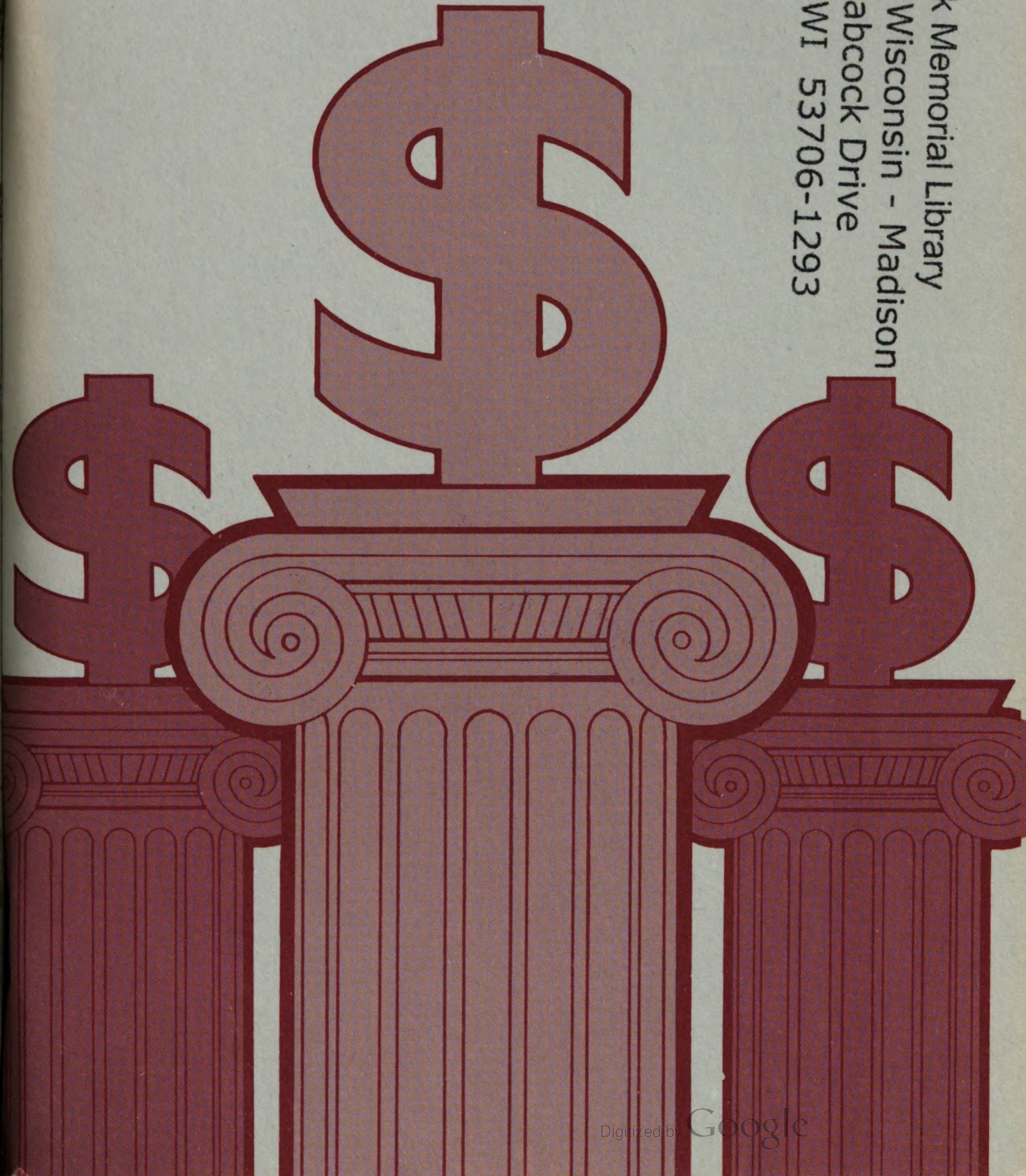
...tates
...ent of
...re
...al
...ve

ACS
Research Report
Number 68

Financial Instruments Issued by Agricultural Cooperatives



Abstract

Financial Instruments Issued by Agricultural Cooperatives

Mary Beth Matthews,
Assistant Professor

School of Law
University of Arkansas

Agricultural cooperatives use various types of instruments to finance operations to provide members services. Certain rights and obligations are associated with these instruments. This study surveys and discusses financial instruments types and characteristics, and effects of special events, mergers, consolidations, and reorganizations, and third party claims associated with particular instruments.

Key Words: Agricultural cooperatives, cooperative law, cooperative finance, financial instruments

Research Report No. 68

March 1988

Preface

This report was prepared by the University of Arkansas School of Law under a cooperative research agreement with Agricultural Cooperative Service. Project Leaders were Don Pedersen and J.W. Looney, University of Arkansas School of Law, and James R. Baarda, Agricultural Cooperative Service. Research and editing contributions by the following candidates for Masters degrees in Agricultural Law are gratefully acknowledged: Douglas Fee, Davis Horne, Gene Olsen, Cynthia Stricklin.

Contents

Highlights

Farmer cooperatives, like all business organizations in private capital based economies, can acquire assets and employ people only if they receive capital investments. Cooperatives use several types of financial instruments to identify and define relationships established when members, patrons, and others invest capital in the cooperative. Each instrument has defined characteristics and serves special purposes for both cooperatives and investors.

Some financial instruments used by cooperatives are similar to those used by noncooperative enterprises, while others are unique. In all cases, however, the special character and purpose of farmer cooperatives must be understood to appreciate fully the rights of various parties associated with cooperative finance. Cooperative principles of member ownership, member control, operation-at-cost, and limited dividends on capital investment influence rights in important ways.

Generally, financial instruments issued by farmer cooperatives fall into several categories: Membership certificates, common stock, preferred stock, deferred patronage refunds, per-unit capital retains, debt instruments, or hybrid instruments.

Membership certificates evidence membership in cooperatives and establish certain relationships between cooperatives and members. They also reflect cooperative characteristics such as limits on membership and rights on acquisition of membership. Common stock possesses many characteristics of common stock issued by noncooperative firms, but reflects limitations on issue and transfer, limits on dividends, voting rights, and redemption peculiar to cooperative common stock. Similarly, preferred stock issued by cooperatives, though having most characteristics of preferred stock generally, can be understood only in the context of its role as a cooperative financial instrument.

Some financial instruments are unique to cooperatives. Retained patronage refunds and per-unit capital retains evidence investments based on business done with the cooperative by its users. They are tailored to cooperative ownership, user, and financing principles. They reflect the close connection between member and cooperative, patronage and patron investment by retained patronage refunds and per-unit capital retains. Owner-user rights, as well as obligations imposed, are based on contract law, corporate law, and cooperative principles.

Special events put financial instruments' rights and obligations to the test. Breach of contract, member death, termination of membership, cooperative dissolution, member or cooperative bankruptcy, and mergers or reorganization are such events. All require careful cooperative planning before the event to be sure cooperatives', members', and patrons' rights are protected. Third party claims on financial instruments in the hands of either cooperatives or patrons can be satisfactorily settled only if rights and responsibilities associated with each instrument are well defined and understood.

Rights and obligations associated with cooperative financial instruments are much more complicated than might initially appear. Part of the confusion comes from a lack of understanding of cooperatives, but much is created by cooperatives when they fail to designate clearly terms and priorities of instruments issued. Because instruments represent claims to money, hard-pressed members of the agricultural sector will surely continue to litigate rights in this area. The consequences should be more careful consideration of the ends the cooperative hopes to achieve, and better drafting of cooperative documents and instruments to achieve these goals.

Financial Instruments Issued by Agricultural Cooperatives

Mary Beth Matthews
School of Law
University of Arkansas

TYPES AND CHARACTERISTICS OF FINANCIAL INSTRUMENTS

Analysis of the financial structure of agricultural cooperatives must begin with an understanding of cooperative goals and principles.[1] Cooperatives are formed to provide producers with marketing services or supply them with needed commodities at cost. They are financed and controlled by producer-members who market their crops or purchase their supplies through the cooperative. Income generated by the cooperative in excess of expenses belongs to patrons. Cooperatives are said to be "non-profit" organizations not because they do not generate profits but because profits must eventually be returned to patrons.

Cooperative principles were first developed during the early 19th century by consumer groups in England and Scotland. Principles they espoused have gradually evolved into modern tenets of cooperative operation. Five underlying principles distinguishing cooperatives from other business enterprises have been described as follows:[2]

1. Ownership is held by member-patrons.

2. Control is on the basis of one vote per member, or on volume provided.

3. Operations have an at-cost (nonprofit) objective.

---

[1]*Lake Region Packing Assn. v. Furze*, 327 So.2d 212, 214 (Fla. 1976).

[2]See the discussion of these principles in Agricultural Co-op. Service, USDA, *Cooperative Principles and Legal Foundations*, Cooperative Information Report No. 1, Sec. 1 (1977).

4. Dividends on member capital are limited.

5. Education is necessary for understanding and support.

Brief explanation of each principle will help in understanding the following discussion.

Cooperatives are owned primarily by members who patronize them. They are thus oriented toward providing benefits to member-patrons rather than profits to investors. Member ownership also encourages participation and support of the cooperative.

Cooperatives are designed to be democratic, with control shared by members rather than concentrated in a few individuals. Most cooperatives limit voting to one vote per member, although voting on the basis of patronage volume is permitted in a few States.

Any margins generated by cooperative operations after deducting operating expenses are returned to member-patrons as patronage refunds. Thus, a supply cooperative should return to patrons any charges above cost of supplies purchased, and a marketing cooperative should return excess payments received on the sale of farm products. The refund should be based on each patron's proportionate volume of business with the cooperative.

The cooperative is only a means to an end. Member investment provides marketing or purchasing facilities for farmers. It is not designed to generate returns on investment. Therefore, payments for the use of capital should be restricted.

Cooperatives' progress and development should be protected and advanced by constant education. The duty to educate cooperative members and the public about goals and methods of cooperative enterprise is viewed as a special obligation of cooperatives.

Benefits of cooperative operation have been pursued beyond the local level to the regional, national, and even international scale. Individual cooperatives often combine to form associations known as "federated" cooperatives, which are structured on the same cooperative principles.

This study, though at times referring to problems peculiar to federated cooperatives, focuses primarily on local or centralized cooperatives. As will become evident, the unique cooperative character strongly affects the nature of the financial instruments issued by all cooperatives, whether centralized or federated.

Overview

Agricultural cooperatives use assorted legal documents in dealing with members and third parties, many of which have financial consequences. Cooperatives usually enter into some type of purchasing contract with patrons in which producers agree to market designated portions of their product through the cooperative. Cooperatives will also contract to sell that product to a third party, and may enter into a commodity futures contract. Cooperatives that provide storage issue warehouse receipts and scale tickets. Cooperatives also execute documents providing security for obligations incurred, including security agreements, financing statements, and real estate mortgages.

Though each of these documents can affect a cooperative's economic status, they are not the means by which the cooperative is financed. They may facilitate a cooperative's capital raising effort, either through members' equity contributions or incurrence of debt, but they do not represent the obligation or interest created. For this reason, they are not included in the definition of "financial instruments" used in this study, despite their importance in the cooperative setting.

Agricultural cooperatives issue a variety of financial instruments to fulfill differing needs. Instruments may be designed to set out terms of the member relationship, reflect an obligation to repay debt, manifest an ownership interest, or perform a combination of functions. Despite efforts to introduce a degree of uniformity, cooperatives still lack standard documents. A wide variety of financial instruments are used to fulfill similar functions. Further confusion is created by nonstandard terminology. As the subsequent discussion indicates, the same substantive document may be labeled differently by various cooperatives.

Generally, financial instruments issued by agricultural cooperatives fall into one of the following categories, and the discussion will examine them accordingly:

1. Membership certificate

2. Common stock

3. Preferred stock

4. Deferred Patronage Refunds

5. Per-Unit Capital Retains

6. Debt Instruments

7. Hybrids

Before examining the first two categories of financial instruments issued by cooperatives—membership certificates and common stock—it is helpful to understand the distinction between types of issuing cooperatives. It is also important to analyze reasons for the choice between membership and stock cooperatives. Under most State statutes, cooperatives have three choices of organization form to be adopted. First, a cooperative may be organized as an unincorporated association. Second, an organization may elect incorporation, but still choose to issue no stock. Finally, a cooperative may elect incorporation as a stock-issuing cooperative.

Unincorporated Associations Early cooperation was often begun by unincorporated associations. These associations encountered a variety of problems, in part because the unstructured form lacked both definition of authority and function, and a fixed term of existence. More importantly, members were threatened with potential unlimited liability for acts of the cooperative's agents. Unincorporated organizations are rarely used today. They may be used, often unwisely, if the group is small and services are limited in number and complexity, or the cooperative is still in the formative stages and wishes to avoid organizational costs.

Incorporated Associations Reasons for cooperative incorporation are those traditionally cited for any business—limited liability, continuity of existence, centralization of management, pooling of capital. Of these, limited liability appears to be the most significant factor. What is not so clear are the reasons for the decision to operate as a stock or nonstock (membership) cooperative. Stock cooperatives issue shares of stock to members while nonstock cooperatives generally indicate membership by a form of document such as a membership certificate. A choice must be made early in the formative process. Because 78 percent of cooperatives choose to issue stock,[3] there is obviously a strong inclination toward the stock cooperative,[4] but reasons cited often do not withstand scrutiny.

One argument frequently advanced to support a stock decision is that members will have greater protection from liability. In reality, however, both forms of incorporation result in the same degree of protection, whatever that protection may be in a particular jurisdiction. Sixty-four of eighty-six State statutes[5] say members are not liable for cooperative debts beyond sums remaining unpaid on membership fees or subscription to stock. No line is drawn between stock and nonstock corporations. Furthermore, one noted authority states:[6] "Even if the statute is not clear, the courts have taken the position that no distinction as to limited liability is to be drawn between the stock and nonstock cooperative."

A second argument in support of stock issuance is the suggestion that stock is readily transferrable—a reflection of the ease of transferring corporate shares. The argument is not persuasive. Transfer of shares of cooperative stock will normally be subject to strict limitation, such as a limitation on transfer only to producers or first refusal rights

---

[3]E. Roy, *Cooperatives: Development, Principles and Management* 344 (1981).

[4]For the viewpoint that there is a trend away from the stock decision, at least in California, see F. Kerner, *Securities and Capital Structures of Farmer Cooperatives in California*, 19 Hastings L.J. 309 (1968).

[5]J. Baarda, Agricultural Co-op. Service, USDA, *State Incorporation Statutes for Farmer Cooperatives 68* (1982) [hereinafter cited as State Inc. Stats.].

[6]I. Packel, *The Organization and Operation of Cooperatives* 198-199 (1970).

exercisable by the cooperative. Ease of transfer of both nonstock membership rights and of stock will depend equally on State statutes, articles and bylaws.[7]

A third argument in favor of stock also involves a conceptual carryover from general corporate experience. The stock form is somehow thought to facilitate raising capital by a large stock offering. Due to lack of investment incentives and restrictions on transfer, however, cooperatives' common stock enjoys a limited market and will normally be issued to the same persons willing to pay a membership fee. Even preferred stock with superior rights to dividends is not usually an attractive investment. Indications are that capital is raised as easily by either stock or nonstock cooperatives.[8]

Nor do other arguments favor stock choice. No distinction is generally drawn between stock and nonstock cooperatives for antitrust exemptions,[9] tax treatment,[10] or eligibility to borrow from Banks for Cooperatives.[11]

In fact, nonstock or membership cooperatives may enjoy certain

---

[7]*See* I. Packel, *supra* note 6 at 99-100, where the author discusses restrictions on transfer of cooperative stock.

[8]Farmer Coop. Serv., USDA, *Legal Phases of Farmer Cooperatives*, 30 (1976) [hereinafter cited as *Legal Phases*].

[9]*See* Capper-Volstead Act, 7 U.S.C. §§291-2 (1982). Capper-Volstead specifically grants both stock and nonstock cooperatives certain special antitrust treatment. The previously enacted Clayton Act, Ch. 323, §6, 38 Stat. 730, 731-32 (1914) (current version at 15 U.S.C. §17 (1982)) granted the limited exemption from antitrust liability only to nonstock organizations. This limitation in the Clayton Act was a major impetus for enactment of the Capper-Volstead Act.

[10]Subchapter T of the Internal Revenue Code (26 U.S.C. §§1381-1388 (1982)), which governs the federal income tax treatment of cooperatives, makes no distinction between the two. *See also* 26 U.S.C. §521(b)(2) (1982), which provides the tax exemption granted farmer's cooperatives under 7 U.S.C. §521 shall not be denied because the organization has capital stock, if the dividend rate on such stock does not exceed the legal rate of interest in the state of incorporation or 8 percent per annum, whichever is greater, and if substantially all such stock is owned by producers who market their product or purchase supplies through the cooperative.

[11]*See* 12 U.S.C. §2129 (1982); *See also*, *Legal Phases*, *supra* note 8 at 527

advantages. Stock certificates need not be printed, nor stock transfers recorded on cooperatives' books, though this advantage is probably of little significance. A franchise tax advantage may also exist if the tax is based on stock issued. As a practical matter the choice will probably be the one with which the incorporators or their attorneys are most familiar, with some prejudice in favor of stock issuance. At least one attorney has specifically recognized the significance of custom and familiarity in making the decision.[12]

If a cooperative chooses to incorporate but operate without stock, the membership relationship with its patrons will be evidenced by a membership certificate. If a cooperative chooses to operate with stock, however, a further question may arise as to which stockholders are entitled to exercise membership rights. The State statute may specifically provide that holders of stock become members,[13] or courts may hold that every holder of common or preferred stock is a member. However, in rare instances membership rights may be divided. For example, under Wisconsin statute,[14] a cooperative incorporated with capital stock may designate only certain classes of stock as membership stock. Members, not necessarily all of the shareholders, are entitled to vote. Cooperatives customarily handle the problem by creating two classes of common stock, or one of common and one of preferred stock, and issuing one to members only. When that class votes, it conceptually votes as members rather than shareholders.

Membership Certificate

Terminology The first instrument analyzed is the membership certificate issued by nonstock cooperatives. Though it may be difficult conceptually to characterize this instrument as "financial", it creates financial rights and will be so classified. It is important to distinguish

---

[12]Nieman, *How to Start and Dissolve a Co-op.*, 2 Nat'l Symp. on Coops. and the Law, 126 (April 22-24, 1975).

[13]*State Inc. Stats.*, *supra* note 5, at 63 and table 10.01.

[14]*See* discussion in Nieman, *supra* note 12, at 125. Wisc. Stat. Ann. 185.05(1)(g) (1957) requires that cooperative articles designate which classes of stock are membership stock. Sec. 185.11 sets out the rules on membership acquisition.

terms used for member relationships evidenced by this certificate. These are "agreement," "interest," "certificate," "fee," and "application."

Membership Agreement The relationship of member to cooperative is basically founded on contract. The two enter into a legal relationship by which each promises to render some performance to the other. In a marketing cooperative, the cooperative agrees to purchase members' products outright, or act as members' representative in their marketing. In a supply cooperative, the cooperative agrees to purchase supplies on behalf of the membership. In either case, the member agrees to support the cooperative financially according to the terms of the agreement. Whether a contract of agency or purchase is created is often litigated,[15] but the relationship is basically contractual in nature. This agreement establishes the relationship between the cooperative and its members. In actual practice, the term "agreement" is generally used to refer to the actual document committing the member to market goods through the cooperative—the marketing contract. However, in this study "marketing contract" will represent the document binding members to sell their goods through the cooperative, while "agreement" will describe the entire legal relationship between the parties.

Membership Interest "Membership interest" should be more narrowly construed. It represents the interest in cooperative assets members acquire under the membership agreement. That interest is the subject of much litigation and depends on definitions in cooperative documents, if any, and on case law discussed subsequently in this study.

Membership Certificate The "membership certificate" is the paper evidence of the member relationship issued by the cooperative. It is generally simple in form and short.[16] It may say only that the named

---

[15]*See, e.g.*, *Buford v. Florin Fruit Growers' Assn.*, 210 Cal. 84, 291 P. 170 (1930); *California Bean Growers Assn. v. Williams*, 82 Cal App. 434, 255 P. 751 (1927); *Texas Farm Bureau Cotton Assn. v. Stovall*, 113 Tex. 273, 253 S.W. 1101 (1923); *Associated Fruit Co. v. Idaho-Oregon Fruit Growers' Assn.*, 44 Idaho 200, 256 P. 99 (1927).

