Financing the Cooperative Enterprise

I. Cooperative Financing Techniques

The principle that a cooperative is owned and controlled by those who use it implies a financing obligation on the part of member patrons. A fourth principle is sometimes used to make that obligation explicit and point out the uniqueness of financing and patronage relationship. Cooperatives are said to be financed by those who use them in proportion to that use. From an equitability standpoint, such financing proportionality places the burden of financing upon those who receive benefits from the cooperative in proportion to the benefits received.

A considerable portion of authority and information on cooperative taxation is related directly to cooperative financing methods. In addition to the "typical" tax implications of a business corporation's capital structure, cooperative taxation principles applied to distribution of net margins or other income to patrons is integrally connected to cooperative financing techniques. This is expected because the patronage refund and per unit retain allocation process are part of a typical cooperative's financing method.

Every cooperative has a financing system and structure tailored to its needs and the wishes of its farmer members. Because of this, a variety of financing methods exists. Some cooperative financing has attributes of systems used by any noncooperative corporation, other methods are quite unique to cooperatives.

Methods unique to cooperatives may be classified two ways -- methods used to get capital from patrons and systems developed to determine how much capital should be contributed and returned. The method used to add capital based on the patronage relationship can, in turn, be of two types. Patronage refunds may be paid in certificates, notices, or other evidences of the patron's capital contribution rather than being paid to the patron in cash. Patronage refunds are determined by reference to cooperatives' net margins. On the other hand, per unit retain allocations are patron contributions based on an established amount per unit of product.

A second division relates to the system cooperatives may use to determine how much capital is required from each patron and how such capital can be returned to patrons. Two financing methods unique to cooperatives are the revolving fund financing system and the base capital financing system. These two may also be related to each other depending on the particular method a cooperative uses to implement its capital structure. They are described in following sections.

Some financing methods typical for noncooperative corporations are found in cooperatives. Some are used in a very similar fashion but, for the most part, even those superficially similar methods have a somewhat different application in cooperatives than in noncooperative corporations.

The use of stock is common among cooperatives, which are sometimes divided into "stock cooperatives" and those not using stock, called "nonstock cooperatives" or sometimes "membership cooperatives."[1] The Stock cooperatives issue common stock to evidence "membership."[2] The stock carries with it the right to vote in the cooperative's affairs. Two differences emphasize the characteristically cooperative use of common stock. The stock is generally nontransferable and it is typically restricted in voting power it carries so the cooperatives' control system is preserved. Common stock is not usually issued as a main source of financing.

Cooperatives may issue preferred stock, also in different classes if so desired. Preferences and other characteristics of a cooperative's preferred stock are defined by the cooperative.

A substantial amount of written information exists on cooperative financing, perhaps more than on any other single cooperative topic. Following is a small sampling of the literature to suggest the range of topics covered.

Binion, R. Wade, *Understanding Cooperative Bookkeeping and Financial Statements*. USDA, Rural Business-Cooperative Service, Cooperative Information Report 57 (June 1998).

Caves, R.E., and B.C. Peterson, "Cooperatives' Tax 'Advantages': Growth, Retained Earnings, and Equity Rotation," 68 AMER. J. AGRIC. ECON. 207-213 (1986).

Chesnick, David S. *Financial Management and Ratio Analysis for Cooperative Enterprises*. USDA, Rural Business-Cooperative Service, Research Report 175 (January 2000).

Cobia, David, *et al.*, *Equity Redemption: Issues and Alternatives for Farmer Cooperatives*. USDA, Agricultural Cooperative Service, ACS Research Report No. 23 (October 1982).

Cooperative Financing and Taxation. USDA, Rural Business-Cooperative Service, Cooperative Information Report 1, Section 9 (Rev. July 1995).

Cotterill, Ronald W., "Agricultural Cooperatives: A Unified Theory of Pricing, Finance, and Investment," in Jeffrey S. Royer. *Cooperative Theory: New Approaches*. USDA, Agricultural Cooperative Service, ACS Service Report 18 (July 1987).

Knoeber, Charles R., and David L. Baumer, "Understanding Retained Patronage Refunds in Agricultural Cooperatives," 58 AMER. J. AGRIC. ECON. 30-37 (1983).

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[1]See, for discussion, Matthews, Mary Beth, Financial Instruments Issued by Agricultural Cooperatives, U.S.D.A., Agric. Coop. Service Research Rept No. 68 (March, 1988).

[2]Some cooperatives issue different classes of common stock and the exact character of each class is defined by the cooperative.

