations, which conduct their business primarily for the benefit of their members as patrons of a corporation, are required to distribute to members their earnings, savings, and benefits proportionately based on each member's contribution to the corporation. Federal law allows a for-profit cooperative to deduct the value of its patronage distributions from its gross income, and for cooperatives with competing cash flow needs, distributions in the form of capital credits (equity or shares). This bill would make capital credits derived from patronage distributions exempt from the state's qualification requirements, and clarify that such capital credits do not count against the existing \$1,000 aggregate investment threshold that exempts certain shares issued by a cooperative from qualification requirements. With these two amendments to existing law, cooperatives will be able to issue patronage distributions in the form of equity shares without paying for a permit from DFPI.

This bill is sponsored by the Nonprofit Organizations Committee of the Business Law Section of the California Lawyers Association and supported by Worker-Owned Recovery California. There is no known opposition. This bill passed out of the Senate Banking and Financial Institutions Committee on with a 9-0 vote.

**PROPOSED CHANGES TO THE LAW**

Existing state law:

- 1) Establishes the Cooperative Corporation Law, which authorizes the formation of a corporation for any lawful purpose provided that it is organized and conducts its business primarily for the mutual benefit of its members as “patrons” of the corporation. (Corp. Code, tit. 1, div. 3, pt. 2, §§ 12200 et seq.)
- 2) Provides that cooperative corporations are democratically controlled and are not organized to make a profit for themselves or their members as such, but rather for their members as patrons. Accordingly, the earnings, savings, or benefits of a cooperative corporation shall be used for the general welfare of the members or proportionately and equitably distributed to some or all of its members, or patrons based on their patronage, in the form of cash, property, evidences of indebtedness, capital credits, memberships, or services. (Corp. Code, §§ 12201, 12243.)
  - a) A “patronage distribution” is any transfer made to a patron of the corporation, the amount of which is computed with reference to the patron’s patronage of the corporation. (Corp. Code, § 12244.)
- 3) Provides that it is unlawful for any person to offer or sell any security in this state, unless such offering or sale has been qualified by the Commissioner of Business Oversight, as specified, or unless the offering or sale is covered by an express exemption. (Corp. Code, §§ 25005, 25110.)
- 4) Provides exceptions to the qualification requirement for certain cooperative securities sales, in relevant part, exempting shares or memberships issued by a cooperative if the aggregate investment of a shareholder or member in shares or memberships sold does not exceed \$1,000. (Corp. Code, § 25100(r).)

Existing federal law:

- 1) Allows a cooperative corporation to deduct the amount of patronage dividends from its gross income. (26 U.S.C. § 1382(b).)

This bill:

- 1) Updates references to the Commissioner of Business Oversight to refer instead to the Commissioner of the DPFI.
- 2) Revises the qualification exemption for sales of interests in cooperative corporations as follows:
  - a) Adds an exemption for credits to a member’s capital issued to a shareholder or member, subject to the existing limitations on transfers of shares and memberships.

- b) Provides that the \$1,000 limitation does not apply to shares, memberships, or credits to that member's capital as all, or part of, any patronage distributions.

### COMMENTS

#### 1. Author's comment

According to the author:

Under current statute, cooperative corporations are unduly burdened by reporting requirements related to disbursements that are made to co-op members. This bill would allow a California cooperative incorporated under the Cooperative Corporation Law an exemption from qualification requirements under California securities law for any equity-related securities it issues as patronage distributions to its members. This bill would also clarify that the existing \$1,000 exemption limit for cooperative equity-related securities applies to each member specifically rather than being inapplicable if any member owns more than \$1,000 in equity-related securities in the cooperative. In doing so, the bill will make clear that each member may directly purchase up to \$1,000 in capital units without the co-op needing a permit related to that member.