[16]For an example of a membership certificate form, see the sample in *Legal Phases*, *supra* note 8, at 589.

person is a member of the cooperative and entitled to all rights, benefits, and privileges of the association.[17]

Membership Fee and Membership Application The "membership fee" is the amount paid for membership privileges. If not paid, the member remains liable for any amount unpaid.[18] "Membership application" is the form signed and submitted by a prospective member requesting admission to the cooperative. It may incorporate the agreement to market the applicant's agricultural products through the cooperative for some designated time—the marketing contract. Sample legal documents promulgated by USDA include a marketing contract.[19]

Acquisition of Membership A person must generally complete the membership application and pay the requisite membership fee to become a member of a nonstock cooperative. The application is reviewed by the board of directors and, if approved, a membership certificate is issued. Most State statutes provide for such certificates in nonstock associations.[20]

Membership fees may range from 25 cents[21] to as much as $1,000, but are generally quite low. They are usually viewed as incidental financing, perhaps covering only organizational expenses. Such fees are frequently used by marketing cooperatives in Western states and by service cooperatives. In 1976, nonstock membership fees represented

---

[17]In *Raulston v. Everett*, 561 S.W.2d 635, 639 (Tex. Civ. App. 1978), the court discussed the rights created by a membership certificate, stating that, "The certificate does not constitute the membership relationship; it is but the evidence of that relation."

[18]Most State statutes recognize members of incorporated cooperatives enjoy limited liability, but only to the extent exceeding the sum remaining unpaid on their membership fees or subscription to capital stock. *See State Inc. Stats., supra* note 5, at 68, table 10.06.03.

[19]*Legal Phases, supra* note 8, at 554-559.

[20]*State Inc. Stats., supra* note 5, at 66. This survey shows 50 of 86 statutory schemes provide for membership certificates for nonstock associations.

[21]*See, e.g., Attinson v. Consumer-Farmer Milk Cooperative*, 197 Misc. 336, 94 N.Y.S.2d 891 (1950).

only .5 percent of membership equity invested.[22] Though the application generally calls for cash payment, cooperatives may provide for payment from proceeds of sale of members' agricultural products. The membership fee is generally a one-time obligation, and the amount will usually be set out in articles or bylaws.[23]

Limitations on Ownership The initial grant and subsequent transfer of membership in an agricultural cooperative is nearly always subject to strict limitations. Limitations are rooted in cooperative principles of one vote per member and maintenance of control in the hands of agricultural producers. These principles are also reflected in statutes that apply particularly to agricultural cooperatives.

For example, antitrust exemptions in the Clayton Act[24] and Capper-Volstead Act[25] require that cooperatives be composed of producers. Rights to borrow from Banks for Cooperatives are also conditioned on producer membership.[26] Another area of concern is eligibility for favorable Federal income tax treatment. To qualify for limited exemption under Internal Revenue Code Section 521,[27] a cooperative must be "organized and operated on a cooperative basis." The statute requires that if the cooperative is a stock cooperative, substantially all common

---

[22]D. Cobia, J. Royer, R. Wissman, D. Smith, D. Davidson, S. Lurya, J. Mather, P. Brown, K. Krueger, Agricultural Co-op. Service, USDA, Research Report No. 23, *Equity Redemption: Issues and Alternatives for Farmer Cooperatives*, 116 (1982) [hereinafter cited as *Equity Redemption*].

[23]*State Inc. Stats.*, *supra* note 5, at 42, 53.

[24]15 U.S.C. § 17 (1982).

[25]7 U.S.C. §291 (1982); *See Case-Swayne Co. v. Sunkist Growers, Inc.*, 389 U.S. 384, *reh'g denied*, 390 U.S. 930 (1968), in which the Supreme Court considered the question of what constitutes a producer. The Court held an organization of orange growers was not entitled to the status of a qualified cooperative under the Capper-Volstead Act composed of "persons engaged in the production of agricultural products" because approximately 15 percent of its members were so-called agency associations which only processed fruit for producers. *See also National Broiler Marketing Assn. v. United States*, 436 U.S. 816 (1978), in which the Supreme Court held inclusion of even one nonfarmer disqualified a cooperative from Capper-Volstead Act protection.

[26]12 U.S.C. § 2129 (1982); *Legal Phases*, supra note 8, at 527-28.

[27]26 U.S.C. § 521 (1982).

stock must be held by producers.[28] However, Internal Revenue Service (IRS) has indicated in one Private Letter Ruling that the "substantially all" test is not applicable to membership cooperatives not having capital stock.[29]

Therefore, it is common to find transfer of the membership interest prohibited completely, or at least subject to restrictions such as board approval or cooperative first refusal rights. Such restrictions must usually be clearly stated in cooperative articles or bylaws, and should also be included in the membership certificate itself.

Rights on Acquisition Typical membership certificates state that applicants are entitled to all privileges and benefits of membership upon admission. This includes the right to vote. Cooperatives are usually structured to protect each member's right to an equal vote. This structure is based on both cooperative principles and statutory requirements. For example, I.R.S. at one time indicated that to be "operating on a cooperative basis" for purposes of both Subchapter T Federal income tax deductions and Section 521 treatment a cooperative should operate on a one-person, one-vote basis.[30] Qualification for partial antitrust exemption under the Capper-Volstead Act[31] may also depend on voting rights. In addition to other restrictions, the Capper-Volstead Act requires that either no member of the association has more than one vote because of the amount of stock or membership capital owned, or that dividends be restricted to 8 per-cent per annum. A similar limitation is set for eligibility to borrow from Banks for Cooperatives.[32]

One variation in voting rights that would still meet the Capper-Volstead test is vote according to the amount of product currently

---

[28]26 U.S.C. § 521(b)(2) (1982).

[29]PLR 7814002. See discussion in 229-2nd T.M., *Taxation of Agricultural Cooperatives*, A-4 (1984).

[30]*See* discussion *Id.*, at A-19.

[31]7 U.S.C. § 291 (1982).

[32]12 U.S.C. § 2129(a) - (b) (1982).

handled by the cooperative. The vote may, for example, require a majority of membership votes plus a majority of votes based on units (boxes, tons) marketed to balance rights of high-volume members. Weighted voting is specifically authorized by some statutes.[33]

Members have other rights traditionally accorded members in an association. These include the right to use association facilities and services for association purposes, and to share in assets on dissolution.

Return on Investment Return on membership fees consists of the right to market products through the cooperative, not monetary gain. Financial benefit comes in the form of better prices from marketing strength and efficiencies of scale. The fee is the price paid for these benefits. Therefore, no interest or "dividend" is generally paid on the membership fee, in contrast to certain other financial instruments issued by a cooperative. However, an occasional case has used the term "dividend." In *DeMello v. Dairyman's Cooperative Creamery*, for example, the court stated, "[E]ach member paid $100 for his membership and was paid a so-called dividend, not to exceed 8%, or $8 per annum."[34] This amount was deducted from net margins at the close of the accounting year before the balance was divided among patrons on the basis of patronage. Such a return on the basis of the membership fee itself is rare, however.

Cooperative bylaws may provide that membership fees are without monetary value and will be forfeited on membership termination.[35] It is common to find forfeiture for breach of the marketing contract.[36] The membership fee is not considered a cooperative debt unless a specific

---

[33]Voting power based on amount of business done with the cooperative is specifically noted in twelve State statutes. *See* discussion in *State Inc. Stats.*, *supra* note 5, at 73, and table 11.01.

[34]*DeMello v. Dairyman's Co-op. Creamery*, 73 Cal. App. 2d 746, 167 P.2d 226, 226 (1946).

[35]*See Sanchez v. Grain Growers' Assn.*, 123 Cal. App. 3d 444, 176 Cal. Rptr. 655 (1981), *reh'g denied*, 126 Cal. App. 3d 665, 179 Cal. Rptr. 459 (1981).

[36]*See, e.g.*, *Buford v. Florin Fruit Growers' Assn.*, 210 Cal. 84, 291 P. 170 (1930); *California Bean Growers' Assn. v. Rindge Land & Navigation Co.*, 199 Cal. 168, 248 P. 658 (1926).

provision so states. However, the cooperative may provide for membership fee refund at withdrawal[37] or on dissolution.[38] Absent a provision to the contrary, fees are part of the cooperative's assets and will be shared by members at dissolution.

Securities Regulation Issues An agricultural cooperative issuing any type of financial instrument should be concerned with Federal and State securities law. The Securities Act of 1933[39] imposes detailed filing requirements governing the offer of securities for sale, while the Securities and Exchange Act of 1934[40] imposes reporting requirement on certain trading transactions. Compliance with these acts involves large expenditures for accounting services, legal advice, printing, and filing fees, as well as hidden internal costs to the cooperative itself.[41] Additional filing requirements may also be found in applicable State "blue sky" laws. The burden of registration makes agricultural cooperatives eager to fall outside the scope of these statutes. As of the early 1980's, fewer than 15 agricultural cooperatives had filed registration statements with the U. S. Securities and Exchange Commission.[42]

The initial question that determines if an agricultural cooperative must register is whether the instrument qualifies as a "security" within the meaning of the appropriate act. Even if it does, the cooperative may still be able to claim a statutory exemption.[43]

Statutory definition of a security under the 1933 and 1934 Federal acts

---

[37]*See, e.g., DeMello v. Dairyman's Co-op. Creamery, supra* note 34.

[38]*See, e.g., Southeastern Colo. Co-op. v. Ebright*, 38 Colo. App. 326, 563 p.2d 30 (1977), in which the cooperative bylaws provided for the return of $95 invested in a "certificate of interest," althrough the $5 "membership fee" was not returned.

[39]15 U.S.C. §§ 77a-77aa (1982).

[40]15 U.S.C. §§ 78a-78hh (1982).

[41]For a discussion of costs to the agricultural cooperative see Weiss, *Reasons for and Cost of Registration of Agricultural Cooperative Securities*, 1981-82 Agri. L.J. 201.

[42]*Id.* at 207.

[43]*See generally* 14 N. Harl, Agri. Law, ch. 136 (1985); Centner, *Retained Equities of Agricultural Cooperatives and the Federal Securities Acts*, 31 Kan. L. Rev. 245 (1983).

is very broad, but case law interpretation indicates it does not include instruments similar to typical cooperative membership certificates. In *United Housing Foundation v. Forman*,[44] the United States Supreme Court held that shares issued to purchasers in a cooperative housing project were not securities under Federal acts, even though designated "stock." The Court noted that the stock was not transferrable, could not be pledged or bequeathed, carried only one vote despite the number of shares held, and was issued for the sole purpose of enabling the purchaser to occupy an apartment. The Court recognized that purchasers were seeking certain economic benefits as opposed to profits, and therefore held that the stock did not fall within the statutory definition of a security.

Even if a financial instrument is classified as a security, a cooperative may claim the benefit of available exemptions. The 1933 Act sets out a variety of transactional exemptions available to all issuers[45], as well as a specific exemption for any security issued by "a farmer's cooperative organization exempt from tax under Section 521 of Title 26" of the United States Code.[46] Thus, if a cooperative qualifies for Section 521 status, its securities also qualify for registration exemption.[47]

The 1934 Act also provides an exemption for certain agricultural cooperatives. Securities issued by a "cooperative association" as defined in the Agricultural Marketing Act of 1929[48] are exempt from registration.[49] To qualify as a "cooperative association" under the Agricultural Marketing Act a cooperative must either base voting on some standard other than capital ownership, limit dividends paid on stock or membership capital to 8 percent per annum, or both. In addi-

---

[44]*United Housing Foundation v. Forman*, 421 U.S. 837 (1975).

[45]For a discussion of these exemptions as related to the agricultural cooperative see 14 N. Harl. Agri. Law ch. 136.02 (3) (1985).

[46]15 U.S.C. § 77c(a)(5)(B)(i) (1982).

[47]Statistics show less than half of existing cooperatives qualify for the §521 exemption.

[48]12 U.S.C. §§ 1141 - 1141j (1982).

[49]15 U.S.C. § 781(g)(2)(E) (1982).

tion to certain other requirements, the cooperative is also prohibited from conducting nonmember business in an amount exceeding member business.[50]

It is also common for State securities laws to recognize some type of exemption for farmer cooperatives. Forty-two States give farmer cooperatives some special status, ranging from complete exemption to limited exemptions for very restricted financial instruments.[51]

Even if an agricultural cooperative is exempt from registration, it is still subject to antifraud provisions of both the 1933 and 1934 Acts, and possibly State law as well. An offer for sale of a security using a device, scheme or artifice to defraud would violate securities statutes.

Common Stock

If cooperatives choose to incorporate as stock cooperatives, they will issue shares of stock. Stock may consist of common stock only, perhaps of multiple classes, or of common and preferred stock. Membership rights may be restricted to a particular stock class.

Stock issued by an agricultural cooperative shares some characteristics with conventional corporate stock. These include possible division into common and preferred classes, a par value, shareholder liability for unpaid purchase price, and void overissued shares.[52] However, many characteristics of common stock issued by agricultural cooperatives eliminate the investment motive associated with conventional corporate stock purchases. Dividends are limited or nonexistent, transfer is restricted, and voting control is usually impossible to acquire. Opportunities for capital gains may be nonexistent.

Cooperative financial instruments reflect the unique nature of the agricultural cooperative. Purchase of common stock is not intended to

---

[50]12 U.S.C. § 1141j(a) (1982).

[51]*See* J. Baarda, *Farmer Cooperative Exemptions in State and Federal Securities Laws: Compilation of Statutory Provisions* (Nov. 1983, rev. April 1984).

[52]As to void unissued shares, *See Graf v. Neith Co-op. Dairy Products Assn.*, 216 Wisc. 519, 257 N.W. 618 (1934).

generate profit for a stockholder, but enables a cooperative to finance facilities for the holder for sale and purchase of products. As one writer explains: "By limiting the return on capital, (member equity), the obvious benefits come from patronage usage—not capital invested, from the goods and services at cost—not large profit rewards for equity capital, and from democratic membership control—not. . . a small group of large investors interested in maximizing their return on investment."[53]

Acquisition State cooperative statutes generally require articles of incorporation to state the number and par value of shares authorized to be issued by a cooperative. This general corporate rule was adopted in the Standard Cooperative Act[54] that provided the model for many State statutes.[55] An unauthorized share is void.[56] The stockholder generally acquires his initial share of the common stock authorized by the articles by simple purchase at stated par value. Par values are usually low—ranging from $1 to perhaps $100.[57] The lower the par value, it is believed, the faster patrons can become shareholder-members. Low par value also eases transfer and redemption. Purchase of common stock is generally a prerequisite to membership rights. The requirement is strictly enforced, and failure to pay for stock may bar a shareholder from participating in available refunds.[58]

---

[53]Beall & Homestead, *Legal and Financial Foundation*, vol. 32, No. 3 Cooperative Accountant 31, 33 (Fall 1979).

[54]From 1921 to 1928, 39 State legislatures adopted the Standard Cooperative Marketing Act, an agricultural cooperative incorporation statute developed by California attorney Aaron Sapiro; *See Equity Redemption*, *supra* note 22, at 117.

[55]For statutory references to capital stock, *see State Inc. Stats.*, *supra* note 5, at 41 and Table 8.03.10.

[56]*See Graf v. Neith Co-op. Dairy Products Assn.*, 216 Wisc. 519, 257 N.W. 618 (1934).

[57]*See, e.g.*, *Evanenko v. Farmers Union Elevator*, 191 N.W.2d 258 (N.D. 1971) ($100); *Lambert v. Fisherman's Dock Co-op.*, 115 N.J. Super. 424, 280 A.2d 193 (1971); *modified*, 61 N.J. 596, 297 A.2d 566 (1972) ($50); *Hood River Orchard Co. v. Stone*, 97 Or. 158, 191 P. 662 (1920) ($1); *Bessette v. St. Albans Co-op. Creamery*, 107 Vt. 103, 176 A. 307 (1935) ($10).

[58]*See, e.g.*, *Farmers Truck Assn. v. Strawberry & Vegetable Auction*, 163 So. 181 (La. Ct. App. 1935).

If cooperatives use common stock to reflect capital retained by the cooperative from sale of members' product, the bulk of common stockholdings will be acquired by members' use of the cooperative. A cooperative will retain an agreed amount of margins generated by sale of agricultural products, and will issue a proportionate amount of stock to evidence a member equity investment. The stock will then be redeemed at some future date at the discretion of the board of directors. As will be subsequently discussed, equity retirement involves serious questions of policy and economics whether equity is retained in the form of common stock, preferred stock, or some other type of equity certificate.

Limitations on Issuance For the same reasons applicable to membership certificates, restrictions are normally placed on issuance and transfer of common stock in an agricultural cooperative. Limitations are often designed to protect equal voting rights, keep control of the cooperative in the hands of agricultural producers, or comply with statutory requirements. It is common to find limitations on the amount of common stock an individual may own. The State statute may specifically limit the purchase to some number (1, or perhaps 5), dollar value (e.g. $1,000) or percentage level (usually 5, 10, or 20%), and authorize further restriction in the bylaws.[59]

A second common restriction on common stock ownership is a requirement that purchasers be eligible for membership.[60] By definition this usually means the purchaser be a farmer—an agricultural producer who markets product through the cooperative. If unqualified persons come into possession of common stock, they cannot exercise membership rights, though they may be entitled to a return of the price paid.[61]

Limitations on transfer should be stated not only in articles or bylaws, but on share certificates as well. Controlling State statutes often require that transfer limitations be printed on the certificate.[62]

---

[59]*State Inc. Stats.*, *supra* note 5, at 108-9.

[60]*See, e.g.*, *Carpenter v. Dummit*, 221 Ky. 67, 297 S.W. 695 (1927); *Evanenko v. Farmers Union Elevator*, *supra* note 57.

[61]*Id.*

[62]*State Inc. Stats.*, *supra* note 5, at 66.

Number of shares held will not be limited if common stock is a true capital-raising device. In that case, cooperatives encourage the purchase of many shares, and might even have a minimum shareholding requirement as a condition of membership. If a cooperative is in a strong enough financial position, it may require share purchases as a condition of continuing membership. Some cooperatives encourage stock purchase by basing volume of business that may be done with the cooperative on the number of shares held. Common stock may also be offered for sale to the general public; however, this is rarely done and may present securities law problems.

Limitations on Transfer Before examining common stock transfer restrictions, it is useful to inquire why a person may want to acquire such stock. A few courts have recognized the lack of a market for cooperative stock because it provides no return on investment.[63] Valuation is often controlled by statute, articles, or bylaws. It would seem a poor choice for investors. The answer is that the transferee is often either a speculator or a creditor seeking a producer's asset. Creditors may prefer to have stock with redemption potential rather than nothing at all.

Any transfer must comply with generally substantial restrictions imposed by the cooperative. Limitations are of several types. First, transfer may be totally prohibited. Despite objections that such provisions are unreasonable restraints on alienation of property, transfer limitations are authorized by many States.[64] Second, the transferee may be required to meet standards for initial issuance of the stock, including numerical limitations and number status. Third, certain procedures may be required that could thwart the transfer. Common provisions require either board approval of proposed transfer or grant right of first refusal to the cooperative.[65] Further, as in conventional

[63]*See, e.g., Whitney v. Farmers' Co-op. Grain Co.*, 110 Neb. 157, 193 N.W. 103 (1923).

[64]For a discussion of the statutory restricting on transfer of common shares, *See State Inc. Stats., supra* note 5, at 69, Table 10.08.04.

[65]*See, e.g., Stuttgart Co-op. Buyers Assn. v. Louisiana Oil Refining Corp.*, 194 Ark. 779, 109 S.W.2d 682 (1937) (exclusive right of repurchase by cooperative); *Bessette v. St. Albans Co-op. Creamery*, 107 Vt. 103, 176 A. 307 (1935) (first refusal to cooperative).

corporations, some administrative procedure such as transfer of stock on organization books and notation of the assignment on the certificate may be necessary.

Though such restrictions on transfer were once thought to be arbitrary and unreasonable restraints on alienation, they have been upheld by courts if reasonable in the commercial setting for which they are designed. Approving restrictions on transfers, the Kentucky Supreme Court in *Carpenter v. Dummit* stated:

"The success of a cooperative marketing association such as the one here involved must depend upon the loyalty of its members and their interest in its success. To permit the sale of its stock to persons not interested in cooperative marketing, and possibly unfriendly thereto, would render it possible to defeat the very purpose which it was organized to accomplish.[66]"

Securities Regulation Issues Securities issues raised by membership certificates apply equally to common stock issue. If stock is issued merely to reflect the membership relationship and provide a purchasing or marketing facility to members rather than generate a profit, the stock may not fall within the statutory definition of a security. Cooperatives may also be able to claim some statutory exemption.