Lerman, Zvi, and Claudia Parliament, "Financing Growth in Agricultural Cooperatives," 15 REV. AGR. ECON. 431-441 (1993).

Matthews, Mary Beth. *Financial Instruments Issued by Agricultural Cooperatives*. USDA, Agricultural Cooperative Service, ACS Research Report 68 (March 1988).

Moller, Lynn G., Allen M. Fetherstone, and David G. Barton, "Sources of Financial Stress in Agricultural Cooperative," 11 J. COOPERATIVES 38 (1996).

Moore, Charles V., and Jay E. Noel, "Valuation of Transferable Delivery Rights for Marketing Cooperatives," 10 J. AGRIC. COOPERATION 1 - 17 (1995).

Parcell, Joseph L, Allen M. Featherstone, and David G. Barton, "Capital Structure Under Stochastic Interest Rates: An Empirical Investigation of the Midwestern Agricultural Cooperative," 58 AG. FINANCE REV. 49 - 61 (1998).

Pederson, Glenn. *Cost of Capital for Agricultural Cooperatives*. USDA, Rural Business-Cooperative Service, RBS Research Report 163 (September 1998).

Rathbone, Robert C. *Managing Your Cooperative's Equity*. USDA, Rural Business-Cooperative Service, Cooperative Information Report 56 (October 1997).

Rathbone, Robert C., and Donald R. Davidson. *Base Capital Financing of Cooperatives*. USDA, Rural Business-"Cooperative Service, Cooperative Information Report 51 (November 1995).

Royer, Jeffrey S., "Cooperative Principles and Equity Financing: A Critical Discussion," 7 J. AG. COOPERATION 79 (1992).

Royer, Jeffrey S., "A Comparative Financial Ratio Analysis of U.S. Farmer Cooperatives Using Nonparametric Statistics," 6 J. AG. COOPERATION 22 (1991).

Sporleder, Thomas L., "Capital Market Innovations and Agricultural Cooperatives," 81 AM. J. AGRIC. ECON. 1245-1249 (1999).

Tauer, Loren W., and Alfons Weersink, "Optimal Equity Recovery for a Cooperative Financial Institution," 3 J. AG. COOPERATION 59 (1988).

Wissman, Roger A. *Working with Financial Statements: Guide for Cooperative Members*. USDA, Rural Business-Cooperative Service, Cooperative Information Report 43 (Rev. May 1996).

II. Patronage Based Financing

The unusual features of cooperative financing are systems used to relate financial obligations of members and patrons to their use of the cooperative rather than to their direct investment with a view toward returns on investment. Because cooperatives are intended to provide benefits to owners as users rather than as investors and because cooperatives are owned and controlled by those who use them, the obligation to provide finance falls unequally upon members. In addition to the desired goal of financing related to use, the patronage refund system of returning net margins to users has become a convenient and important mechanism by which cooperative financing goals are achieved.

Patronage based financing is the most common way cooperative members and patrons meet their obligation to their cooperative. The concept of patronage based financing is comprised of several parts. First, the proportion of financial contribution made to the cooperative by each member or patron is important. Second, two overall methods are available to achieve the balance of financing required. The first is through direct contribution and the second is based on the fact cooperatives generate net margins from which the patron may contribute the required share.

The second method, more directly related to patronage based financing, can be divided into two parts -- how the financial obligations are contributed to the cooperative by the cooperative's users and how they are returned by redemption. The combination of contribution and redemption yields the cooperative's final capital structure.

Patronage based contribution may be made in two ways.[3] A portion of the patronage refund paid to patrons out of the cooperative's net margins may be paid in a form other than cash. That is, the refund is made but in a certificate of some kind evidencing capital contribution. The system operates as if the patronage refund were paid in full and the patron reinvested part or all of it in the cooperative. This system is recognized in tax law.[4]

A second method in which cooperative patrons contribute their share of the financing is based on units of product handled by the cooperative rather than on the cooperative's return of net margins. The system has become known as the per unit retain system. The cooperative typically retains a set portion per unit of product sold on behalf of the patron as the patron's capital contribution.

As is clear from the above descriptions, capital contributions will continue to build as time passes and patronage occurs. Without redemption an undesirable amount and balance of capital would result both from the cooperative's and patron's perspective. Two systems have been devised

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[3]Classification into only two for summary purposes should not obscure the multitude of variations actually found.

[4]This is a traditional system and was recognized by Courts and the Service long before it received Code authorization.

to give the cooperative the kind of capital structure it wants. One is the "revolving fund financing system" and the other is the "base capital plan system." Although the two systems are often viewed as a dichotomy, they may, in fact, operate together.