#### 2. Background on cooperative corporations

A cooperative corporation conducts its business primarily for the mutual benefit of its members as patrons of the corporation; to that end, the earnings, savings, or benefits of a cooperative corporation are legally required to be used for the general welfare of the members.<sup>1</sup> Whereas a traditional corporation generates earnings for its owners or shareholders, a cooperative corporation is required to proportionately and equitably distribute earnings to some or all of its members or its patrons, based upon their patronage of the corporation.<sup>2</sup> Cooperatives also differ from general corporations in their governance: cooperatives are democratically governed, with each member having one vote.<sup>3</sup>

Cooperative corporations are generally structured as one of two types: consumer cooperatives, which are organized for the benefit of the members who purchase goods or services from the corporation; or worker cooperatives, which are organized for the benefit of the members who provide their labor for the production of goods sold by the corporation.<sup>4</sup> Consumer cooperatives' distributions are based on the amount of money

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<sup>1</sup> Corp. Code, § 12201.

<sup>2</sup> *Ibid.*

<sup>3</sup> *Id.*, § 12480.

<sup>4</sup> *Id.*, §§ 12201, 12553, 12253.5, 12404.5.

spent by the member at the corporation, also known as the member's "patronage."<sup>5</sup> The distributions often take the form of an annual dividend, refund, or discount, but may also include property, capital credits (e.g., shares), and other assets or benefits. For worker cooperatives, distributions are based on the members' hours worked or wages earned,<sup>6</sup> and often take the form of a share in year-end profits.

3. This bill exempts from qualification requirements any shares, memberships, or credits to a member's capital as all, or part of, any patronage distributions made by a cooperative corporation

The Senate Banking and Financial Institution Committee's analysis of this bill has a thorough discussion of securities laws in California; the analysis is incorporated by reference here. In brief, state securities laws require cooperative corporations to qualify, i.e., obtain a permit from the DFPI for, issuances of shares over \$1,000.<sup>7</sup> According to the author, there is ambiguity as to whether the \$1,000 cap applies as a per-member cap or to the aggregate of the cooperative's issued shares. The result is a very low threshold for qualification for cooperatives' year-end securities issuances—which are done not to raise capital, but to comply with the obligation to redistribute benefits to members.

While a cooperative could avoid the qualification requirement by distributing its annual patronage benefits in cash, rather than shares, the federal government's treatment of cooperatives' patronage distributions complicates this calculation. Under federal tax law, a cooperative may deduct the value of its patronage distributions from its gross income, thereby reducing its tax liability.<sup>8</sup> As such, a cooperative with cash flow needs may choose to make its patronage distributions in the form of issue (i.e., shares in the cooperative) instead of in cash in order to save the cash for other purposes. However, because a corporation must obtain a permit from the Department of Financial Protection and Innovation to issue capital credits in excess of \$1,000. For many cooperatives, therefore, issuing capital credits in lieu of a cash distribution is still an expensive option, because the cooperative has to engage an attorney to obtain the permit and pay DPFI fees, the costs of which eat into the cooperative's cash on hand.

This bill attempts to resolve the conflicting incentives facing cooperatives by making capital credits derived from patronage distributions exempt from the qualification and permit requirement for the sales of securities. The bill would also clarify that these cooperative-issued capital credits do not count against the \$1,000 aggregate investment ceiling for the exemption for the qualification and permit requirement. With these two amendments to existing law, cooperatives will be able to issue patronage distributions in the form of equity shares without paying for a permit from DFPI.

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<sup>5</sup> *Id.*, § 12243(a). The outdoor supply company Recreational Equipment, Inc. (REI) is a well-known consumer cooperative based in Washington. (See REI, About REI, <https://www.rei.com/about-rei> [last visited Jun. 17, 2021].)

<sup>6</sup> Corp. Code, § 12243(b).

<sup>7</sup> Corp. Code, § 25100(r).

<sup>8</sup> 26 U.S.C. § 1382.

The bill leaves in place the current exemptions to the qualification and permit exemptions; relevant for this Committee is the fact that shares, memberships, or capital credits issued by a nonprofit cooperative organized to facilitate the creation of an unincorporated interindemnity arrangement between physicians and surgeons will not be exempted from the qualification and permit requirement under this bill. The Committee has received no opposition to the bill and the bill's relatively narrow scope appears to be a reasonable way to balance the unique nature of cooperative patronage issuances and the state's interest in regulating securities.