Dividends Agricultural cooperatives usually have authority to declare dividends, within limits, on common stock issued. Amounts paid are generally fixed percentages and do not fluctuate in proportion to cooperative income. A maximum dividend rate on common stock is set by 57 State statutes,[67] ranging from 5 to 12 percent. Even under the more liberal statutes, cooperatives may impose additional restrictions to comply with certain Federal statutes. To receive favorable antitrust treatment under the Capper-Volstead Act,[68] for example, cooperatives must either base voting on some standard other than capital ownership

---

[66] *Carpenter v. Dummit*, *supra* note 60, 297 S.W. at 698-9 (1927).

[67] *State Inc. Stats.*, *supra* note 5, at 113.

[68] 7 U.S.C. §§ 291-2 (1982).

or limit dividends on stock to 8 percent per annum, in addition to other requirements. To qualify for Section 521 of the Internal Revenue Code,[69] the dividend rate may not exceed the greater of either 8 percent per annum or the legal rate of interest in the applicable state. Banks for Cooperatives borrowing eligibility also requires that dividends be limited to levels approved by the Farm Credit Administration.[70]

Other pressures for dividend limitations may also exist. It is clear that payment of any dividend is at the board of directors' discretion.[71] In light of cooperative philosophy emphasizing return based on patronage and not on investment, the boards' tendency is to keep dividends low, particularly when common stock was issued as equity investment to older members, now perhaps retired or deceased, while active younger members are pressuring the cooperative for larger patronage refunds.

Other considerations may encourage low dividend policies. If a cooperative is a non-Section 521 cooperative, dividends will be taxable at both cooperative and member levels, while patronage refunds would be taxed only once. Dividend payments may also require the preparation of many small checks. Finally, cooperative bylaws may limit or remove director discretion by providing dividends cannot be paid in certain circumstances (e.g., until a certain reserve is accumulated).

Statistics indicate low dividends are the normal rule. Two-thirds of United States cooperatives paid no dividends in 1976,[72] and the percentage of net margins paid as dividends by the top 100 cooperatives was only 2.6 percent of the total distributed in 1983.[73]

---

[69]26 U.S.C. § 521 (b)(2) (1982).

[70]12 U.S.C. § 2129 (1982).

[71]*See, e.g.*, *Collie v. Little River Co-op.*, 236 Ark. 725, 370 S.W.2d 62 (1963); *Driver v. Producers Co-op.*, 233 Ark. 334, 345 S.W.2d 16 (1961); and *Schmeckpeper v. Panhandle Co-op. Assn.*, 180 Neb. 352, 143 N.W.2d 113 (1966).

[72]*Equity Redemption*, *supra* note 22, at 16.

[73]Agricultural Coop. Serv., USDA, *Top 100 Coops., 1983 Financial Profile* 11 (Sept. 1984) [hereinafter cited as *Top 100 Cooperatives*].

Rights to dividends may be forfeited by members. Failure to pay debts owed the association, or breach of a marketing contract could cost members rights to declared dividends.

Voting Rights Holders of common stock issued by an agricultural cooperative are usually entitled to only one vote, regardless of the number of shares held. Fifty-six of 85 State statutes surveyed by USDA in 1982 limit individual members' voting power to one vote.[74] This reflects cooperative principles and complies with certain Federal and State[75] statutes. If stock is issued to nonmembers, some device is needed to separate members from nonmembers for purposes of exercising voting rights.

Redemption The majority of State statutes authorize cooperatives to repurchase their common stock.[76] Redemption price is usually set at par value rather than market value. While repurchase provisions are usually optional—cooperatives "may" make such a purchase—several State statutes require common stock repurchase in special circumstances, such as when the board rejects a proposed transferee or has expelled a member. Statutes may also impose a time limit on payment, or prohibit purchases that place a cooperative in financial difficulty.[77]

The program adopted by a cooperative will vary depending on the common stock issue's purpose. If stock is issued to establish membership, redemption will take place only upon termination of membership rights. However, if common stock is issued to reflect equity invested through business done with the cooperative, some type of revolving repurchase program should be adopted to retire investment periodically. The need for such revolving programs and the inadequacy of

---

[74]*State Inc. Stats.*, *supra* note 5, at 73.

[75]Voting rights may be restricted to receive favorable antitrust treatment under the Capper Volstead Act, 7 U.S.C. §291-2 (1982), which requires the cooperative to restrict voting rights to one vote per member or limit dividends on stock to 8 percent, in addition to other requirements. Also, to be eligible to borrow from Banks for Cooperatives, no member of an association may be allowed more than one vote because of the amount of stock or membership capital he may own. [12 U.S.C. §2129 (1982)].

[76]*State Inc. Stats.*, *supra* note 5, at 117.

[77]*Id.*

current efforts to establish them have been repeatedly emphasized. The same problem occurs regardless of the form of equity investment, whether common stock, preferred stock, deferred patronage refunds or per-unit capital retains.

Preferred Stock

The amount and character of preferred stock to be issued must, like common stock, be authorized by articles of incorporation. State statutes generally give cooperatives wide latitude to establish dividend rates, preferences and ownership requirements. Preferred stock issued by an agricultural cooperative has many characteristics of conventional corporate issues. Most State statutes require that the stock's characteristics be stated in the articles to give purchasers notice of rights to which they are entitled. This will usually include dividend preferences, rights at dissolution, and maximum dividend rate. Any restrictions on transfer, voting rights, or redemption rights by the cooperative must also be stated. Typically a single class of preferred stock will be issued, but preferred stock can be divided into series and classes as with conventional corporate preferred stock.[78] Shareholders' preferred rights are evidenced by preferred stock certificates.

Acquisition Preferred stock is used to raise revenue to a greater degree than common stock. Acquisition may therefore be by purchase at par value, usually ranging from $10 to $100. The stock is structured for somewhat greater appeal to investors than other cooperative financial instruments, reflected by the fact that 21.7 percent of equity invested in the top one hundred cooperatives in 1983 was in the form of preferred stock.[79]

As with common stock, however, preferred stock is usually issued to reflect equity retained by a cooperative. Therefore, a member, or even a nonmember, may acquire large amounts of preferred stock simply by patronizing a cooperative, creating the same redemption problems associated with patronage based common stock. Cooperatives may also

---

[78] *See, e.g., Carpenter v. Dummit, supra* note 60.

[79] *Top 100 Cooperatives, supra* note 73, at 7. These calculations are based on figures in Table 2.

require exchange of common stock for preferred stock at some event such as cessation of patronage.

Limitations on Ownership Because preferred stock may be oriented toward raising capital, not creating membership rights, it generally has fewer restrictions on issuance and transfer. Cooperatives usually limit common stock purchase to members, but permit issuance of preferred stock to nonmembers. This practice is recognized by Federal statutes with which cooperatives might be concerned. For example, holders of preferred stock are not required to be producers by Section 521 of the Internal Revenue Code if their participation in association profits is limited to fixed dividends.[80]

Unlimited transfer increases whatever limited marketability such preferred stock may have. Though restrictions on transfer similar to those imposed on common stock may still be found, they are now generally regarded as the exception.

Return on Investment As with common stock, preferred stock will not likely enjoy any significant market appreciation. Cases specifically recognize its lack of marketability.[81] This is due to several factors, not all unique to cooperatives, that make it unattractive to an outside investor. First, though preferred stock may enjoy a dividend preference, dividends are often limited by statute to submarket levels, and payment is at the board of directors' discretion. Second, preferred stock has no maturity date, so its redemption is also at the board's discretion. Third, preferred stock is usually redeemable by the cooperative at par value, which means no incentive for purchases over that value. Finally, it normally lacks voting rights.

The result is that preferred stock issued by many cooperatives is purchased by members as a demonstration of member support, despite efforts to encourage preferred stock financing by the general public to strengthen cooperatives' financial structure.[82]

---

[80]26 U.S.C. § 521 (1982).

[81]*See Collie v. Little River Co-op.*, *supra* note 71.

[82]*See generally*, Evans, *Financing Alternatives*, Vol. 34, No. 3 Cooperative Accountant 32 (Fall 1981).

Preferred stock dividends are usually subject to State statutory limits that hold yields to what has been characterized as "well below market rates."[83] These limits usually apply to common and preferred stock, so State statutes must be examined to determine maximum rates. Buyers must also consider Federal restrictions cooperatives must observe under various Federal statutes, which were discussed previously in regard to common stock.

Though preferred shareholders will receive dividends before return to common shareholders, dividend declaration is at the discretion of the board of directors. Further, dividends are usually noncumulative. If not declared in the current year, therefore, rights to such dividends are lost.

Securities Regulation Issues Securities concerns raised by the issuance of membership certificates and common stock are even greater for preferred stock, which does not represent the membership relation. If preferred stock is issued to reflect equity invested by members, it is arguable that it does not qualify as a security because its purpose is to provide a purchasing or marketing facility rather than generate profit. If stock is sold to the general public as a revenue-raising device, however, this argument is much weaker. Cooperatives may therefore be forced to rely on an exemption, or may choose to register. An issue of preferred stock is therefore more likely to be registered than other equity instruments discussed in this study.[84]

Voting Rights Holders of preferred stock in an agricultural cooperative generally have no right to vote on ordinary cooperative issues, though they may have voting rights on designated special matters. Voting rights are restricted to holders of common stock, as in a noncooperative corporation, or to the holders of membership certificates. The cooperative is not designed to apportion votes according to equity invested.

---

[83]Gideon, *Report of Subcommittee on New Developments Regarding Capital and Financial Structure of Cooperatives*, Vol. 34, No. 2 Cooperative Accountant 63, 63 (Summer 1981).

[84]*See* Weiss & Crosland, *Fact vs. Fiction in Regulation of Agricultural Cooperative Securities*, Vol. 31, No. 1 Cooperative Accountant 12, 19 (Spring 1978).

Redemption Preferred stock generally has no maturity date. Therefore, as in noncooperative corporations, redemption is at the board's discretion. Redemption problems that plague cooperatives for common stock and patronage retains are equally troublesome with preferred stock under these circumstances.

Preference at Dissolution Limited investment incentive and other restrictions may make preference at dissolution the only real benefit preferred stockholders enjoy. On dissolution preferred stockholders will be entitled to distribution of their investment prior to distributions to common shareholders, if assets remain to satisfy either.

Deferred Patronage Refunds

Description Agricultural cooperatives are designed to serve producers at cost to the cooperative. Because operating costs cannot be estimated with certainty, cooperatives need sufficient margins to ensure they will cover expenses for the coming year. They need operating funds in addition to capital invested as membership fees and stock purchases. These additional funds are generated from cooperative business operations. Cooperatives keep for their use a portion of the money generated by sale of products (or savings generated by purchases in a supply cooperative). The excess of these margins over costs of doing business are then returned to patrons as ''patronage refunds'' in proportion to business done. Cooperatives thus return profit to members according to basic cooperative principles.

This additional cooperative capital generation involves three steps. First, some net margin must be realized. In a marketing cooperative, a cooperative must have generated profit by selling farmers' products at prices greater than costs, including amounts already advanced to patrons. In a supply cooperative, a cooperative must have purchased materials at a price lower than that charged to patrons, after adding its costs of operation.

The second step involves allocation of net margins to the patrons. Some portion of the margins may be set aside under the bylaws for a variety of purposes, such as the payment of dividends or the creation of a surplus fund for other purposes. The remainder will be allocated to the individual accounts of the patrons based on business done with the cooperative during the fiscal year.

In the third step, a cooperative must decide how these net margins are to be distributed. Distribution may be partly as a cash patronage refund, and partly in some form of book allocation or equity certificate representing "deferred" patronage refunds retained by the cooperative. Deferred patronage refunds retained by the cooperative are in reality patron equity investment. They finance not only ongoing operation but investment in land, plant and working capital. Refunds are retained well beyond the accounting cycle in which they are generated, perhaps indefinitely. Equity in the form of deferred patronage refunds represents the greatest percentage of equity investment in cooperatives—31.9 percent for the top 100 cooperatives in 1983.[85]

Calculation Cooperative bylaws usually contain at least general directions to determine and distribute net margins to patrons.[86] Sample bylaws promulgated by Agricultural Cooperative Service, for example, state: "To assure that the association will operate on a service-at-cost basis the association is obligated to account on a patronage basis to all its patrons for all amounts received from the furnishing of these services in excess of operating costs and expenses properly chargeable against the type of service furnished."[87]

Even more specific terms may be in bylaws or marketing contracts between the cooperative and its members. One calculation issue that frequently arises, for example, is whether the cooperative is entitled to pool the members products. One cooperative authority states:

"Generally considered, the pooling of products, expenses and receipts is valid in a cooperative provided the members have approved it in their bylaws or marketing contracts. The contracts usually state whether the products will be pooled and what options are open to the members. Unless an association is given the authority to pool its

---

[85]*Top 100 Cooperatives*, *supra* note 73, at 11.

[86]*State Inc. Stats.*, *supra* note 5, at 60. The writer indicates 33 State statutes require the bylaws to give some general direction on determination and distribution of net margins to patrons.

[87]*Legal Phases*, *supra* note 8, at 578.

members' products, it cannot do so legally.''[88]

Bylaws and agreements usually give boards of directors some degree of discretion. Calculation may vary depending on commodity involved,[89] but will be based on some formula related to patronage volume.

Decisions on pooling, allocating losses and accounting matters are generally tested by the business judgment rule, so absent fraud or unfairness, the board is granted some leeway to make decisions regarding net margins determination and allocation.

Distribution of Refunds Cooperatives may distribute patronage refunds in many forms. The choice most desirable to patrons (if the cooperative could still exist) is generally cash, and cooperatives may pay the entire refund in cash. A cash refund will be taxable to the patron but deductible by the cooperative if it meets the tests of Subchapter T of the Internal Revenue Code.[90] Few cooperatives are in a financial condition to pay completely in cash. A cooperative will therefore probably distribute part of the refund in some other form. To deduct the entire amount for Federal income tax purposes, distribution must meet the requirements of a ''qualified written notice of allocation'' in Subchapter T.[91] This requires that at least 20 percent of the refund be paid in cash. Patrons must be notified in writing of the allocation amount and must either be entitled to redeem the remainder within 90 days or consent to include it in taxable income. Cooperatives generally pay a portion of the patronage refund in cash and the remainder in some other written form. The percentage of cash payment among commodity marketing cooperatives in 1976 ranged from 27 percent to 87 percent.[92] The top 100 cooperatives generally

[88]Baaken and Schaars, quoted in E. Roy, *supra* note 3 at 400. *See also* Note, *The Patronage Refund*, 35 Minn. L. Rev. 549 (1951).

[89]*See, e.g.*, *Money v. Farmers' Mercantile & Elevator Co.*, 133 Minn. 199, 164 N.W. 804 (1917); *Klein v. Greenstein*, 24 N.J. Super. 348, 94 A.2d 497 (1953).

[90]26 U.S.C. §§ 1381-88 (1982).

[91]26 U.S.C. § 1388(c) (1982).

[92]*Equity Redemption*, *supra* note 22, at 17.

pay a larger percent of their refunds in cash—50 percent in 1983.[93] Large cash refunds tend to attract new members but often disadvantage older members who would rather see older equity redeemed.

The form of the noncash portion of the refund will vary. It may consist of an entry on the cooperative's books, with notice to the patron of the amount allocated. Notice may be by written letter or attachment to the patronage check, and may be called a "book allocation," "book credit," "letter of advice," or "equity credit." Such uncertificated allocations are convenient—they are simple, may involve less paperwork, allow the cooperative member control over transfers, and look less like securities than other forms. In order for such notices to qualify as written notices of allocation for Subchapter T purposes, cooperatives must disclose to recipients the stated dollar amount allocated and the portion constituting the patronage refund, all within the statutory time.[94]

A second method to reflect retained patronage refunds is to issue a formal certificate. A cooperative may make ongoing book entries and issue a certificate at the end of the accounting year. This may be called an "equity certificate," "revolving fund certificate," or other term. The document generally designates to whom it is issued, states the amount of patronage refunds allocated to the holder, and includes identifying material such as account, series, and certificate numbers. It may include a general statement of terms relating to retirement, priorities, transfer, and interest.

Finally, an agricultural cooperative may elect to issue common or preferred stock to evidence patronage refunds. This method has frequently been used by cooperatives in the past but can lead to confusion about voting and redemption rights if rights are not adequately detailed in relevant documents.

Characteristics Deferred patronage refunds have some characteristics of corporate stock. They represent equity invested, have no due date for redemption, are generally subordinated to all other debts and obli-

---

[93]*See Top 100 Cooperatives*, *supra* note 73, at 11.

[94]26 U.S.C. § 1388(b) (1982).

gations of the cooperative, and are usually evidenced by some type of instrument. However, they generally do not earn dividends nor give holders voting rights, and are intended to be paid to patrons at some future date.

Such unique characteristics have caused difficulty in attempts to classify refunds. One writer has described them thus:

"If revolving fund credits or capital credits must be classified or characterized perhaps they can best be designated as hybrid securities. On an appropriate contractual foundation they are the net worth of the cooperative, and informed creditors so regard them. It would seem that although revolving fund credits have characteristics of both shares of stock and indebtedness, they are not properly designated as either; they are *sui generis*."[95]

Limitations on Ownership The reasons for restricting the issuance of membership certificates and common stock do not seem to apply to deferred patronage refunds. Control by member producers is not endangered because refunds carry no voting rights. There is therefore generally no requirement that they be issued to members only. Some cooperative observers, however, fear nonmember equity at least introduces a "noncooperative" element into cooperative financial structures, even if no formal control is granted.

The same observations are true of the transfer of such equity certificates. Cooperatives may impose procedural requirements such as notice if transfer is possible, but such equity is generally transferred only in rare cases.

Return on Investment A return or "dividend" on deferred patronage refunds is unusual. Cooperative principles dictate that members finance their cooperative and that returns on capital invested be limited. Some confusion is generated by terminology.

"Patronage dividend" is often used in cooperative legislation, IRS

---

[95]*See* Kerner, *supra* note 4, at 311, 315.

rulings, and elsewhere in place of "patronage refund." Such usage has been criticized because the amount paid is not a dividend on capital invested but a return of a portion of net margins generated by the member's business with the cooperative.[96]

A patron's deferred patronage refund investment generally cannot increase in value. Because no interest is usually paid, dollars left in the cooperative will in fact decrease in value by the time of redemption if inflation has occurred. Uncertainty about time of payment will undermine any marketability the refunds may have even if transferrable. If the cooperative has a strong redemption program, however, a creditor may be willing to take certificates by assignment, or as collateral for an obligation. Such a transfer probably will be sufficient to entitle creditors to refunds once declared by the cooperative, though insufficient to give creditors membership rights.

Retirement of Equity "Retirement" of deferred patronage refunds refers to cash payment for outstanding equity invested by patrons. Of the 86 general and agricultural cooperative incorporation statutes in the United States, none requires that cooperatives adopt a systematic redemption program.[97] Some of these State statutes have adopted what is termed a "discretionary" approach. This approach provides no rule for equity redemption or merely suggests rules the cooperative may apply at its option, in specific situations. These statutes generally require that redemption rules be stated in articles or bylaws, marketing contracts, allocation notices or the certificate itself. Other States have adopted a "mandatory" approach, but mandate payment only under such circumstances as the members' death, withdrawal, or expulsion. Mandatory statutes further give broad discretion to the cooperative to define the property interest to be retired and the method of valuation. Nearly 30 percent of the 857 reporting farmer cooperatives in a 1976 USDA study had no equity redemption program. Another 39 percent redeemed equity only at certain specified events, such as death.[98]

Agricultural cooperatives' failure to retire outstanding equity to

[96]*See, e.g.*, M. Abrahamsen, *Cooperative Business Enterprise* 310 (1976).

[97]*See generally Equity Redemption*, *supra* note 22, at 112-26.

[98]*Id.* at 4.

patrons' satisfaction has long been a source of conflict. The average time from issuance of the equity certificate to retirement has been 10.5 years in recent experience.[99] The problem was highlighted in studies by the USDA and a 1979 report of the General Accounting Office,[100] which urged adoption of improved programs and raised the possibility of mandatory Federal legislation. There followed a variety of reports and studies designed to encourage voluntary retirement.[101] Efforts have been undermined, however, by a poor agricultural economy, high interest rates, restrictions on the application of funds imposed by lending institutions, reluctance of active patrons to allow cooperatives to borrow funds to retire older equity, and relatively weak cooperative financial structures. Because courts generally hold that patronage refund retirement is in board of directors' discretion, and that the right to collect refunds vests only when declared, cooperatives are under tremendous pressure to postpone equity retirement in favor of more pressing obligations. Conflict over equity retirement therefore continues.