A. Retained Patronage Refunds

The following is taken from a manual on cooperative basics prepared by the author for international cooperative development and training purposes.

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1. Principles and Financing

Two cooperative principles describe motivation and suggest goals for cooperative financing. One principle (number three as listed in this coursebook) states: **Returns on investment are limited.** Another says: **Cooperatives are financed substantially by those who own them**.

The first, limiting returns on investment, emphasizes the fact that cooperatives are designed and operated for the purpose of providing goods and services to farmers to improve the profitability of the farm. They are not organized to make a profit for themselves as separate business entities nor to generate profit to turn back to investors who expect the highest returns on their investment possible.

While return to equity investment in a cooperative by farmers is limited but not prohibited, most cooperatives do not pay any compensation in dividends on such capital. The reason for this practice is that to the extent the cooperative pays dividends on equity it reduces the amounts of net income available for distribution to farmer users. While getting compensated for use of capital, the farmer receives less patronage refund. Cooperatives usually weight distribution of net income on a patronage basis rather than on an investment basis because it is in more direct keeping with the benefits distribution cooperative principle.

The second principle indicates cooperatives are financed substantially by members. This also is in keeping with the principle that cooperatives are owned and controlled by those who use them. Ownership implies capital investment.

Not included in the principle as stated is another desirable characteristic of cooperative financing--*member investment should be in proportion to business conducted with the cooperative to the extent possible*. This desirable relationship reflects the believe that:

1. Financial contributions are a burden upon farmer members;

2. Members can only receive benefits from the cooperative by using it to enhance their farm income;

3. A greater financing burden should be borne by those who use the cooperative more and are thus able to realize more benefits form the service their investment supports.

Several financing plans unique to cooperatives (discussed later in this session) implement this "proportionality of investment and use" principle.

2. General Capital Structure

A cooperative's overall financial "structure" may look quite similar to other businesses. The balance sheet will reflect assets on the one side and current liabilities, long-term liabilities, and owners' equity on the other. The primary distinguishing feature of a cooperative's structure is the members' equity section.

Cooperatives may rely on borrowed capital if it is necessary and profitable to do so. The very high cost of borrowed capital when interest rates are high is balanced against severe limitations on what farmers are able to add to equity capital, especially in early years when the cooperative has not had time to build member patronage through special cooperative financing techniques.

3. Membership Fees

Cooperatives require a membership fee from farmers who become cooperative members. It may be evidenced by a share of membership stock or a membership certificate.

The membership fee is not usually an amount great enough to add significantly to the cooperative's total capital. Rather, it is the means by which farmers become members and owners with rights to vote in the cooperative's affairs. However, it is usually an amount great enough to show the seriousness of the member-financing relationship between cooperative and member.

4. Determining Cooperative's Needs

The cooperative (with the board of directors making the decisions) must determine how much capital it needs to finance its operations. This process requires analysis:

1. The cooperative's purposes and what specific business it will conduct to achieve its purposes;

2. What equipment, facilities, and operating methods will be needed to carry out its business efficiently and successfully;

3. Financial needs to acquire and use physical and all other assents;

4. The structure used to meet the financial needs in a most cost-effective manner;

5. Sources and methods used to acquire the required capital.

The first such analysis is conducted at the cooperative's organization and results are contained in the first business plan. Thereafter the board of directors constantly monitors financial performance and the cooperative's business and, in addition, continues the planning process to reflect changing needs and cooperative growth.

5. Methods of Membership Capital Contribution

Ways farmer members can meet the financial needs of their cooperative so it can benefit them by its operations are varied. However, they can be divided into three types:

1. Members make investments in the cooperative by direct payment;

2. Members contribute as part of the patronage relationship through patronage refunds paid in equity interests rather than in cash;

3. Members contribute as part of the patronage relationship through per unit contributions.

a) Direct Investment

Other than the direct investment with a membership fee or purchase of a share of membership stock, direct investment is not usually a major source of member capital in cooperatives. An exception is at the initial stage of financing a new cooperative when a cooperative is created. No capital exists through which to add to capital. Therefore a direct capital contribution may be required.

Some cooperatives with sophisticated financial structures may provide for direct investment by selling special equity interests to members, or sometimes others, such as non-voting preferred stock.

The bulk of a cooperative financing comes from members through the patronage relationship.

b) Patronage Refunds

A relatively "painless" method of members capital contribution is through patronage refunds. The method relies on the *form* of patronage refund payment, although it is sometimes incorrectly called "retained" patronage refund.