#### 4. Arguments in support

According to the sponsor, the Nonprofit Organizations Committee of the Business Law Section of the California Lawyers Association:

Whereas a traditional corporation generates earnings for its owners or shareholders, a cooperative corporation conducts its business primarily for the mutual benefit of its members or patrons. Unlike other corporations, when cooperative corporations retain income, tax law provides the cooperative corporation an income tax deduction from the distribution of patronage-related income provided certain requirements are met. From an accounting perspective, retained patronage income is equity of the cooperative, either as part of unallocated "retained earnings" of the corporation or earnings allocated to each member. From a California securities law perspective, the patronage allocation may be viewed as an issuance of a security, requiring the corporation to obtain a permit from the [DPFI] for qualification to offer or sell securities...

If the retention and distribution of patronage is viewed as the sale of a security, such a retention and distribution requires a cooperative to issue equity credits on an annual basis. This, the qualification requirement imposes a significant hardship on cooperatives that is not shared by other corporations. Other corporations seek a permit only when they are raising capital, but they are not required to obtain a permit annually to do their bookkeeping. Because the DPFI permit system operates on an annual basis, cooperatives must seek a permit for each year they believe they may have net income which will be retained as allocated patronage.

This bill would resolve the issue identified above by amending Corporations Code section 25100(r) to exempt from the qualification requirements...[for] equity-related securities and other equity "credits" issued by a cooperative corporation incorporated under the California Cooperative Corporation Law.

According to bill supporter Worker-Owned Recovery California:

Many cooperatives have had to incur internal costs, outside professional fees, and fees from the [DPFI] to meet the qualification requirements for securities

they issue related to patronage distributions, even where such distributions are required. Forcing these cooperatives to obtain qualification to retain patronage imposes unique burdens on the cooperatives.

Also, the existing \$1,000 exemption has caused some debate as to whether the sale of a membership or share to a new member or an existing member owning less than \$1,000 needs to be qualified with the DPFI if at least one other member owns more than \$1,000 in equity-related holdings under some other descriptions...

To achieve compatibility with cooperative structure and operations, this bill allows a cooperative to make equity-related patronage distributions to its members without the hardship and expense of qualification. It also retains but clarifies the existing \$1,000 exemption limitation for equity-related securities and adds "capital credits" as an additional category of equity to which the exemption applies.

### **SUPPORT**

California Lawyers Association, Business Law Section, Nonprofit Organizations  
Committee  
Worker-Owned Recovery California

### **OPPOSITION**

None known

### **RELATED LEGISLATION**

Pending Legislation: None known.

Prior Legislation:

AB 2244 (Chen, 2020) would have made substantially similar changes to the qualification requirements for corporations organized under the Cooperative Corporation Law. AB 2244 was held in the Assembly Banking and Finance Committee due to COVID-19-related bill limits.

AB 2751 (Brown, 2016) would have exempted from the qualification requirement the sale of a security raised through an offering by an agricultural enterprise that met specified criteria. AB 2571 died in the Assembly Appropriations Committee.

SB 577 (Hueso, 2015) would have increased the amount of an exempted sale for shares in cooperative corporations from \$300 to \$1,000, and increased the individual

qualification exemption level for sales of indebtedness. SB 577 died in the Senate Judiciary Committee.

AB 816 (Bonta, Ch. 192, Stats. 2015) renamed the Cooperative Corporation Law, expanded it to create more visibility for worker cooperatives organized pursuant to that law, and increased the amount of an exempted sale for shares in cooperative corporations from \$300 to \$1,000.

AB 2525 (Bonta, 2014) would have established the Limited Liability Worker Cooperative Act and exempted from the qualification requirement any membership issued by a worker cooperative, provided the primary motivation of the purchaser is to use or consume the products or services of the worker cooperative company or to otherwise patronize the worker cooperative company and is not primarily motivated by the prospect of a return on investment. AB 2525 died in the Assembly Banking and Finance Committee.

**PRIOR VOTES:**

Senate Banking and Financial Institutions Committee (Ayes 9, Noes 0)

Assembly Floor (Ayes 77, Noes 0)

Assembly Appropriations Committee (Ayes 16, Noes 0)

Assembly Banking and Finance Committee (Ayes 12, Noes 0)

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