Securities Regulation Issues The securities concerns raised by the issuance of membership certificates and common and preferred stock also apply to the issuance and redemption of deferred patronage refunds.[102] Cooperatives argue such instruments do not fall within the definition of securities because they are issued solely to finance marketing or purchasing facilities for members, rather than generate a profit on investment. Cooperatives further claim return to members at redemption is part of the price of the commodity sold or the savings generated, rather than profit earned from the efforts of others. In response to requests to comment on the applicability of the Securities Acts to retained equities of two agricultural cooperatives in 1977, the Securities and Exchange Commission issued letters recommending no action be taken against the cooperatives on the equity redemption

---

[99]*Id.* at 24.

[100]Comptroller General, U.S. General Accounting Office, Report to Congress: *Family Farmers Need Cooperatives—But Some Issues Need To Be Resolved* (July 26, 1979).

[101]*See, e.g.*, *Equity Redemption*, *supra* note 22; Economics, Statistics and Cooperatives Serv., USDA, *The Changing Financial Structure of Farmer Cooperatives*, Report No. 17 (March 1980).

[102]*See* generally Centner, *supra* note 43.

programs in question.[103] Though the Commission left open the possibility of enforcement action against agricultural cooperatives in the future, no such proceedings have been instituted.

Per-Unit Capital Retains

Per-unit capital retains represent an investment by patrons in a cooperative, but the method of retention differs from that for deferred patronage refunds. Instead of relating the amount kept by the cooperative to net margins realized at the end of the fiscal year, per-unit capital retains are based on a set amount per physical unit of product marketed through the cooperative. This amount is generally retained by the cooperative when members' products are sold and may even be collected in addition to deferred patronage refunds. The retain amount is set out in the agreement between member and cooperative, and no additional amount may be charged.[104]

Per-unit capital retains are used primarily by marketing rather than supply or combination cooperatives.[105] These have become associated with marketing certain types of products. They are used most often by fruit, nut, and vegetable cooperatives of the West Coast and Florida, and by dairy, rice, sugar, and cotton cooperatives.

Per-unit capital retains are created by a different process than deferred patronage refunds. This distinction may be important in calculating each member's investment in the cooperative. It is also important when determining deductibility of distributions for Federal income tax purposes. Unlike patronage dividends, there is no requirement that per-unit retains be distributed 20 percent in cash to qualify for deductibility under Subchapter T.[106] Rights and obligations once created may

---

[103] *Mid-American Dairymen, Inc.* [1977-1978 Transfer Binder], Fed. Sec. L. Rep. (CCH) §81, 110 (Feb. 2, 1977); *United Suppliers, Inc.* [1977-1978 Transfer Binder], Fed. Sec. L. Rep. (CCH) §81, 147 (Mar. 14, 1977).

[104] *See Silveira v. Associated Milk Producers*, 63 Cal. App. 572, 219 P. 461 (1923).

[105] *Equity Redemption*, *supra* note 22, at 15.

[106] The definition of qualified per-unit retain certificate in 26 U.S.C. §1388(h) (1982) does not include the 20 percent cash requirement in §1388(c)(1).

be similarly treated by the courts, however. In *Weise v. Land O'Lakes Creameries*, for example, the court said:

"The revolving fund here was somewhat different from the usual one. Ordinarily a portion of the profit goes to make up the revolving fund. Here it was built up by an arbitrary deduction of one cent per pound of all turkeys processed. Regardless of the source of the funds, however, this was a revolving fund under the sections above referred to. Though not identical with deferred patronage dividends, payments from the fund are governed by the same rules."[107]

Debt Instruments

Cooperative studies show an increase in debt capital compared with equity capital over the past 20 years.[108] Since 1962, debt capital among the top 100 cooperatives climbed from about 19 percent to 42.2 percent of total cooperative capital, with a corresponding decline in equity investment.[109]

Sources available for cooperative financing are varied. If the instruments issued to represent cooperative obligations do not differ greatly from standard promissory notes or bonds, the rights and obligations created present few problems. Obligations are payable according to their terms as interpreted and applied under general commercial law.[110] Priorities in cooperative assets are also governed by general commercial priority rules.

Certificate of Indebtedness Cooperatives may issue certificates of indebtedness representing obligations to repay money advanced by members, or resulting from the conversion of equity investment held by members. They are normally issued in denominations ranging from $25 to $500, and unlike the normal equity certificate, are usually

---

[107] *Weise v. Land O'Lakes Creameries*, 191 N.W.2d 619, 623 (Iowa 1971).

[108] Davidson, Street & Wissman, *Top 100 Dominate Business Scene: Sales Hit $50.3 billion by '80*, Vol. 35, No. 1 Cooperative Accountant 73, 76 (Spring 1982).

[109] *Id.* at 76.

[110] *See generally* Gideon, *supra* note 83.

interest bearing. Interest rates are usually much closer to market rates than dividend rates on cooperative stock. Unlike cooperative stock dividends, interest is limited only by local usury laws. If the certificate has a due date, rather than being paid at the board's discretion, it will normally be 1 to 4 years from the date of issuance. Certificates create no voting rights and are often subordinated to other cooperative indebtedness.

Cooperatives with this form of debt have encountered problems. Certificates of indebtedness have often been issued in bearer form with no restrictions on sale and no securities registration. Subsequent transfers have not been recorded on the cooperative's books. Furthermore, if certificates are issued without a maturity date and are payable at the discretion of the board, cooperatives may encounter the same retirement problems as equity redemption programs. Cooperatives have resorted to redemption at a discount, recapitalization to convert debt into equity, and even bankruptcy.[111]

Promissory Note In addition to certificates of indebtedness,[112] cooperatives may issue promissory notes for funds advanced by commercial institutions, including commercial banks, insurance companies, and Banks for Cooperatives. Such financing has some advantages over the issuance of bonds. Transaction costs are lower, no third parties need be involved, and payment terms may be more negotiable than is possible with bond issues. However, the cost for these benefits may be a somewhat higher interest rate.

Bonds Cooperatives may also issue bonds (secured) and debentures (unsecured), though it appears only larger cooperatives find public issue of such securities a successful means of financing.[113] Bonds are generally long-term and bear competitive interest rates. They may be subordinated to other cooperative debt. Transaction costs, which

---

[111]*See generally*, Daley, *New Developments Regarding Capital and Financial Structure of Cooperatives*, Vol. 32, No. 1 Cooperative Accountant 94 (Spring 1979).

[112]In contrast to promissory notes, certificates of indebtedness are generally issued to members rather than third parties, are smaller in denomination, and may contain no due date but rather be subject to repayment at the discretion of the board.

[113]*See generally* Gideon, *supra* note 83, at 64.

include legal fees, printing, and brokerage services, can be quite high. Depending on the type of issuance and legal status of the cooperative, the bond issue may also require SEC and State securities registration.

Industrial development bonds have been used by cooperatives, particularly for building physical structures.[114] Such sources, when available, have the advantages of 100 percent financing, long-term payoff at relatively low interest rates, and a payoff period equal to the facility's useful life. Costs can be managed by current patrons if transactions are properly structured.

Hybrids

Though all instruments reflecting deferred refunds or per-unit capital retains are in some sense hybrids, the term is used here to categorize an instrument issued by an agricultural cooperative that falls somewhere between equity certificates representing member investment and pure debt instruments.

The cooperative in *In re Kitsap-Mason Dairymen's Association*,[115] for example, issued an instrument labeled a "Finance Fund Certificate." This instrument represented a share in a reserve capital fund created by retains of up to 10 percent of the resale price of milk and dairy products sold through the cooperative. Certificates came due 10 years from date of issue and bore interest at a designated rate. They were also assignable to members or nonmembers provided proper procedures were followed.

Understandably, the certificates were difficult for a court to classify as either equity or debt. The court in *Kitsap-Mason* acknowledged that owners of Finance Fund Certificates "fit into a status which might indeed be categorized as *sui generis*, somewhere between that of creditor and true owner of common stock." In establishing the priorities of various parties at cooperative dissolution, therefore, the court placed owners of Finance Fund Certificates in the same category as holders of stock representing per-unit capital retains.

---

[114] *See generally* Davidson, *Industrial Development Bond Financing for Farmer Co-ops.*, (August 1980).

[115] *In re Kitsap-Mason Dairyman's Assn.*, 6 Wash. App. 926, 497 P.2d 604 (1972).

RIGHTS AND OBLIGATIONS OF COOPERATIVE AND ITS MEMBERS

Questions about rights and obligations associated with an instrument may arise while members continue to participate in the cooperative. Issues may be raised in one of two ways. First, a member may seek to enforce payment of a financial instrument during the member's ongoing relationship with the cooperative. Second, the cooperative itself may assert a claim against the member. The discussion here is limited to the relationship between the two parties and assumes the member remains in the cooperative.

Membership Interest

It is clear that members of an unincorporated association or an incorporated cooperative formed without capital stock cannot force a cooperative to pay the value of their property interests in the association on demand. A member may have a proportionate interest in the cooperative assets, subject to its liabilities, that may asserted on dissolution, but that right may not be asserted while the cooperative continues to operate. For example, when a grazing cooperative sells an appreciated tract of land, a member may not recover an individual interest in the association's assets prior to its dissolution.[116]

Common Stock

Dividends State statutes usually set a maximum rate of dividends to be paid on cooperative common stock, but no statute sets a minimum. Like noncooperative corporations, the amount of dividends paid on common stockare in the board of directors' discretion. Absent abuse of discretion, fraud, or illegality, no common stockholder can force the payment of dividends until declared.

Redemption The majority of State statutes give agricultural cooperatives the authority to repurchase their common stock.[117] If the stock being repurchased represents a membership relation, repurchase should

---

[116] *See Fulbright Grazing Assn. v. Randolph*, 524 S.W.2d 798 (Tex. Civ. App. 1975).

[117] *State Inc. Stat*, *supra* note 5, at 117, and Table 15.15.01.

be coordinated with the applicable procedure for membership termination. If the stock being repurchased only represents redemption of part of a member's equity investment, however, the membership relation continues. Statutory restrictions on repurchase are generally limited to maintaining cooperative solvency,[118] so any member protection from forced repurchase should be set out in articles or bylaws.

State statutes usually let cooperatives repurchase their common stock, but none mandate repurchase absent specific circumstances. As with noncooperative corporations, stockholder efforts to force redemption without the statutory requirements or article or bylaw provisions have not succeeded. For example, in *Evanenko v. Farmers Union Elevator*,[119] a deceased member's representative sought to liquidate one share of $100 par value common stock. The applicable statute and bylaws permitted repurchase at death but did not require it. The court rejected the claim, stating that: "(I)t will be noted that although the cooperative has the legal right to purchase its stock, even on a prior-rights basis, it is not compelled to do so."[120] Even if the previous policy had been to allow withdrawal of shares at par value, the court in *Lewiston Cooperative Society v. Thorpe*[121] recognized that the board could discontinue the practice if it was detrimental to remaining shareholders. The court based its decision on the venture's cooperative nature and stated: "The success or even continuance of the business might be endangered or ruined if shareholders, at pleasure, could withdraw the capital contributed by them to the enterprise. (The cooperative was) in no sense indebted to (the members)."[122]

Preferred stock

Dividends Rules relating to mandatory dividends and preferred stock redemption parallel those for common stock. However, two significant

---

[118]The limitations on stock repurchase generally prohibit repurchase if association debts exceed 50 percent of its assets. *Id.* at 117, and Table 15.15.01.

[119]*Evanenko v. Farmers Union Elevator*, *supra* note 57.

[120]*Id.* at 262.

[121]*Lewiston Co-op. Society v. Thorpe*, 91 Me. 64, 39 A. 283 (1897).

[122]39 A. at 285.

cases illustrate board abuse of discretion. Both are Arkansas cases decided in the early 1960's.

In *Driver v. Producers Cooperative*,[123] an inactive holder of preferred stock in a cotton gin cooperative sued to compel payment of dividends and institution of a revolving fund to retire preferred stock. The stock had been acquired as patronage distributions in the cooperative's early years and was entitled under the bylaws to dividends of up to 5 percent per annum. Bylaws further provided that after adequate capital had been generated, preferred stock in an amount equal to new preferred stock issued during the year should be redeemed or retired. For several years before suit was filed, however, all net earnings had been distributed to active patrons as postseason payments. Preferred stock issue had been discontinued and no provision was made by the new system for either dividend payments or for the retirement of preferred stock. The cooperative argued it needed the new system to keep patrons in a highly competitive situation. The court noted, however, that no attempt was made to explain how other cotton gins could compete despite providing some return on invested capital. Further, more than 80 percent of the cooperative's ginning business came from its present directors. The court stated that ''the ginning business which they are afraid of losing is largely their own patronage.''[124]

Though specifically acknowledging that stockholders were not entitled to the full 5 percent dividend in any year as a matter of right, the court found abuse of discretion by the board in both its dividend policy and its failure to establish a system for preferred stock retirement. The court therefore granted the plaintiffs ''appropriate relief'' with respect to the establishment of the revolving fund and payment of dividends.

Following the court's mandate, the cooperative filed a revolving fund plan. Difficulties in complying with the plan were illustrated in the sequel to *Driver* that reached the court 5 years later.[125] The coopera-

---

[123]*Driver v. Producers Co-op.*, 233 Ark. 334, 345, S.W.2d 16, 17 (1961).

[124]*Id.* at 340, 345 S.W.2d at 20.

[125]*Driver v. Producers Co-op.*, 233 Ark. 334, 345, S.W.3d 62 (1963).

tive argued it could not make certain payments into the revolving fund because of losses and remodeling expenditures. Nevertheless, the Arkansas Supreme Court affirmed the order requiring payments.

A second case, *Collie v. Little River Cooperative*,[126] was decided by the Arkansas Supreme Court between the *Driver* opinions. As in *Driver*, preferred stockholders sought to compel both dividend payment and the establishment of a revolving fund to retire preferred stock. Bylaws similarly provided for payment of dividends on preferred stock up to a stated limit (6 percent), and for a revolving fund. The cooperative paid dividends over the years, but always below ceiling rate, and failed to establish a revolving fund.

The court in *Collie* found abuse of discretion by the board. The court noted that the cooperative's control was absolutely vested in 26 common stockholders who comprised most of its active patrons. Directors were chosen from this group and received the "lion's share" of the savings. The court concluded that directors had abused their discretion in "failing to develop or maintain a rational balance between the amounts paid the preferred stockholders and the active members, and in failing to provide, maintain and build the allocated reserve required by the articles of incorporation."[127]

Unfortunately, neither opinion seems to recognize the unique problems and needs of cooperative entities. This fact substantially undermines the opinions' precedential value. In *Driver*, for example, the court said that "the method of allocating the profits that was adopted in 1953 excludes these stockholders from any return upon their holdings."[128] The court was concerned that "the preferred stockholders' investment is being used solely for the benefit of the active members, while the stockholders are denied dividend as well as redemption rights."[129] Even more surprising is the language in *Collie v. Little River Cooperative* in which the court stated: "It is axiomatic that the owners of a

---

[126]*Collie v. Little River Co-op.*, *supra* note 71.

[127]*Id.* at 730, 370 S.W.3d at 64.

[128]*Driver v. Producers Co-op.*, *supra* note 71.

[129]345 S.W.2d at 19.

profitable business are entitled to a reasonable share of the profits of that business as well as being able to sell their interests in that profitable business. This is one advantage of our capitalistic system."[130] Such language indicates a misunderstanding of cooperatives. The court fails to address the fact that cooperative investment by members is not intended to generate specific dollar return but facilitate product marketing.

Redemption Shareholders are generally not entitled to mandatory redemption of preferred stock on demand unless cooperative statutes or documents so provide, and such provisions are rare. However, the *Driver* and *Collie* cases suggest that failure to redeem stock may be an abuse of discretion by the board in certain circumstances. Abuse was found in *Collie* despite the fact that the language of the applicable article merely provided that "The preferred stock...may be redeemed or retired upon call of the directors from time to time" and that the revolving fund "may" be used for that purpose.

Deferred Patronage Refunds and Per-Unit Capital Retains

The first step in determining the right to the payment of patronage retains is the examination of applicable statutes. No Federal or State statute mandates redemption (i.e., payment in cash for patronage retains previously withheld by the cooperative) of patronage retains during continued membership. Unless modified in the future, no statute allows members to enforce mandatory redemption.

Cooperative documents must next be examined. It is unlikely that a cooperative will have a provision mandating redemption except at death or withdrawal, though cooperative articles or bylaws may indicate circumstances in which the board is likely to redeem. Patronage retains provide ongoing financing, and mandatory retirement would create a degree of inflexibility most cooperatives would consider unworkable.

If such an article or bylaw provision exists, of course, the courts will enforce it. However, patrons are typically seeking to compel redemption in the absence of any supporting statute, article, or bylaw. In

[130] 370 S.W.2d at 65.

these circumstances, courts almost unanimously agree that members cannot compel payment.

Reported decisions repeatedly hold that the decision to redeem patronage retains is in the discretion of the board of directors. Discretion is interpreted broadly under the sound business judgment standard. For example, courts have upheld board decisions to: (1) accumulate reserves beyond a minimum set by statute;[131] (2) exhaust such reserves for business purposes;[132] and (3) use reserves to arbitrate and settle disputes.[133] Though courts recognize that payment may be compelled if directors abuse their discretion, no patronage retain case has yet found such abuse. Examples of conduct sufficient to constitute abuse of discretion were described by the Florida Supreme Court as "establishing charges to the producers at an inordinately low rate in relationship to the competitive market" and "permitting the accumulation of excessive reserves."[134] However, abuse was not found in the case in which those examples were cited.

Once the board declares retains payable in cash, the general rule is that they are then payable on demand.[135] Positive determination by the board causes the interest in retains to vest. Even then, however, the board may be able successfully to rescind the declaration if it can convince a court that its declaration was not final, but rather that additional reasonable time was allowed for referendum and review by stockholders.[136]

A recent decision which at first appears to contradict the theory that no payment of patronage retains will be made on demand should also

---

[131]*Schmeckpeper v. Panhandle Co-op. Assn.*, *supra* note 71.

[132]*Burley Tobacco Growers' Co-op. v. Tipton*, 227 Ky. 297, 11 S.W.2d 119 (1928).

[133]*Burley Tobacco Growers' Co-op. v Brown*, 229 Ky. 696, 17 S.W.2d 1002 (1929).

[134]*Lake Region v. Packing Assn. v. Furze*, *supra* note 1, at 217.

[135]*See, e.g.*, *State ex rel. Baker v. Intermountain Farmers Assn.*, 668 P.2d 503, 506 (Utah 1983).

[136]Such a rescission was permitted by the court in *Callaway v. Farmers Union Co-op.*, 119 Neb. 1, 226 N.W. 802 (1929).

be mentioned. In *Southeastern Colorado Cooperative v. Ebright,*[137] the court ordered redemption of patronage retains when raised as a setoff defense by the member. The court's decision appears to be based on the cooperative's failure to follow procedural requirements rather than the court's belief that such retains are subject to redemption on demand, however. The case will be discussed subsequently in more detail.

Hybrids

A member seeking mandatory payment of a "hybrid" instrument may have a better chance of recovery than an equity certificate holder. A court may more likely characterize the instrument as a debt, immediately due and payable, than equity, payable at the boards' discretion. Courts will scrutinize the instrument to determine whether it is payable on demand or at a date certain. The instrument's terms will control absent ambiguity.

For example, in *Hicks v. Polk County Farmers Cooperative,*[138] the plaintiff manager purchased two "Certificates of Preferred Interest" issued by the defendant cooperative for $10,000 each. The certificates reflected a promise to pay the face amount plus interest, but had no stated maturity date. They created no right to vote, but gave holders setoff rights and liquidation preference over other patron equities. However, they were subordinated to creditors' claims. The Court agreed that the certificates were neither "fish nor fowl"—they appeared to be preferred stock but the articles specified that the association could issue no capital stock. The court noted that the certificates had no maturity date but by their terms were to be called serially in order of issuance. The court held these provisions sufficiently ambiguous to permit additional evidence (parol evidence), which showed the certificates had been redeemed as a matter of course upon demand in the past. Payment was ordered despite evidence that the cooperative's financial condition would not sustain payment of all such certificates outstanding.

---

[137] 38 Colo. App. 326, 563 P.2d 30 (1977).

[138] *Hicks v. Polk County Farmers' Co-op.*, 51 Or. App. 699, 627 P.2d 890 (1981).

Debt

A recipient of a debt instrument[139] issued by an agricultural cooperative generally will be in the same legal position as a recipient of a debt instrument issued by any other entity. The debt will be payable according to the instrument's terms. Only in case of ambiguity will the court resort to other evidence. In *Gold Kist Inc. v. Ford*,[140] for example, a local cooperative exchange issued an "investment security" of $20,800 to bear interest at 9 percent. The instrument stated it matured in 1992, but the recipient demanded payment in 1980, claiming the cooperative's manager had represented that the certificate was fully redeemable prior to maturity. The certificate stated it could be prepaid, but at the board of directors' discretion. The court held as a matter of law that the instrument was unambiguous because it clearly stated a maturity date of 1992. Therefore, the cooperative was not obligated to pay it until that date.

Cooperative's Rights

Cooperatives may assert rights against their own members for a variety of reasons. A member may have breached a marketing contract, or may have failed to pay for supplies purchased from the cooperative. In those cases, cooperatives might attempt to recover part of an advance to a member who later failed to make adequate delivery or recover for losses on sale of members' products even if no advances were made.[141] In such situations, rights created by the cooperative's financial instruments may also be asserted by members. For example, financial instruments may give members a right of setoff if a cooperative prevails in its action. Most cooperative bylaws authorize the board to set off patronage retains, whether in stock or other

[139]Characterizing an instrument as debt or equity can be a difficult issue. The courts will consider such factors as the language of the instruments, the ratio of debt to equity, provisions for redemption, voting rights, and convertibility in making this determination. *See generally*, H. Henn & J. Alexander, *Laws of Corporations* §162-4 (1983). Patronage retains held by a cooperative are usually characterized as equity.

[140]*Gold Kist Inc. v. Ford*, 439 So.2d 39 (Ala. 1983).

[141]For example, the cooperative may have advanced the member $6 a bushel for some product that it was forced to sell for $5, or may even have expended more on sorting and preparation than the price for which the product could be sold.

form, against amounts due the cooperative. Few use this option, however, because it lets the member accelerate receipt of retains to the possible detriment of other members and the cooperative.[142] If one member is allowed such a setoff while others similarly situated are denied such treatment, the board may be liable for abuse of discretion. Patronage retains as setoffs, therefore, are usually raised as a member's defense when sued by a cooperative.

In general, a member claiming patronage retains as a setoff is in no better position than one seeking payment on demand. Both are asserting a current right to funds payable according to existing case law only at the board's discretion.

This general rule is illustrated by the holding of the Mississippi Supreme Court in *Clarke County Cooperative v. Read.*[143] The cooperative in that case sued a member for an amount owed on a promissory note for farm supplies. The member claimed a setoff for equity credits allocated to him on the cooperative's books. The court recognized that such credits were designed to provide the cooperative capital while reflecting ownership interests of patrons. In order for the equity credits to be used as a setoff, however, the court held that the defendant member must demonstrate that his claim to immediate payment of credits would sustain an independent suit. In holding that equity credits failed to meet that test the court stated, "The patron has no right to offset such equity credits, not being an indebtedness which is presently due and payable, against an indebtedness which is presently due and payable by him to the cooperative."[144] The same position has been taken by courts when patronage retains are issued in the form of stock. In *Lewiston Cooperative Society v. Thorpe*,[145] the defendant member sought to obtain setoff by forcing the cooperative to repurchase common stock at par value. The court denied the claim, holding the

---

[142] Guenzel, *The Relationship Between Cooperatives and Their Members in Litigation*, 21 S.D.L. Rev. 628, 637 (1976).

[143] *Clarke County Co-op. v. Read*, 243 Miss. 879, 139 So.2d 639 (1962).

[144] 139 So.2d at 641.

[145] *Lewiston Co-op. Society v. Thorpe*, 91 Me. 64, 39 A. 283 (1897).

cooperative was "in no sense indebted to the defendant." The court recognized the danger to the cooperative business if such withdrawals of capital were permitted at will.[146]

One 1960 case allowed setoff based on prepaid grazing fees, but the facts appear to distinguish it from the normal rule.[147] More recently, however, a surprising decision from Colorado allowed a claimed setoff of accrued but unpaid patronage refunds. In *Southeastern Colorado Cooperative v. Ebright*,[148] an agricultural cooperative sued for the price of goods sold, and the defendant member claimed unpaid patronage refunds as a setoff. The trial court denied setoff on traditional grounds, but the Colorado Court of Appeals reversed. The court based its decision on a seemingly technical interpretation of the bylaws. Bylaws provided for a revolving capital fund generated by patronage retains, but used permissive language:
"Each...member...shall...invest in the capital of this association in capital credits as requested by the board of directors...and in addition, such further sum or sums of money as the board of directors may specify."[149] Because the cooperative had not formally declared the need for such deductions or debited patronage refund accounts, the court held members were entitled to payment in cash of the entire allocation. The setoff claim was upheld.

Though the opinion can be read as only an admonition for careful compliance with procedural requirements rather than as a departure from the normal no-setoff rule, the holding understandably has caused concern among cooperatives.

---

[146]39 A. at 285. *See also Forrest County Co-op. v. Manis*, 235 So.2d 925 (Miss. 1970) and *Howard v. Eatonton Co-op. Feed Co.*, 226 Ga. 788, 177 S.E.2d 658 (1970), in which both courts refused to allow patronage retains to be set off against amounts due the cooperatives. For cases recognizing that patronage retains are not a debt in other situations, *see Evanenko v. Farmers Union Elevator*, *supra* note 57; *In re Cosner*, 3 B.R. 445 (D.C. Or. 1980).

[147]*See Ft. Hall Indian Stockmen's Assn. v. Thorpe*, 82 Idaho 458, 354 P.2d 516 (1960) and discussion by Guenzel, *supra* note 142, at 638.

[148]*Southeastern Colorado Co-op. v. Ebright*, 38 Colo. App. 326, 563 P.2d 30 (1977).

[149]563 P.2d at 32.

EFFECT OF SPECIAL EVENTS

In addition to questions arising in an ongoing member-cooperative relationship, special events may require resolution of competing claims. A variety of events may affect that relationship with regard to financial instruments—breach of contract by member, death, termination of membership, bankruptcy of either member or cooperative, cooperative dissolution, and merger.

Breach of Contract

A marketing contract is a member's agreement to market all or part of his or her agricultural products through the cooperative. It may be a separate document or incorporated in bylaws to which the member agrees. State incorporation statutes specify a cooperative's remedies upon breach by a member, generally including liquidated damages and injunctions. Breach may also result in forfeiture of certain rights created by financial instruments. Forfeiture may be thought of as a type of liquidated damage for breach of contract, though not discussed in the case law in such terms.

Breach in a nonstock cooperative may cause forfeiture of the membership interest. In *California Bean Growers' Association v. Rindge Land & Navigation Co.*,[150] cooperative bylaws provided that upon a member's failure to market beans as required by the crop agreement, "his membership shall *ipso facto* cease and determine, and his certificate and his membership in this association and all of his rights and interest therein shall by that act be automatically cancelled." The court interpreted the provision literally, rejecting the member's argument that such cancellation also terminated the cooperative's rights to enforce the contract. The association was therefore allowed to recover liquidated damages.

A similar bylaw provision effecting forfeiture of membership rights on members' breach of contract was considered in *Buford v. Florin Fruit Growers' Association*.[151] The court noted with seeming disfavor,

[150]*California Bean Growers' Assn. v. Rindge Land & Navigation Co.*, 199 Cal. 168, 248 P. 658 (1926).

[151]*Buford v. Florin Fruit Growers' Assn.*, 210 Cal. 84, 291 P. 170 (1930).

however, that no such forfeiture took place for member expulsion: "We thus see that an expelled member retains his property interests until appraised and paid for, but a member who has committed perhaps a less serious offense is in effect expelled and at the same time forfeits his property interests in the association."[152] This may explain the court's finding that the cooperative was estopped to enforce forfeiture.

Forfeiture of common stock has also been enforced. The member-stockholder in *Bessette v. St. Albans Cooperative Creamery*,[153] held 48 shares of common stock, upon which were printed bylaw terms requiring forfeiture if members ceased to deliver milk to the cooperative. The court rejected the member's claim that the provision was unenforceable because it was against public policy. The stock was forfeited.

Courts have also upheld bylaws forfeiting rights to redeem patronage retains. The case most often cited for this position is *Rusconi v. California Fruit Exchange*.[154] In that case, a member-grower contracted to deliver 65 percent of his grape crop to the cooperative. He delivered only 35 percent. Because the contract provided that the grower could receive patronage retains "having carried out the provisions" of the contract, the court held breach was fatal to his redemption rights. Only growers who had fulfilled their contracts were entitled to participate in the unconsumed withholding fund.

Neither can a member avoid consequences of breach by acting through a third party. In *Proodian v. Plymouth Citrus Growers' Association*,[155] the court held a member-wife was barred from the recovery of retains when the breaching husband was acting as her agent.

---

[152]291 P. at 171.

[153]*Bessette v. St. Albans Co-op. Creamery*, *supra* note 57.

[154]*Rusconi v. California Fruit Exch.*, 100 Cal. App. 750, 281 P. 84 (1929).

[155]*Proodian v. Plymouth Citrus Growers' Assn.*, 152 Fla. 684, 13 So. 2d 15 (1943).

Death

A member's death frequently triggers an effort to enforce payment of a financial interest in a cooperative, either due to monetary needs of the surviving family or simply a desire to liquidate estate assets. The Standard Cooperative Act, which served as the basis for cooperative statutes of many States, includes death as one of four events that give a cooperative an option to redeem members' equity.[156] The provision is permissive, but several States have amended the section to require payment at death.[157] Even under permissive statutes, of course, individual cooperatives may create a mandatory payment right by article or bylaw provision.

State statutes, article, or bylaw provisions for payment at death will be enforced, although an unclear definition of the property interest to be paid or the method of valuation may cause controversy. However, if no provision exists members' estates may still assert some right to payment as alleged creditors of the cooperative. In such situations, litigation is often required to determine if the interest is payable to the estate.

The general rule is that the membership interest in specific assets of a nonstock cooperative is terminated by a member's death. This was the rule of associations at common law and is still generally followed. Neither will a member's estate have a right to reach any increase in asset value or force an association's dissolution.[158]

Nor will a deceased member's estate be entitled to payment of the value of common stock absent a specific provision otherwise. In *Evanenko v. Farmers Union Elevator*,[159] the administrator of a deceased member's estate attempted to force liquidation of one share of cooperative stock at the par value of $100. Because applicable

---

[156]*Equity Redemption*, *supra* note 22, at 118.

[157]*Equity Redemption*, *supra* note 22, at 119.

[158]*Legal Phases*, *supra* note 8, at 499, 509.

[159]*Evanenko v. Farmers Union Elevator*, *supra* note 57.

bylaws were permissive as to payment at death, the court rejected the claim. Though the cooperative had a legal right to purchase its stock on a prior-right basis, the court held it was not obligated to do so.

A provision requiring repurchase of shares will be enforced according to its terms. In *Loch v. Paola Farmer's Union Cooperative Creamery*,[160] an agricultural cooperative had adopted a bylaw clearly mandating repayment of the face value of capital stock together with accrued interest and patronage refunds within 12 months of death. The court applied the bylaw as written despite objections by the cooperative that it violated restrictions on stock purchases found in general corporation law.

The same rule that no payment is made at death absent a contrary provision applies to patronage retains issued as common stock, preferred stock, equity allocations or certificates. A redemption-at-death policy would disturb the normal order of redemption by giving an individual's estate priority over other holders. The issue was well discussed in *Claasen v. Farmer's Grain Cooperative*,[161] a recent decision of the Kansas Supreme Court. The executrix attempted to enforce payment of deferred patronage of over $9,000. The statute was permissive as to payment at death, the articles were silent, and bylaws granted the board discretion to pay "for the purpose of facilitating the settlement of any estate." The board refused to pay though the cooperative was able. The court rejected the estate's claim that such retains were debt. Retains were instead characterized as capital investments to be paid when determined by the board in the exercise of its discretion. The court based its decision on cooperative principles. Cooperative organizations, it stated, were "deemed to be for the personal benefit of members only to the extent that the individual profited through the operation of the enterprise." Accordingly, a member should not be permitted to withdraw his interest at the expense of "the financial condition or the life of the cooperative." The court made these statements though the payment in issue would apparently do neither.

---

[160] *Loch v. Paola Farmer's Union Co-op. Creamery*, 170 Kan. 136, 285 P. 523 (1930), *reh'g denied*, 130 Kan. 522, 287 P. 269 (1950).

[161] *Claasen v. Farmer's Grain Co-op.*, 208 Kan. 129, 490 P.2d 376 (1971).

This position has been affirmed by other decisions, including *Evanenko v. Farmers Union Elevator*,[162] in which the issue was addressed in addition to the stock repurchase issue discussed above. The court agreed that patronage retains are not debt payable at death, but rather a contingent interest vesting only upon declaration by the board.

Even with a discretionary bylaw a cooperative may be required to redeem patronage retains by a past history of redemption. Cooperative principles of equal treatment and mutuality of benefit may be used to buttress a board abuse of discretion charge if patrons are treated differently at death. This argument was successfully made by the plaintiff patron-member in *In re Great Plains Royalty Corp.*[163] The cooperative had traditionally redeemed patronage refunds at individual members' death, but was unwilling to redeem at plaintiff's "corporate death" (bankruptcy). The court ordered the cooperative to redeem plaintiff's equity. The holding may be somewhat limited, however, because the court relied on a North Dakota statute prohibiting discrimination among members. Further, the cooperative bylaws required the board to act under "policies of general application" in making decisions whether to pay at death.

Great Plains is interesting for another reason. The "death" of the claimant was bankruptcy of a corporate patron. Though acknowledging a corporation does not die in the organic sense, the court held it was "de facto" dead and entitled to the same rights accorded deceased individuals. This decision was criticized by the Kentucky Supreme Court in a subsequent case.[164] The Kentucky court pointed to the wording of the bylaws in each case (such as the use of the word "his") which recognized differences between natural persons and corporate entities. The Kentucky court also relied on specific policy reasons for treating deceased persons differently from defunct corporations, such as needs of the individual's surviving family and the fact that an individual would have no right to payment if merely ceasing

---

[162] 191 N.W.2d at 261.

[163] *In re Great Plains Royalty Corp.*, 471 F.2d 1261 (8th Cir. 1973).

[164] *Richardson v. South Kentucky Rural Electric Co-op. Corp.*, 566 S.W.2d 779 (Ky. Ct. App. 1978).

business. The Kentucky court therefore held that bankrupt corporate patrons were not entitled to the same retirement of capital credits as were deceased patrons.

Termination of Membership

Absent a statute, article, or bylaw provision mandating redemption of a financial interest at membership termination, members are not entitled to redemption at that time. This seemingly simple rule is difficult to apply. Cooperative incorporation statutes often define mandatory redemption terms vaguely. For example, termination of a member's relationship with an agricultural cooperative may be expressed in a variety of ways—withdrawal, suspension, resignation, expulsion, cessation of membership, abandonment—and many mandatory statutes or bylaw provisions do not clearly designate the type of termination triggering immediate payment. Statutes may also be unclear about what type of interest must be paid or the method of valuing that interest. Thus, even if the State of incorporation has adopted a mandatory provision, courts may still be required to determine precisely what its language means.

Mandatory Provision Relevant statutes and the cooperative documents must be examined to determine if an agricultural cooperative is required to retire a member's financial interest on termination of membership. At the Federal level, no statute requires payment at membership cessation or any other time. However, at least one proposal has been introduced in Congress regarding mandatory equity retirement in recent years.[165] A General Accounting Office report indicated such legislation should be encouraged unless better redemption programs are adopted voluntarily by agricultural cooperatives.[166]

At the State level, applicable cooperative statutes generally take one of two approaches. They either mandate redemption upon termination, or let cooperatives elect to require redemption in articles or bylaws. Generally, the latter approach is used. The Standard Cooperative Act[167]

---

[165] *Equity Redemption*, *supra* note 22, at 114.

[166] Comptroller General, U.S. General Accounting Office, *Report to Congress*, *supra* note 100.

[167] *Supra* note 54.

includes both mandatory and nonmandatory provisions. This has caused some confusion in States that enacted both portions of the statute.[168]

The mandatory language of that Act, included in 11 State statutes without amendment[169] and 10 State statutes with amendments,[170] provides that the cooperative "shall repurchase the member's outstanding stock if the member withdraws or is expelled." Thus, it covers both voluntary and involuntary termination. The statute requires the cooperative to pay the value of the member's interest in cash within 1 year. Obviously, a number of withdrawals in a short time could bankrupt a cooperative. For this reason, many States adopting this section substituted terms more lenient than those of the Standard Act. Time for payment is lengthened to 2, 3, or 5 years,[171] is unspecified, or has been left to the board's discretion.

Statutes may also permit payment in a form other than cash,[172] or let the cooperative override statutorily required payment.[173] Statutes may also distinguish among different termination methods (e.g., withdrawal v. expulsion).

Another method also softens the impact on cooperatives of a mandatory payment provision. State statutes may require payment of members' "property" interest at termination without defining that interest. A bylaw provision may therefore define the interest narrowly, such as requiring only refund of the price paid for membership stock, and thus exclude from required payment financial instruments

---

[168]*See generally Equity Redemption*, *supra* note 22, at 117-121.

[169]*Id.* at 119.

[170]*Id.*

[171]*State Inc. Stats.*, *supra* note 5, at 72, and Table 10.09.06.

[172]For example, preferred stock or a debt instrument may be used. *See Equity Redemption*, *supra* note 22, at 120.

[173]*See, e.g.*, the statutes of Kentucky, Illinois, Missouri and California discussed in *Equity Redemption*, *supra* note 22, at 119.

representing retained equity. A sample bylaw suggested in an Agricultural Cooperative Service publication excludes amounts evidenced by certificates.[174]

Permissive Provision Nonmandatory portions of the Standard Act allow each cooperative to choose whether to require redemption at termination. The section states the cooperative "may" pay in the case of withdrawal, expulsion, or forfeiture of membership. If a State has adopted both sections of the Standard Act, members are entitled to payment as required by the mandatory portion.[175]

The permissive statute is prevalent and recent statutory amendments indicate it retains its popularity.[176] Therefore, cooperative articles, bylaws, and marketing contracts must be closely examined to determine members' rights.

Application If a mandatory provision clearly applies to termination, it will be enforced by the courts. In *Adams v. Sanford Grower's Credit Corp.*[177] a mandatory bylaw required a cooperative to repurchase common stock of a withdrawing member unable to find a satisfactory buyer. The cooperative claimed the provision was unenforceable because prior State case law held a member forfeited all rights to cooperative assets on voluntary withdrawal. The Florida Supreme Court agreed that forfeiture was the normal rule on withdrawal but held the rule did not apply in the face of a contrary provision adopted by the cooperative. Given mandatory language in the bylaws, the member prevailed.

Mandatory provisions sometimes present difficult questions of interpre-

---

[174] *Legal Phases, supra* note 8, at 568. The suggested bylaw states that in determining property rights and interests at termination, "all amounts allocated to each member or evidenced by certificates of any kind shall be excluded."

[175] This is the conclusion reached in the discussion in *Equity Redemption, supra* note 22, at 118.

[176] *Equity Redemption, supra* note 22, at 124-126.

[177] *Adams v. Sanford Growers' Credit Corp.*, 135 Fla. 513, 186 So. 239 (1938), *aff'd*, 151 Fla. 178, 9 So. 2d 713 (1942).

tation. Articles or bylaws may only require redemption if the membership termination occurs in a particular way. For example, voluntary and involuntary withdrawal are frequently distinguished. Members are often accorded greater rights on expulsion than voluntary withdrawal. Though this may seem somewhat unfair,[178] the cooperative depends on continuing membership support, and may seek to discourage withdrawal at will. Greater rights accorded an expelled member may enable a cooperative to expel a hostile or delinquent member with less potential for dispute, and encourage the cooperative to consider the question of expulsion carefully.

If a difference in rights depends on the voluntary nature of withdrawal, courts must classify member actions. In *DeMello v. Dairyman's Cooperative Creamery*,[179] a dairy marketing cooperative's bylaws provided a member was to recover only the $100 membership fee on withdrawal, but was entitled to a proportionate share in the creamery's net worth on expulsion. Though the member claimed to be forced out by cooperative reorganization with which the member did not agree, the court found withdrawal voluntary because the member was given an option to remain a member of the reorganized creamery. Therefore, under the bylaws the ex-member was entitled only to his initial $100.

Massaro v. Tampa Better Milk Producers Cooperative reached a similar result.[180] A member claimed termination was involuntary because he withdrew due to the course of business adopted by the cooperative. The court rejected his effort to compel partition of cooperative property, holding withdrawal was voluntary and denying the member recovery.

A second problem courts have in applying mandatory payment provisions at membership termination is determining the interests to be paid. Though some statutes clearly designate the types of interests to be paid,[181] many do not distinguish among membership interests,

---

[178]*See* the discussion in *Buford v. Florin Growers Assn.*, *supra* note 15.

[179]*DeMello v. Dairyman's Co-op. Creamery*, *supra* note 34.

[180]*Massaro v. Tampa Better Milk Producers Co-op.*, 146 Fla. 64, 200 So. 211 (1941).

common stock, or financial instruments representing equity invested. Thus cooperatives have much discretion to define in their bylaws the interests to be paid.

Applicable bylaws will be strictly enforced by the courts. In *Avon Gin Co. v. Bond*,[182] a member involuntarily terminated due to loss of eligibility sought to recover a proportionate share of the association's assets. The applicable bylaw, however, gave the cooperative a right to repurchase members' shares at par value, a somewhat lower figure. In upholding the bylaw, the court stated that there was no violation of the member's right to due process of law in restricting recovery. The court held that when one joins a cooperative, the individual is charged with notice of such a bylaw provision and it must be "read into his contract of purchase of the stock."

A third recurring problem is interpreting valuation requirements, if any, in mandatory redemption provisions. Some statutes designate a standard of measure,[183] but the guideline is usually left to definition in cooperative bylaws. Courts will enforce a designated measure. Bylaws using par value,[184] price paid,[185] or fair book value[186] have been enforced. Measures stated at the time membership is acquired will be enforced rather than an altered measure in a subsequently adopted bylaw.[187] However, even a stated standard may prove difficult to apply. The court in *Lambert v. Fisherman's Dock Cooperative*[188] strug-

---

[181]*See, e.g.*, the statutes of North Carolina, South Carolina, and Illinois cited in *Equity Redemption*, *supra* note 22, at 120.

[182]*Avon Gin Co. v. Bond*, 198 Miss. 197, 22 So.2d 362 (1945).

[183]*See, e.g.*, the statutes of Nevada and Iowa noted in *State Inc. Stats.*, *supra* note 5 at 72.

[184]*Avon Gin Co. v. Bond*, *supra* note 182.

[185]*Whitney v. Farmer's Co-op. Grain Co.*, 110 Neb. 157, 193 N.W. 103 (1923).

[186]*Lambert v. Fisherman's Dock Co-op.*, *supra* note 57.

[187]*See, e.g.*, *Whitney v. Farmers Co-op. Grain Co.*, *supra* note 185.

[188]297 A.2d at 571.

gled with the definition of "fair book value" of common stock. The court conceded the term had no single definition, but depended on the parties' intentions. Ultimately, it interpreted the term to mean book value of cooperative assets less liabilities. The court carefully noted that this figure was not calculated with reference to market value, stating that a market value standard might be impossible to meet and could cause cooperative dissolution.

The court is in an even more difficult position if no standard is stated. It may articulate a "reasonable value" standard or other appropriate test. In *Adams v. Sanford Growers' Credit Corp.*,[189] for example, the par value of shares to be repurchased was $10 per share, but the appellate court instead adopted a measure of "reasonable value" used by the trial court, which set the value at $5 per share.

Absence of Mandatory Provision Absent a stipulation requiring redemption at membership termination, a cooperative member cannot force immediate payment of any financial interest in the cooperative. In accord with common law, the member will generally forfeit membership interest upon withdrawal. Forfeiture terminates all rights to share in land, equipment, or other cooperative assets at any time, including dissolution, as well as the right to exercise membership privileges.[190] However, the right to collect patronage retains will be protected. Absent a mandatory payment-at-termination provision, the time of payment of these retains will remain in the board of directors' discretion.

These results are in accord with cooperative principles. The purpose of investment in cooperatives is not to acquire a property interest but to provide a means of marketing products or obtaining needed services. A member need not be allowed to arbitrarily withdraw an interest at the expense of the life of the association.

Cases generally hold that membership interests are forfeited by withdrawal, and bylaws usually so stipulate. This was clearly illustrated in

---

[189]*Adams v. Sanford Growers' Credit Corp.*, *supra* note 177.

[190]This may be modified by statute. Some statutes apportion assets remaining after dissolution on the basis of patronage, which could generate some return even to a former member.

Clearwater Citrus Growers' Association v. Andrews,[191] where several members involved in an unsuccessful attempt to dissolve a cooperative withdrew voluntarily. They subsequently attempted to exercise membership rights. The court held their action had the effect of "severing their membership and all connection with or interest in the association, its business, its property, or its assets."[192]

The same rule has been applied in an expulsion case. In *Gottlieb v. Economy Stores*,[193] the court refused to let an expelled member exercise membership rights, stating: "His property right in [the cooperative] was merely incidental to his membership, and ceased when he was expelled as a member for misconduct."[194] Even a statute mandating payment on expulsion may defer to a bylaw providing membership is without financial value. The California statute involved in *Sanchez v. Grain Growers' Association*,[195] for example, required cooperatives to pay an expelled member the value of his property interest within one year unless cooperative bylaws adopted a different procedure. Because the bylaws specifically said that membership was without financial value, the court held the requisite "procedure" was satisfied and the member was not entitled to payment.

Common stock purchased by cooperative members may also be subject to forfeiture if bylaws so provide. In *Bessette v. St. Albans Cooperative Creamery*,[196] a member holding 48 shares of $10 par value common stock ceased doing business with the cooperative. The stock was declared forfeited by the board under a bylaw reprinted on stock certificates. The court upheld forfeiture, stating that the plaintiff member was bound by the bylaws upon accepting the stock and there

---

[191] *Clearwater Citrus Growers' Assn. v. Andrews*, 81 Fla. 299, 87 So. 903 (1921).

[192] 87 So. at 904.

[193] *Gottlieb v. Economy Stores*, 199 Va. 848, 102 S.E.2d 345 (1958).

[194] 102 S.E.2d at 353.

[195] *Sanchez v. Grain Growers' Assn.*, *supra* note 35.

[196] *Bessette v. St. Albans Co-op. Creamery*, *supra* note 57.

was no reason a stockholder could not contract to forfeit stock upon failure to comply with certain conditions.

As for preferred stock, however, it would seem improper to require preferred stock forfeiture at membership termination. Ownership is usually not restricted to members and it should be irrelevant whether the stockholder retains membership. No reported case appears to have addressed this issue.

In contrast to membership interests, a member's right to patronage retains has generally been held to survive membership termination. This does not mean members can collect that interest immediately upon withdrawal, however.

One of the earliest cases considering this issue, *Hood River Orchard Co. v. Stone*,[197] involved a member who voluntarily cancelled membership. Bylaws provided that cancellation would "ipso facto cancel and terminate the membership of such grower, together with all benefits accruing thereunder, and all voting power, right, and interest of every kind and nature shall thereupon immediately cease and terminate."[198] Despite the very broad, inclusive bylaw language, the court restricted forfeiture to the member's share of the association's net assets. It allowed the member to recover retains held by the cooperative which had been determined to be surplus. The court characterized the funds as monies the cooperative had promised and agreed to pay the member by express contract. After advances, that amount represented the balance of the selling price of fruit marketed. Even at this early date courts were willing to treat patronage retains by a different standard than membership interests.

A similar holding was reached by the court in *Bogardus v. Santa Ana Walnut Growers' Association*.[199] Current members of a local walnut cooperative attempted to enjoin payment to former members of

---

[197]*Hood River Orchard Co. v. Stone*, *supra* note 57.

[198]191 P. at 663.

[199]*Bogardus v. Santa Ana Walnut Growers' Assn.*, 41 Cal. App. 2d 939, 108 P. 2d 52 (1940).

patronage refunds received from a federated cooperative after they withdrew. The local cooperative's articles provided all interest in the association would cease upon withdrawal by a member. The former members of the local conceded any right in the net assets of the association had been forfeited, but claimed they were nevertheless entitled to the refunds. The court agreed, labeling the fund returned to the local by the federated a "trust fund," and characterizing the relationship between the former member growers and the local cooperative as fiduciary in nature. The court said that to allow the local association to retain the funds would let it enjoy a profit in violation of cooperative principles. Further, such retention would permit current local members to use the money not as producers but simply as members of the local cooperative. Because refunds had already been declared payable, the former members received immediate payment.

The right to receive declared refunds does not entitle withdrawing members to refunds not yet payable. In *Lake Region Packing Association v. Furze*,[200] former members who had voluntarily withdrawn brought a class action to recover retains collected on boxes of fruit marketed through the cooperative. The court analyzed the nature of retains and cooperatives in general, and concluded that retains were not payable until declared by the board in its discretion. Nor did the court find that the prior association practice of revolving such retains compelled it to continue to do so. The court also held, however, that despite withdrawal the members would be entitled to the retains when rendered payable by future board action. The court in *Furze* indicated that its decision was in accord with cooperative principles. Investment represented by retained funds was not intended to yield returns as dividends or appreciation in value, but to advance active producers' interests in production and marketing of their crops.

The same rationale was applied to expulsion in *Sanchez v. Grain Growers' Association*.[201] The court recognized that members are entitled to receive retains despite having been expelled for failure to sign marketing agreements. However, the trial court's order of payment was reversed because retains had not yet been declared surplus. The

---

[200]*Lake Region Packing Assn. v. Furze*, *supra* note 1.

[201]*Sanchez v. Grain Growers' Assn.*, *supra* note 35.

court stated: "It is undisputed that retains declared to be surplus cannot be withheld from members, but prior to such a determination, members have no enforceable right to these funds."[202]

An interesting declaration of payment question arose in *Southeastern Colorado Cooperative v. Ebright*,[203] a case involving former members seeking to recover equity invested as patronage retains. The court ordered refunds paid to former members not because the cooperative had affirmatively declared them payable, but because the cooperative *failed* to take necessary steps to render them nonpayable required by the bylaws.

Dissolution

As the foregoing discussion indicates, members are usually unable to force payment of members' financial interest either during the ongoing relationship with the cooperative or upon withdrawal. However, members can generally enforce payment at cooperative dissolution, assuming the association has sufficient assets.

State statutes typically provide for cooperative dissolution either voluntarily out of court, or voluntarily or involuntarily under court supervision.[204] The typical voluntary out-of-court procedure requires the members to appoint trustees who wind up the cooperative's business and liquidate its assets. Funds are distributed according to statutory priorities and pertinent cooperative articles and bylaws. If the order of priorities is clearly stated, it will be followed. Ambiguities in priority rules or financial instruments that defy clear categorization may present problems.

Premature Distribution Predissolution attempts to divide the cooperative's assets to recover individual interests will not be sanctioned by the courts. In *Fulbright Grazing Association v. Randolph*,[205] land

[202]176 Cal. Rptr. at 659.

[203]*Southeastern Colorado Co-op. v. Ebright*, *supra* note 38.

[204]For a general review of statutory dissolution schemes, see *State Inc. Stats.*, *supra* note 5, at 122 and Tables 17.01.01-17.03.02.

[205]*Fulbright Grazing Assn. v. Randolph*, *supra* note 116.

owned by a grazing cooperative was sold, and the plaintiff claimed a membership share in the proceeds. The trial court awarded the plaintiff a 1/8 interest, but the appellate court reversed because the plaintiff failed to plead or prove the cooperative was either dissolved or in the process of dissolution. Though the sole purpose of the cooperative was abrogated by the sale, no formal dissolution had taken place.

In effect, members' efforts to force redemption during an ongoing relationship with the cooperative or at termination of membership are in effect attempts to force premature distributions. Dicta often appears in such cases to the effect that although members are not entitled to current recovery, they can claim a share at dissolution. For example, when the court in *Lake Region Packing Association v. Furze* refused to order payment of retains to withdrawing members, it stated:

"That does not mean that a forfeiture is worked upon the respondents or that recourse to the courts is foreclosed to them. Clearly, upon a dissolution of the association, respondents will be entitled to their proportionate share of any then-existing reserves after payment of all other superior obligations of the Association."[206]

It is doubtful if this was of much consolation to the members.

Priorities Funds generated by non-bankruptcy cooperative dissolution and liquidation are distributed according to priorities set out in relevant statutes, articles, and bylaws. Statutes, if they refer to the matter, often leave priority rules to cooperative articles and bylaws. If statutes have adopted a priority scheme, it often provides only that cooperative debts should be paid and residue be divided among members. The problem then becomes one of determining if a particular financial instrument can be classified as debt.

Some State statutes give priority to particular financial interests. Statutes may call for payment of the par value of common shares, par value of preferred shares plus accrued dividends, deferred patronage refunds, or amounts paid toward membership before the residue is divided.[207] Statutes do not consistently specify instruments given

---

[206]*Lake Region Packing Assn. v. Furze*, *supra* note 1, at 217.

[207]*See State Inc. Stats.*, *supra* note 5, at 124, and Table 17.03.01.

priority. The Iowa statute[208] appears to set out the most detailed and logical priority rules. It provides that upon dissolution association assets are applied toward satisfaction of the following obligations in the order stated:

1. Liquidation expenses.

2. Obligations other than patronage dividends.

3. Preferred stock plus accrued dividends.

4. Deferred patronage dividends (if insufficient assets remain, these are to be prorated).

5. Amounts for which memberships or common shares were originally issued, plus accrued dividends.

6. Residue to be divided among members in proportion to their deferred patronage dividends.

Creditors' priority has been repeatedly recognized. Authorities acknowledge that third parties would be unwilling to extend credit to agricultural cooperatives without such protection. Thus, many State statutes require proceeds of liquidation first be applied to debts and obligations owed by the association.[209] Such a rule may also be placed in articles or bylaws.[210] Even if not so stated, courts recognize this principle.[211]

One creditor's priority over another is governed by general noncooperative law. Secured creditors are generally preferred over unsecured to

---

[208]Iowa Code Ann. §499.48 (1949).

[209]*State Inc. Stats.*, *supra* note 5, at 124 and Table 17.03.01.

[210]*See, e.g.*, bylaws discussed in *Placerville v. Fruit Growers' Assn. v. Irving*, 135 Cal. App. 2d 731, 287 P.2d 793 (1955).

[211]*See, e.g.*, *In re F.L.F. Farmers Co-op. Assn.*, 170 F.Supp. 497 (D.N.J. 1958); *Lake Region Packing Assn. v. Furze*, *supra* note 1; *Associated Fruit Co. v. Idaho-Oregon Fruit Growers' Assn.*, *supra* note 15; *Lambert v. Fisherman's Dock Co-op.*, *supra* note 47; *Texas Farm Bureau Cotton Assn. v. Lennox*, 117 Tex. 94, 297 S.W. 743 (1927).

the extent of the security's value, and a creditor's agreement to subordinate to other debt may be enforced. Cooperative members may have the same priority as third party creditors if obligations are properly structured. However, the obligations owed to members in the form of certificates of indebtedness and similar instruments are usually subordinated by agreement to other debts of the cooperative. Members will only recover under such instruments if sufficient funds are available after satisfying other creditors.

Once creditors' obligations are satisfied, priority rights become less clear. At this point preferred stock may be given priority, as in the Iowa statute. This priority also may be required by articles or bylaws, and reflected by notation on the stock.

Investment disadvantages inherent in cooperative stock may make the preference at liquidity the primary incentive for preferred stock purchase (apart from the desire to aid the enterprise). Such stock is usually liquidated at par value together with accrued dividends.

Patronage retains held by the cooperative may be the next level of priority. Though such amounts reflect an equity investment in the cooperative, this investment was to be refunded at some future date. The court in *Weise v. Land O'Lakes Creameries*,[212] after concluding dissolution had actually taken place and sufficient funds existed, held that members were immediately entitled to "revolving fund credits," which matured at that time under Iowa statute. This was true though credits were built up by per-unit retains rather than deferred patronage refunds. The court stated: "Regardless of the source of the funds, however, this was a revolving fund under the sections above referred to. Though not identical with deferred patronage dividends, payments from the fund are governed by the same rules."[213] Accordingly, members were awarded varying amounts on the basis of patronage. If funds are inadequate to satisfy all outstanding retains, each member should be entitled to a pro rata share.[214]

---

[212] *Weise v. Land O'Lakes Creameries, supra* note 107.

[213] 191 N.W. 2d at 623.

[214] *See, e.g., Ozona Citrus Growers' Assn. McLean*, 122 Fla. 188, 165 So. 625.

If residue remains after all priority claims are paid, it will be distributed to the holders of membership certificates in a nonstock cooperative, or common stockholders in a stock cooperative. The method of dividing the residue varies, as State statutes indicate.[215] Each State has selected one of three methods to divide the residue: 1) equally among all members; 2) in proportion to stock or property interest; or 3) in proportion to patronage.

A claimant may be required to be a current member to share in this final distribution.[216] Cases concerning liquidation therefore often involve membership termination issues. Affirmative withdrawal will terminate a right to share in residue distribution.[217] Case law also indicates membership can be abandoned by ceasing participation in cooperative activities, even if the certificate is never physically surrendered, forfeited, or cancelled.[218] The board is not required to pass a formal resolution.[219] Abandonment causes the same legal consequences as affirmative withdrawal.

The distribution scheme outlined represents the normal rule, but there are variations. Articles may provide that on dissolution cooperative assets are to be used for public, charitable, or cooperative purposes. One court held assets should be distributed to a charitable entity even absent such a provision. In *Attinson v. Consumer-Farmer Milk Cooperative*,[220] a cooperative created to market milk contemplated a voluntary dissolution. The original articles and bylaws had no provision governing rights on dissolution, so the board amended the bylaws to provide for equal distribution among the members. Despite the amend-

---

[215]*State Inc. Stats.*, *supra* note 5, at 124 and Table 17.03.02.

[216]Former members may be entitled to share in distribution if the statute uses past years' patronage as the basis for division, and the member was still active during that base period. *See* Id. for a list of State statutes so providing.

[217]*See, e.g.*, *Ozona Citrus Growers' Assn. v. McLean*, *supra* note 214.

[218]*Raulston v. Everett*, *supra* note 17.

[219]*Kaneko v. Jones*, 192 Or. 523, 235 P.2d 768 (1951).

[220]*Attinson v. Consumer-Farmer Milk Co-op.*, *supra* note 21.

ment, the court held members had no rights, vested or contingent, in cooperative assets. The court focused on the educational aspects of the cooperative, and held its assets were to be distributed to a charitable organization in accordance with the "cy pres" doctrine. Though the case is interesting, it does not appear to have been followed by any other court.

Hybrids Difficulties may be created with relatively straightforward priority schemes when cooperatives issue "hybrid" instruments. This is especially true if a cooperative designs a unique instrument to meet a particular need. Obligations at liquidation must be considered on a case-by-case basis.

In *In re Kitsap-Mason Dairymen's Association*[221] a milk marketing cooperative issued an instrument designed to represent patronage retains, but included in the instrument a promise to repay retains at a fixed date, with interest. The instruments, labeled "Finance Fund Certificates" (FFC's), were issued in addition to other instruments representing equity invested over the life of the cooperative, including common stock, preferred stock, and revolving fund certificates. When the cooperative dissolved, it proposed to retire the instruments on the same basis as common stock. A nonmember holder of one such instrument objected, claiming FFCs were debt obligations entitled to priority over common stock. He also claimed his nonmember status gave him priority over member holders of FFCs.

The *Kitsap* analysis illustrates the factors courts may consider in determining hybrid instruments' priority at liquidation. The court placed great emphasis on the language contained on the face of the FCC's that they were subject to the board's right to amend their terms and conditions. The court stated: "Clearly, the holder of any such certificate did not have the unqualified right to demand the face amount of the certificate from the association. The holder thereof was therefore not a creditor of the association."[222]

The court also considered the instrument's purpose. FFCs were

---

[221]*In re Kitsap-Mason Dairymen's Assn.*, *supra* note 115.

[222]497 P.2d at 611.

designed to provide capital to pay debts and retire outstanding equity, as well as to furnish funds to process, distribute, and sell members' products. Because they fulfilled the same function as common stock, the court concluded, "(I)t is quite appropriate to classify owners of 'stock' and owners of FFC in the same category; both fit into a status which might indeed be categorized as *sui generis*, somewhere between that of a creditor and true owner of shares of common stock."[223] The court rejected the holder's priority claims either as creditor or nonmember, and allowed him to share in the residue only on a pro rata basis after all other claims were satisfied.

Bankruptcy

The same reasons that prevent a cooperative member from claiming creditor status at dissolution will generally prevent the member from prevailing on a claim as a general creditor at cooperative bankruptcy. Or, if the member rather than the cooperative is bankrupt, they will prevent the members' trustee from collecting immediate payment from the cooperative as a creditor with an enforceable debt. Most courts view the member as a mere holder of an equitable interest in the cooperative, payable only at the board of directors' discretion.

Bankruptcy of Cooperative Farmer-members with a financial interest in a bankrupt cooperative may be able to claim priority over other claimants, depending on the nature of the claim asserted. If the member holds a bona fide debt obligation, such as a certificate of indebtedness or promissory note, the member can assert a claim as creditor, including a secured claim if the debt is validly protected by collateral. Usually, however, such indebtedness will be subordinated by its terms to other cooperative obligations. In that case, Section 510(a) of the Bankruptcy Reform Act of 1978[224] gives effect to the subordination agreement if enforceable under non-bankruptcy law.

An agricultural cooperative qualifies as a debtor for purposes of filing bankruptcy under either Chapter 7 (liquidation) or Chapter 11 (debtor

---

[223]497 P.2d at 611.

[224]11 U.S.C. §510(a) (1982).

rehabilitation) of the Bankruptcy Reform Act of 1978.[225] It can, therefore, voluntarily file bankruptcy or be forced into involuntary bankruptcy upon petition of the requisite number of creditors with requisite amount of claims.[226] In a Chapter 7 proceeding, cooperative assets will be liquidated and the proceeds distributed according to the statutory priority rules. In a Chapter 11 proceeding, the debtor-cooperative will pay its debts from future income under a court-approved plan.

Priority issues for cooperative assets typically arise in Chapter 7 proceedings. Under the Bankruptcy Reform Act, validly secured claims are satisfied before unsecured claims. The distribution of remaining assets to the holders of unsecured claims is governed by Section 726,[227] providing distribution as follows:

1. Priorities under section 507 (These include administrative expenses, claims arising from business conducted after filing, wage claims, contributions to employee benefit plans, consumer deposits, tax claims).

2. Unsecured claims either timely filed or tardily filed by a creditor ignorant of the bankruptcy.

3. Other tardy unsecured claims.

4. Fines and punitive damages.

5. Remainder to the debtor.

Claims in one class must be paid in full before any claim in the next

---

[225] 11 U.S.C. §301 (1982) *et seq*. The definition of a debtor under 11 U.S.C. §109 includes corporations, partnerships or individuals.

[226] 11 U.S.C. §303 (1982) sets out the requisite numbers for an involuntary petition. Section 303 specifically exempts "farmers" from involuntary bankruptcy, but the definition of farmers at 11 U.S.C. §101(17) requires that income be generated from a farming operation owned or operated by the farmer and characterized by the actual *production* of crops, poultry or livestock. Such a definition would seem to exclude the typical cooperative.

[227] 11 U.S.C. §726 (1982).

class is entitled to distribution. If proceeds are not sufficient to satisfy the entire class, claimants share *pro rata*.[228]

Member investment in an agricultural cooperative is usually represented by certificates of membership, stock, or patronage allocations or certificates rather than debt instruments. However, in the typical cooperative bankruptcy proceeding a member may claim the instrument he or she holds is debt. If the court finds the interest is merely an ownership interest, which is generally the case with membership interests or common stock, the members will be unable to prevail as creditors. Any amounts remaining after the payment of creditors would be payable to the debtor-cooperative, and the members could share in the proceeds only if the cooperative dissolves or some right is independently created by statute, article, or bylaw. Cooperatives would generally dissolve at this point, but it is unlikely that sufficient funds would remain for distribution to members.

Instruments representing patronage retains typically generate the litigation in a cooperative bankruptcy proceeding because they more closely resemble cooperative debt. The problem with the members' position is that numerous courts have held in a variety of situations, including member death,[229] attempted setoff,[230] and merger,[231] that patronage retains are not debt. Rather, they represent an ownership interest to be returned to patrons at some later date at the board of directors' discretion.

In *In re F.L.F. Farmers Cooperative*,[232] a nonstock marketing coopera-

---

[228]See 11 U.S.C. §726(b) (1982). For application of these rules to administrative expenses in a cooperative bankruptcy, see *In re Western Farmers Assn.*, 13 Bankr. 132 (Bank. W.D. Wash. 1981).

[229]*Placerville Fruit Growers' Assn.*, 135 Cal. App. 2d 731, 287 P.2d 793 (1955); *Claasen v. Farmers Grain Co-op.*, *supra* note 161; *Evanenko v. Farmers Union Elevator*, *supra* note 57.

[230]*Clarke County Co-op. v. Read*, *supra* note 143.

[231]*Howard v. Eatonton Co-op. Feed Co.*, *supra* note 146; *Pearson v. Clam Falls Co-op. Dairy Assn.*, 243 Wis. 369, 10 N.W.2d 132 (1943).

[232]*In re F.L.F. Farmers Co-op.*, *supra* note 211.

tive was adjudicated an involuntary bankrupt. A member holding patronage retain certificates filed a claim as a general creditor. In rejecting his right to that status, the court stated that the legislature did not intend that patronage retains "be treated as representing debts due, fixed and owing."[233] Noting that retains are payable only after satisfying cooperative debts and expenses in a dissolution proceeding, the court found no reason to treat retains differently in the liquidation of a cooperative in bankruptcy.

To get creditor status, therefore, the burden is on members to convince the court that interests held in the cooperative are closer to debt than investment equity. If the instrument's characteristics more closely resemble debt, as when a hybrid is issued or a special fund created giving members unique rights, a member may prevail. For example, in *Warner v. Schoner*,[234] a 1937 case, a grocers' purchasing cooperative created a special fund to "guarantee the accounts of all members with the association who receive credit." Bylaws said the fund was returnable to members on membership termination, less a pro rata percentage of loss sustained by the association from the extension of credit to members. When the association went bankrupt, members convinced the court that the fund was not available to satisfy general creditors claims, but was payable to members. It is doubtful that such a result would occur under modern bankruptcy law, however.

During the course of a cooperative's bankruptcy, members may be concerned also about the possibility of the bankruptcy trustee's asserting a claim against them. In *Elliott v. Adeckes*,[235] the trustee in bankruptcy for a creamery association attempted to recover alleged overpayments to members for milk. The issue was whether the relationship between member and cooperative was one of agency or purchase.

If the relationship was one of agency, the cooperative was acting as

---

[233] 170 F. Supp. at 501 (emphasis deleted).

[234] *Warner v. Schoner*, 90 F.2d 579 (9th Cir. 1937).

[235] *Elliott v. Adeckes*, 240 Minn. 113, 59 N.W.2d 894 (1953).

the member's agent in marketing milk. Under agency law, the cooperative could recover amounts paid the member in excess of the final sales price. If the contract was one of purchase, the price paid the member was the final contract price between member and cooperative, and no further remedy would exist. The court examined cooperative documents and held the association had purchased the milk; therefore, the cooperative could not recover overpayment.

Many courts, however, have classified the member-cooperative relationship as one of agency[236] and have held that a cooperative has a valid claim for overpayments during its ongoing relationship with its member.[237] Such a claim could be asserted successfully at bankruptcy.

Bankruptcy of Member In the case of member bankruptcy, the member's trustee will generally attempt to force the cooperative to pay the member's financial interests. Two issues are frequently encountered: (1) whether the interest passes to the trustee; and (2) whether the trustee can require immediate payment.

The Bankruptcy Reform Act of 1978 states that the bankruptcy estate includes all property in which the debtor holds a legal or equitable interest.[238] Further, any party owing an obligation to the bankrupt must pay the debt to the trustee if it has matured.[239]

If a bankrupt member's interest in the cooperative is a *bona fide* debt due and owing, the bankrupt's interest passes to and can be enforced by the trustee. A bankrupt's membership interest or share of common stock also will probably be held to pass to the trustee under Section 541.[240] The interest should pass even if the membership interest or

---

[236]*See, e.g., Tomlin v. Petty*, 244 Ky. 542, 51 S.W. 2d 663 (1932).

[237]*See, e.g., Arkansas Cotton Growers' Co-op. Assn. v. Brown*, 179 Ark. 338, 16 S.W.2d 177 (1929); *California Raisin Growers' Assn v. Abbot*, 160 Cal. 601, 117 P. 767 (1911); *California Bean Growers' Assn v. Williams, supra* note 15; *Tomlin v. Petty, supra* note 236.

[238]11 U.S.C. §541(a)(1) (1982).

[239]11 U.S.C. §542(b) (1982).

[240]11 U.S.C. §541 (1982).

stock is designated by cooperative articles or bylaws as nontransferrable because such restrictions will not prevent passage to the trustee under bankruptcy law.[241] Though the interest becomes part of the estate, the trustee may still be prevented from transferring that interest to a third party. Section 363(e)[242] of the Bankruptcy Reform Act states that an entity with an interest in property proposed to be sold may request that the sale be prohibited if necessary to adequately protect that interest. A cooperative could therefore request a court to prohibit the sale of financial instruments to protect a valid cooperative interest in member characteristics such as producer status.

Patronage retains held by a cooperative are probably a much more substantial asset of the estate than membership or common stock. Those retains, whether in the form of stock, book allocations or equity certificates, should also pass to the trustee of a bankrupt member. This was the holding in the 1980 case of *In re Cosner*.[243] The rule should apply with equal force under the new Act. The court in Cosner recognized the unique character of cooperatives and the perplexing body of law surrounding them. It also acknowledged the unique nature of patronage retains, with "characteristics of both shares of stock in a corporation and of corporate obligations."[244] The court agreed such retains were not indebtedness presently due and payable, but held that this alone did not remove them from property passing to the trustee under the Bankruptcy Act. The court said that the Act was intended to secure for creditors everything of value, and that retains were not the type of property necessary for the debtor to make a fresh start. In holding that the rights to patronage retains passed to the trustee, the court stated:

"It is the opinion of this Court that the [trustee] is entitled to have vested in him, with right to sell, interest that the bankrupt held in the

---

[241] 11 U.S.C. §541(c)(1)(A) (1982) states "An interest of the debtor in property becomes property of the estate...notwithstanding any provision...that restricts or conditions transfer of such interest by the debtor."

[242] 11 U.S.C. §363(e) (1982).

[243] *In re Cosner*, *supra* note 146.

[244] 3 Bankr. at 447.

capital reserve accounts, but that such sale is subject to the burdens of delay of payment and restrictions on transfer applicable to them."[245]

Not only is a bankruptcy trustee unable to force immediate redemption, but the cooperative is also unable to claim patronage retains are immediately due and payable. Cooperatives would not usually take this position, but it may be advantageous in a setoff situation. If a member owes the cooperative a debt that will be discharged in bankruptcy proceedings, a cooperative may prefer to hold on to patronage retains in its possession as a setoff against the debt rather than see them become part of the pool all creditors share. The cooperative in *In re Cosner*, for example, wanted to reduce the amount of the member's retains it held by the amount of an obligation due from the member. The court rejected this maneuver, holding that no current fund was payable on which to base an offset. Equity credits were not an indebtedness of the cooperative presently payable, but were payable only as the board of directors determined.

Third parties may also assert some claim in the bankruptcy proceeding to financial instruments issued by a cooperative. Because the bankruptcy trustee has the status of a hypothetical lien creditor[246] the third party will only be able to assert a secured interest in the asset if the interest is perfected.[247] If the interest is not perfected, the trustee can avoid it[248] and the third party will be relegated to unsecured creditor status. Security interest perfection is governed by Article 9 of the U.C.C., and the method of perfection depends on the type of property in issue. Therefore, a court's categorization of the property may well determine whether the interest is perfected.

In the case of *In re Shiflett*,[249] a cooperative member obtaining a loan

---

[245]*Id.* at 449.

[246]11 U.S.C. §544(b) (1982).

[247]Lien creditors prevail over unperfected security interests under U.C.C. §9-301(1)(b).

[248]The interest may be avoided under §544(a) or as a preference under §547 of the Bankruptcy Reform Act, depending on circumstances.

[249]*In re Shiflett*, 40 Bankr. 493 (Bankr. W.D. Va. 1984).

gave a bank a security interest in "all accounts and accounts receivable" that he owned. When the member took Chapter 7 bankruptcy, the bank claimed a perfected security interest in the member's patronage retains held by the cooperative. The bank's perfection depended on whether the retains were classified as an account or as a general intangible under the Uniform Commercial Code (UCC). The court considered the nature of the retains and classified them as a general intangible. The UCC definition of an account requires that there be a right to payment.[250] Because patronage retain payment was conditioned on the board of directors' declaration and was subject to the prior claim of creditors, the court found no right to payment. Since the bank had failed to perfect according to the method necessary for general intangibles, the court found the fund free of the bank's security interest as against the bankruptcy trustee.

A similar issue arose in the earlier case of *In re Cosner*,[251] but the cooperative itself was the party claiming a perfected security interest. Cooperative bylaws provided for the cooperative's retention of an interest in patronage retains to secure obligations owed by members to the cooperative.[252] Although a security interest might be so created, the court held that no valid security interest had been properly perfected so as to be protected against the trustee. As in *Shiflett*, the court held that the account could only be classified as a general intangible, not capable of being reduced to possession for purposes of perfection under the UCC. Because the cooperative failed to record the security interest, the court therefore held it unperfected and subordinate to the trustee's interest.

Possession may perfect a security interest in preferred stock. In *In re Dahlberg*,[253] the cooperative was the secured party but the security

[250]U.C.C. §9-106 (1983) defines an account as "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance."

[251]*In re Cosner*, *supra* note 146.

[252]Though the reason members were indebted to the cooperative was unclear, such an indebtedness could arise through purchases from the cooperative or through excess advances.

[253]*In re Dahlberg*, 21 Bankr. 730 (Bankr. W.D. Mo. 1982).

interest was created in preferred stock. Since the cooperative had custody of the preferred stock certificates, the court held the interest perfected. It therefore denied the bankruptcy trustee's claim to the value of the stock.

It is possible that a corporate member's bankruptcy can trigger immediate payment under a mandatory payment-at-death provision. The court in *In re Great Plains Royalty Corp.*,[254] held a corporate member's bankruptcy was a cessation of existence constituting death, and required payment under a mandatory provision. As discussed previously, this rationale had been rejected by at least one subsequent opinion.[255]

MERGER, CONSOLIDATION, OR REORGANIZATION

Many agricultural cooperatives today are undergoing major structural changes. One cooperative may merge into another, two cooperatives may terminate their existence to consolidate into a new entity, or a cooperative may carry out a business plan to wind up its affairs to reorganize into a new cooperative. Cooperatives may integrate vertically by acquiring another entity at a different level of the production process, or join with other cooperatives to form a federated cooperative. Any of these events generate questions about members' financial rights.

Members' rights may be specifically defined by statute. Thirty State statutes surveyed in an Agricultural Cooperative Service study[256] contain some reference to merger. Most describe the merger procedure, in varying detail, while a few prescribe rights of members who dissent to merger. Six States allow withdrawing, dissenting members immediate payment of their financial interest, three give dissenting members rights of a dissenting shareholder in a business corporation, and two specifically prohibit dissenting members from receiving payment.[257]

---

[254]*In re Great Plains Royalty Corp.*, *supra* note 163.

[255]*Richardson v. South Kentucky Rural Elec. Co-op.*, *supra* note 164.

[256]*State Inc. Stats.*, *supra* note 5, at 119.

[257]*Id.* at 120.

Typically, members' rights must be determined without the aid of sucl a provision. Courts may apply general corporate law to the extent appropriate for incorporated cooperatives. If the cooperative is unincorporated, courts must decide on the basis of applicable case law. Generally, structural change in a cooperative's organization will not require cash payment of members' financial interest, regardless of its form. Instead, continuing members may assert that financial interest, perhaps in a modified form, against the new organization. A member terminating the relationship with the cooperative has the rights of a withdrawing member. This may or may not entitle him or her to greater payment rights.

In *Pearson v. Clam Falls Cooperative Dairy Association*,[258] minority members objected to proposed consolidation of their dairy cooperative with another. The new association was to take over assets and liabilities of both old cooperatives and issue new stock to members in proportion to their interests. Dissenting members sought to enforce cash redemption, claiming they were deprived of property without due process. The court found no requirement that shares in the new organization be converted into cash. It held the association's purpose was protected in the new organization, transfer was fair, and shareholders' and patrons' rights did not appear to be detrimentally affected.

Pearson also recognized that consolidation accomplished by payment in stock might be the only combination method available to cooperatives, stating, "The legislature was aware of the fact that small cooperatives might be unable to unite, although their best interests might so dictate, unless they could do so without raising new capital. If a minority could insist on being paid in cash, they could wreck the plans for consolidation."[259] Accordingly, the court held that the dissenting member had to accept stock in the new cooperative as payment for member interest. Stock was issued in return for both the member's stock in the old cooperative and as payment for patronage dividends previously allocated.

---

[258]*Pearson v. Clam Falls Co-op. Dairy Assn.*, *supra* note 231.

[259]10 N.W.2d at 134.

A member, though forced to accept new stock in payment for member interest, is entitled to fair evaluation. In reorganizing from a profit corporation to a cooperative, the corporation in *Hill v. Partridge Cooperative Equity Exchange*,[260] proposed to issue to each holder of common stock a certificate of indebtedness of $3.75 plus one share of new cooperative stock worth $25. Because the corporate stock was valued at $63.80, the court held that the proposed method was inequitable, and required a fair price be paid for member stock.

In certain situations, members may not even be entitled to payment in stock. In *Funderburk v. Magnolia Sugar Cooperative*,[261] the owner of 20 shares of nonvoting preferred stock sought to prevent a reorganization that completely cut off preferred stockholders' rights. The insolvent cooperative had turned all assets over to a bank to satisfy its obligations. The bank then transferred the assets, on which it retained its mortgage, to a new corporation composed largely of former common stockholders. The court upheld the transaction as a good faith effort to keep the cooperative operating. The court noted that a preferred stockholder was not a creditor of the cooperative, but was only entitled to dividends if declared and to preference over other stockholders at liquidation. Because cooperative debts would be paid first and the cooperative was insolvent, the plaintiff had no equity in the cooperative and was not injured by the reorganization.

A member of an agricultural cooperative is generally treated as a withdrawing member rather than an expelled one if he or she opts to terminate membership at merger or reorganization. Therefore, his or her rights in financial instruments are determined under withdrawal provisions of the existing cooperative rather than those governing expulsion or dissolution. In *DeMello v. Dairymen's Cooperative Creamery*,[262] for example, a dairy cooperative reorganized into a nonprofit cooperative marketing association under California statute. The net worth of the cooperative was determined by an accounting, and was apportioned among members in the amount of $1,065 each. A

---

[260]*Hill v. Partridge Co-op. Equity Exch.*, 168 Kan. 506, 214 P.2d 316 (1950).

[261]*Funderburk v. Magnolia Sugar Co-op.*, 8 So. 2d 374 (La. Ct. App. 1942).

[262]*DeMello v. Dairyman's Co-op. Creamery*, *supra* note 34.

revolving fund was established to pay that amount within 10 years. Certain withdrawing members sought immediate payment of their entire share in cash. Cooperative bylaws entitled members to immediate payment of a share of the association's net worth on expulsion, but only to the initial $100 membership fee on withdrawal. The court held a withdrawing member could demand only $100.

Members who participate or acquiesce in a merger cannot complain. In *Howard v. Eaton Cooperative Feed Co.*,[263] two dairy cooperatives merged and transferred all assets of the old cooperatives, including accounts receivable and patronage allocations, to the new entity. The new cooperative sued several members, who had not objected to the merger, on accounts due. The members claimed that some of their old cooperative's assets belonged to them as patrons of the former cooperative, and were held in trust for them. They claimed the new entity's organization was illegal as to them and they were not liable to the new cooperative for any obligation. The court rejected the argument, holding that if stockholders participate in an act, or acquiesce in and ratify it, they may not complain. The members had approved the merger and could not assert its invalidity as a defense.

The setoff issue was also raised. Members attempted to use patronage retains allocated to them on the books as a setoff against amounts due on account. They were no more successful than members asserting such a defense during ongoing relationship with the cooperative, at withdrawal, or at bankruptcy. The court stated that those allocations did not represent present cooperative indebtedness. Redemption was instead in the board's discretion. Therefore, no setoff was possible.

Absent a statutory provision determining members' rights at merger or reorganization, a court may rely on noncooperative corporate law. Cooperative statutes may require such application to the extent appropriate. Generally, corporate law, either by statute or case law, will provide dissenting shareholders with a right to the fair value of their shares at merger.[264]

---

[263]*Howard V. Eatonton Co-op. Feed Co., supra* note 146.

[264]Revised Model Business Corporation Act §13.02(a)(1).

A transaction must be a legitimate reorganization or merger to entitle a dissenter to the rights of a withdrawing member. If dissolution and sale is involved, however, the members should instead have those rights provided the members at dissolution. These usually will be greater than those of a withdrawing member because they will involve the liquidation of the membership interest. Members are usually entitled to share either pro rata or on a patronage basis in cooperative assets remaining after it satisfies its debts and obligations.[265]

In *Weise v. Land O'Lakes Creameries*,[266] a turkey processing and marketing cooperative underwent an alleged merger. Three dissatisfied members sued to collect patronage retains held by the new cooperative. They argued that the arrangement was a sale and dissolution. The court recognized that the distinction was vital to a determination of the members' financial interests. Iowa statute provided that patronage dividends matured at dissolution, but at merger the right to payment simply followed the funds to the new cooperative, and would be payable only at the new board's discretion.

The *Weise* court held that the circumstances surrounding the transaction indicated a sale of all assets to the new cooperative, rather than a merger. First, no statutory authority for merger existed at time of the sale. The court stated that there could be no *de facto* merger unless there could first have been a *de jure* merger. Second, all factors indicated the parties considered the transaction a sale. No effort was made to comply with corporate merger law, and the relevant notice referred to dissolution and sale. The court ordered patronage retains redeemed because a sale rather than a merger had taken place.

THIRD PARTY CLAIMS

A cooperative and its members may also contend for priority against third party claimants. Claimants may include creditors of either party, assignees, spouses, heirs, tenants or the State. Third parties will generally find they have no greater rights than those through whom they are claiming.

---

[265] *See, e.g., Merker v. Lake Region Packing Assn.*, 126 Fla. 589, 172 So. 702 (1937).

[266] *Weise v. Land O'Lakes Creameries, supra* note 107.

Creditors of the Cooperative

Members' financial interests are almost without exception subordinated to third party creditors' rights. Properly structured bona fide debt instruments can put members on a par with third-party creditors, but usually obligations to members are by agreement secondary in rank to other debt. Holders of membership interests represented by membership certificates or common stock will not prevail over creditors. Both represent equity interests in the association, inferior to claims of a cooperative's creditors. On dissolution, members are entitled to share in the proceeds from the sale of cooperative assets only after all debts are satisfied.[267]

Members holding equity certificates or patronage retain allocations are generally in no better position. A member may claim such an instrument represents debt due from the cooperative, placing him or her on an equal footing with third party creditors but courts have rejected that argument. The court in *Texas Farm Bureau Cotton Association v. Lennox*,[268] for example, stated that a fund representing such retains is a "corporate fund, a trust fund, and cannot be dissipated until the debts of the corporation have been paid."[269]

A cooperative cannot distribute patronage retains to avoid third party creditors. In *Associated Fruit Co. v. Idaho-Oregon Fruit Growers' Association*,[270] the judgment creditor of a federated cooperative garnished local cooperatives to satisfy an $8,000 judgment against the federated organization for failure to deliver apples. The federated cooperative had distributed to locals certain shares of stock purchased on their behalf with the locals' patronage retains, then closed its busi-

---

[267]Although this would be the rule even if the statute were silent, 25 State statutes specifically require that at dissolution cooperative property must first be applied against debts and obligations of the association. *State Inc. Stats.*, *supra* note 5, at 124 and Table 17.03.01.

[268]*Texas Farm Bureau Cotton Assn. v. Lennox*, 117 Tex. 94, 297 S.W. 743 (1927).

[269]297 S.W. at 746.

[270]*Associated Fruit Co. v. Idaho-Oregon Fruit Growers' Assn.*, *supra* note 15.

ness. The court held that such stock was subject to garnishment, stating:

"Conceding that profits earned by cooperative nonprofit associations belong to the members, and not to the association itself, we understand the rule to be that such profits are subject to the claims of such associations' creditors, and that, not until such claims are liquidated, may there be a distribution of profits to members."[271]

In some situations, members may be liable to third party creditors in excess of amounts received from the cooperative. Members of unincorporated cooperatives may be personally liable under an agency theory for debts the member has authorized. A member also may be liable for membership fees or stock subscription yet unpaid. Some older cases also give statutory assessment rights against common stock.[272]

Members of incorporated cooperatives generally enjoy limited liability. The Standard Cooperative Act, incorporated into 64 State statutes surveyed in an ACS study, provides: "No member shall be liable for the debts of the association to an amount exceeding the sum remaining unpaid on his membership fee or his subscription to the capital stock."[273] The same rule applies when general corporate law is utilized.

Creditors of Member

Cooperative members' judgment creditors can reach any obligations due the member if proper procedure is followed. Execution and garnishment procedures vary among the States, but generally a written instrument must be filed with the relevant court and served on the cooperative. The cooperative must disclose any amount it owes a member and cannot deliver cash or property to the member without court order.[274] The attaching creditor has no greater right to force

[271]256 P. at 100.

[272]*In re Farmers' Dairy Co.'s Receivership*, 177 Minn 211, 225 N.W. 22 (1929).

[273]*State Inc. Stats.*, *supra* note 5, at 68 and Table 10.06.03.

[274]*See* discussion in VanderHaagen, *Friction on the Farm: Security Instruments, Assignments, and Garnishments*, Vol. 36, No. 4 Cooperative Accountant 32, 37 (Winter 1983).

payment than the debtor, and may be unable to enforce even debtors' rights if the interest is not transferrable.

The membership interest in a nonstock cooperative is generally nontransferrable. Only a member is entitled to exercise voting rights, share in the cooperative assets at liquidation, or enjoy any other membership privilege.

A creditor will also probably not be able to attach common stock. Common stock is usually subject to ownership restrictions, such as the requirement of producer status, which the creditor is unable to satisfy.

Limitations on transfer, which will be enforced by the courts even against a judgment creditor, are common. In *Stuttgart Cooperative Buyers' Association v. Louisiana Oil Refining Corp.*,[275] a holder of eleven shares of common stock in a supply cooperative delivered the stock certificates to an oil company as collateral for a debt. When the stockholder defaulted, the oil company sought to foreclose and sell the stock. The cooperative sued to enjoin the sale, and the court held in its favor.

The court noted that the oil company took the stock with notice imposed by law of the nature of the organization and the limitations on transfer. Cooperative articles prohibited ownership by nonresidents or those engaged in competitive businesses, either of which excluded the creditor. Stock transfer also required the cooperative's consent. The court said the certificates of stock were in no sense negotiable, but were membership certificates evidencing members' voluntary contribution of funds. A creditor could not elect itself nor any one else a member, nor substitute a stranger to take the member's place. It appears the pledge of such stock is of little value as collateral and creditors are in effect unsecured.

Creditors are much more likely to obtain satisfaction with patronage retains represented by preferred stock, equity certificates, or book allocations. Such accounts are garnished more frequently than in the past,[276] but a cooperative need only report and deliver to the creditor,

---

[275]*Stuttgart Co-op. Buyers Assn. v. Louisiana Oil Refining Corp.*, 194 Ark. 779, 109 S.W.2d 682 (1937).

[276]*See* discussion in VanderHaagen, *supra* note 274 at 36.

on court order, amounts actually due the member. Such amounts include patronage refunds already declared payable, because they are usually classified as debt of the cooperative, but not undeclared patronage retains payable only at the board's discretion. In *In re M.D.F., Inc.*,[277] a bankrupt cooperative member's creditors attempted to garnish patronage retains evidenced by equity certificates prior to any board resolution to retire them. The court held writs of garnishment were premature and ineffective, stating, "The indebtedness of the garnishee to the debtor was, therefore, contingent and nothing was payable to the garnishor."[278]

Creditors may not be able to force immediate redemption, but should be entitled to attach and sell whatever interest a member has. *In re Cosner*[279] recognized this right in a bankruptcy context. Though Cosner involved a claim by a cooperative member's trustee in bankruptcy, a trustee has a judgment creditor's status under commercial law[280] and the holding may be applicable by analogy. The court recognized that patronage retains held by the cooperative were not debts due, and the trustee could no more enforce immediate payment than could the member. However, the court held that the trustee could seize whatever interest the member had, with right to sell, subject to delay of payment or restrictions on transfer established by the cooperative. Judgment creditors should therefore be entitled to reach and sell present financial interests of a cooperative patron in patronage retains, though the time of payment remains uncertain.

A creditor must establish priority over other claimants to the retains, including the cooperative. Agricultural cooperatives often hold an interest in patronage retains to secure obligations due from members and may claim an interest superior to the creditor's. General commercial law will establish order of priority. Thus, a judgment lienor will

---

[277]*In re M.D.F., Inc.*, 39 Bankr. 16 (Bankr. S.D. Fla. 1984).

[278]*Id.* at 18.

[279]*In re Cosner*, *supra* note 146.

[280]*See* U.C.C. §9-301(3).

generally take subject to perfected cooperative security interests but prior to unperfected security interests.[281]

Assignees

Members may want to voluntarily assign financial interest in a cooperative as a sale or gift or pledge it as collateral. Assignments are subject to cooperative restrictions on the issuance or sale of such interest, but may increase the likelihood of payment to a lender by preventing funds from passing through the debtor's hands. Generally, a cooperative is obligated to make any necessary payments to the assignee once it is notified of a valid assignment. If it does not, it may be subject to double liability under the law of assignments. An assignee steps into the assignor's shoes and is bound by the cooperative's articles, bylaws, and any contract between the cooperative and assignor.[282]

An assignee probably cannot enforce membership rights created by the membership certificate or share of common stock. In *Carpenter v. Dummit*,[283] a tobacco marketing cooperative member assigned his interest in crop proceeds "including all common stock" to the nonmember plaintiff. The plaintiff attempted to exercise membership rights, but the cooperative objected because article and bylaw provisions restricted the sale of stock to members. The court analyzed the controversy in light of cooperative principles, concluding that a cooperative marketing association depends on members' loyalty and their interest in its success. Sale of stock to persons not interested in, and possibly even unfriendly to cooperative marketing might defeat the very purpose for which it was organized. The court therefore upheld the restriction on transfer and ruled that the assignment did not pass legal title to the stock. However, the court held that the plaintiff was entitled to a lien on the stock for the amount paid, and barred the association from delivering certificates representing the stock to the member until the lien was satisfied. The court also held that the

---

[281] *See also* U.C.C. §§9-301, 9-312.

[282] *See Davidson v. Apple Growers' Assn.*, 159 Or. 473, 79 P.2d 991 (1938).

[283] *Carpenter v. Dummit*, *supra* note 60.

assignee was entitled to post-assignment dividends earned on the stock.

Assignment of a right to receive patronage retains, in contrast, should be valid, though subject to applicable restrictions on transfer. The assignee, of course, could receive such funds only when declared payable by the board of directors or when statutes or cooperative documents triggered mandatory payment. In *Carpenter v. Dummit*,[284] the court also considered the disposition of patronage retains. The court held that the assignee was entitled to the assignor's portion of the fund the cooperative returned as unused surplus.

Assignments of cooperative interests often raise priority issues. They may involve multiple assignees or other claimants such as judgment creditors. In the case of multiple assignments, a cooperative must usually pay in the order of receipt rather than pro rata. A cooperative may need to keep books recording the date of receipt, amount, and duration of each assignment if the situation becomes complex.[285]

Priority between assignee and creditor depends on the effective dates of the claims. Assignment is generally effective when made, although a cooperative may owe no obligation to the assignee until it receives notice of the assignment. Judgment creditors' claims to patronage retains generally date from the service of garnishment or attachment on the cooperative. Since a creditor can only assert the debtor's claim to patronage retains, subject to payment delay or other restriction, the debtor must have some interest left to assert. The debtor has no claim if the interest has already been assigned to another. In *Stivers v. Steele*,[286] a tobacco marketing cooperative member assigned certificates representing crop proceeds held by the cooperative to a bank. When another creditor of the member attempted to attach the fund in the hands of the cooperative, the court held the member had no remaining interest to attach: "[The member] could not have recovered the property from [the purchaser] or the bank. Consequently the creditor of [the member], who stands in no better position, could acquire no

---

[284] *Id.*

[285] *See generally*, VanderHaagen, *supra* note 274, at 36-37.

[286] *Stivers v. Steele*, 230 Ky. 700, 20 S.W.2d 717 (1929).

lien.''[287] The assignee of a valid prior assignment will therefore prevail over a judgment creditor.

Finally, patrons may create problems when they attempt to avoid their own assignments. They may decide to change markets, or alter their business identity by changing from one organizational form to another (e.g. sole proprietorship to corporation) or operate in a spouse's or child's name. A cooperative that knowingly makes payments to the member may be liable for violating secured interests of third parties or for fraudulent conveyance.[288]

Divorced Spouse

Memberships in agricultural cooperatives are granted to individual persons. Family memberships or automatic transfers of membership to surviving or divorced spouses would complicate cooperative efforts to restrict membership to producers. Therefore, cooperatives do not often provide for the transfer of membership interests to spouses at death or divorce. A spouse, like other third parties, cannot reach a membership interest represented by a certificate or common stock. Restrictions and limitations denying creditors' membership rights should also apply to a spouse.

A spouse should be entitled to receive his or her proportionate right to patronage retains held by the cooperative if they it qualify as property of the marriage, unless they are property received individually by a spouse through gift or inheritance, or are property excluded by valid agreement of the parties. The spouse, of course, can receive payment only when the member is entitled to do so.

At least one court has awarded an interest in retains to a divorcing spouse. In *Sandner v. Sandner*,[289] the court awarded the wife ''one half the retainages at cooperative canneries.'' Unfortunately, the court did not discuss the rationale underlying its decision.

---

[287] 20 S.W. 2d 718.

[288] *See* discussion in VanderHaagen, *supra* note 276 at 36.

[289] *Sandner v. Sandner*, 243 Or. 349, 413 P.2d 424 (1966).

Claimants at Death of Member

Claimants at a member's death must first determine whether any member interest remains to be claimed, and secondly, who has priority. If the member's right was merely a membership interest represented by membership certificates or common stock, there is probably no interest left to claim. Member rights to patronage retains, however, should become part of the decedent's estate. Immediate payment depends on whether the State or cooperative has a mandatory payment-at-death provision. Absent such a provision, the prevailing claimant must await future decision by the board of directors that retains are payable.

A mandatory payment-at-death provision usually provides for payment of refunds to the member's legal representative, assignee, or estate. Even absent such a directive, declared patronage refunds should be paid to the estate if open or the party the court designates in the final order of distribution if the estate has been terminated.

A member may attempt to make a nontestamentary payee-at-death designation. In *Placerville Fruit Growers Association v. Irving*,[290] for example, the deceased during his lifetime had directed the cooperative to pay his patronage refunds to his daughter at his death. The cooperative passed a resolution to that effect, and noted the change on its books. The court, over the personal representative's objections, held that a trust fund had been created with the cooperative as trustee and the daughter as beneficiary. The daughter was therefore entitled to the patronage refunds at the member's death. Such a designation may be ineffective in the absence of statutory authority, however, because it may violate the statute of wills.[291]

If patronage retains are not claimed, a cooperative and the State may dispute the proceed's ownership. The State may claim the retains under escheat laws. State statutes address this issue in one of four

---

[290]*Placerville Fruit Growers' Assn. v. Irving*, 135 Cal. App. 2d 731, 287 P.2d 793 (1955).

[291]*See* discussion in I. Packel, *supra* note 6, at 101 n.75 (1970).

ways:[292] 1) a statute may clearly provide that unclaimed interests in a cooperative escheat to the State after a specified period of time; 2) a statute may contain a broad definition of property escheating to the State, which is administratively interpreted to include cooperative interests; 3) statutes may exempt property interests in cooperatives from escheat law, with the possible exception of debt instruments or other securities; or, 4) a statute may provide forfeiture in the cooperative's favor.

The Utah statute, which appears to fall into the second category, was examined in *State ex rel Baker v. Intermountain Farmers Association*.[293] The State argued that certain unclaimed patronage retains had escheated to the State treasury. The cooperative argued that they belonged to the cooperative because the applicable statute of limitations had already run on the member's right to claim them. The court held in favor of the cooperative, stating that the State's rights were derived from the rights of the owners of the abandoned property. Therefore, if the statute of limitations barred the owner's claim, the State could not assert it. The court emphasized the fact that Utah had not enacted the Uniform Disposition of Unclaimed Property Act section that permits escheat to the State despite the running of the statute of limitations.

The *Baker* case also established the effective date for the commencement of the statute of limitations. The court said that the statute begins to run against owners "on the date when the patronage credits are available for cash payment on demand."[294]

Tenants

Third-party tenant claims usually occur when patronage dividends attributable to the tenant's share of the crop marketed are paid to the landlord-member. The tenant is generally not the only unhappy party. Income tax will be assessed against the cooperative for distributions

---

[292]The statutory patterns are discussed in *Wheeler, Recent Developments in Equity Redemption and Escheat*, Vol. 37, No. 1 Cooperative Accountant 42 (Spring 1984).

[293]*State ex. rel. Baker v. Intermountain Farmers' Assn.*, 668 P.2d 503 (Utah 1983).

[294]668 P.2d at 506.

paid to someone other than the patron who generated the business because they do not meet the patronage dividends tests necessary for deductibility from income under subchapter T. In *Iberia Sugar Cooperative v. United States*,[295] a cooperative paid patronage dividends to member-landlords for sugar cane harvested and delivered by nonmember tenants under crop sharing arrangements. The cooperative argued that its contractual dealings had been exclusively with the landlords, but the court disallowed exclusion from income of that portion of the payments attributable to non-member tenants' share of the crops.

Nor can the cooperative avoid income tax liability by simply refusing to pay patronage dividends on the tenants' shares. A sugar cooperative in *W.N. Bergeron & Sons v. Caldwell Sugar Cooperative*,[296] in response to the *Iberia* decision, paid the landlord only the one-fifth share of patronage dividends attributable to his crops. The landlord sued for breach of the marketing contract requiring the cooperative pay patronage dividends on all cane delivered by the member. The court said payment of patronage dividends to the landlord for cane grown by his tenants did not violate Federal tax law but merely subjected such amounts to income taxation. The landlord was entitled to patronage refunds. Tenants had asserted no claim on their own behalf, and the court did not discuss their interests further.

Tenants in *Houck v. Birmingham*,[297] however, made such a claim. A cotton ginning cooperative paid all patronage dividends to a landlord under a bylaw provision specifically excluding sharecroppers from the definition of patrons. The tenant sharecroppers claimed one-half of the dividends in a suit against the landlord. The landlord claimed that the generation of patronage dividends could not be attributable to the sharecroppers because such tenants had no title to the crop until their one-half shares were set apart.

---

[295]*Iberia Sugar Co-op. v. United States*, 480 F.2d 548 (5th Cir. 1973).

[296]*W.N. Bergeron & Sons v. Caldwell Sugar Co-op.*, 340 So.2d 1054 (La. App. 1976).

[297]*Houck v. Birmingham*, 217 Ark. 449, 230 S.W.2d 952 (1950).

The court disagreed, stating that the issue was not one of title to crops but whether net proceeds included patronage dividends. The court declared:

"The mere fact that [landlord] hauled the cotton to the gin and made a division of the proceeds of the sale of the cotton should not work a forfeiture of [sharecroppers] right to receive their share of the patronage payments. Such payments are in reality refunds or rebates which reduce the costs of ginning to both [landlord] and [sharecroppers] and thereby increase the net proceeds of the sale of the cotton."[298]

The court therefore held that the sharecroppers could recover their share. The right to recover the refunds would probably extend to claims against any equity certificate representing refunds retained by the cooperative.

CONCLUSION

This study shows that the rights and obligations associated with cooperative financial instruments are much more complicated than might initially appear. Some confusion comes from a lack of understanding of the cooperative nature, but much is created by cooperatives when they fail to designate clearly terms and priorities of instruments issued. Instruments represent claims to money and hard-pressed members of the agricultural sector will continue to litigate their rights to these instruments. Cooperatives should carefully consider the ends they hope to achieve in issuing such instruments, and better draft their documents and instruments to achieve those goals.

---

[298]*Id.* at 453, 230 S.W.2d at 955.

U.S. Department of Agriculture
Agricultural Cooperative Service
Washington, D.C. 20250

Agricultural Cooperative Service (ACS) provides research, management, and educational assistance to cooperatives to strengthen the economic position of farmers and other rural residents. It works directly with cooperative leaders and Federal and State agencies to improve organization, leadership, and operation of cooperatives and to give guidance to further development.

The agency (1) helps farmers and other rural residents develop cooperatives to obtain supplies and services at lower cost and to get better prices for products they sell; (2) advises rural residents on developing existing resources through cooperative action to enhance rural living; (3) helps cooperatives improve services and operating efficiency; (4) informs members, directors, employees, and the public on how cooperatives work and benefit their members and their communities; and (5) encourages international cooperative programs.

ACS publishes research and educational materials and issues Farmer Cooperatives magazine. All programs and activities are conducted on a nondiscriminatory basis, without regard to race, creed, color, sex, age, handicap, or national origin.