Patronage refunds, as discussed last session, may be paid in cash. In addition, however, part of the total amount paid to a patron may be paid not in cash but in the form of some evidence of investment in the cooperative.

The amount not paid in cash is credited directly to the member's equity account in the cooperative and will be part of that individual member's equity until it is "redeemed" (paid back), a process discussed later.

An example can be based on the example of patronage refunds given in the previous session. Patronage refunds were paid as follows:

Patron	Patronage Refund
A	$2,469
B	1,235
C	3,086
D	1,481
E	1,728

We shall call this the refund for YEAR 1. Suppose the cooperative pays 50 percent of the patronage refund in cash and 50 percent is added to the member's equity account, resulting in the following:

Patron	Cash	Equity
A	$1,235	$1,235
B	618	618
C	1,543	1,543
D	740	740
E	864	864

In YEAR 2 the cooperative pays patronage refunds in a similar way, and suppose additions to capital are as follows:

Patron	Cash	Equity, YEAR 1	Equity, YEAR 2	Total Equity
A	$1,235	$1,235	$1,010	$2,045
B	618	618	400	1,018
C	1,543	1,543	1,550	3,093
D	740	740	900	1,640
E	864	864	350	1,214

Total equity in the cooperative for each farmer is indicated in the total.

This process can continue each year. The 50 percent amount is arbitrary and can vary widely depending on a number of factors. It is, for the most part, determined by the cooperative.

c) Per Unit Contributions

"Per unit" contributions to capital are based on patronage by unit of product, not dependent upon net income distribution as patronage refunds. In this method, the cooperative keeps and adds to member's equity on the basis of product marketed through the cooperative. Examples are: A set amount per kilo of milk delivered to the cooperative, per bushel of grain, tone of vegetables, or head of livestock.

An example for head of cattle is as follows with a retain of $10 per head:

Patron	Head of Cattle	Equity
A	20	$200
B	50	500
C	30	300
D	75	750
E	45	450

This pattern will continue into the future with continued livestock delivery.

Each year in both the *patronage refund certificate* and *per unit retain* system each farmer doing business with the cooperative will add equity to the cooperative capital structure. At some point the cooperative will have the amount needed.

Two systems can be used to regulate the total amount of equity each member has in the cooperative:

1. *The revolving fund method* in which equity added to the cooperative is in past years is "redeemed" and replaced by new equity being added by either of patronage related equity contribution systems;

2. *The base capital plan* in which each members' desirable share of total cooperative capital is determined and redemption or addition is adjusted so each member has that amount of equity in the cooperative.

These two systems are not entirely independent and can, if the cooperative wishes, be made to work together.

6. The Revolving Fund Method

The *revolving fund* equity system determines how much total capital the cooperative needs, then begins to "redeem out" the oldest equities in such amounts that new equities being added will maintain the needed capital levels. The cooperative:

1. Pays a portion of a patronage refund in cash or collects a per unit contribution;

2. Totals its member equity after current additions;

3. Determines its current equity needs;

4. Determines the excess equity capital;

5. Redeems earliest equities proportionally so total equity redemption brings member equity to current equity need levels.

The method can be demonstrated by returning to the patronage refund financing example given earlier. Totaling equities added each year for all patrons gives total contributed equity.

Patron	Equity, YEAR 1	Equity, YEAR 2
A	$1,235	$1,010
B	618	400
C	1,543	1,550
D	740	900
E	864	350
Added	$5,000	$4,210
Total		$9,210

At the end of YEAR 2, the cooperative has $9,210 member equity.

Suppose further that in YEAR 3 the cooperative continues to add equity in the amounts shown in the next table.

Patron	Equity, YEAR 1	Equity, YEAR 2	Equity, YEAR 3
A	$1,235	$1,010	$ 960
B	618	400	500
C	1,543	1,550	1,900
D	740	900	450
E	864	350	350
Added	$5,000	$4,210	$4,160
Total	$5,000	$9,210	13,370
Desired			10,000
Excess			$3,370

Suppose further that the optimum amount of capital in the cooperative is determined by the board of directors to be $10,000. At the end of YEAR 3 the cooperative has $13,370, or $3,370 in excess.

To maintain its desired capital level, the cooperative redeems $3,370 worth of equity that had been added in YEAR 1. Because $3,370 is 67 percent of all YEAR 1 equities, the cooperative redeems 66 percent of each patron's equity, thus leaving total equity of $10,000 in the cooperative.

The following redemption will take place. The cooperative will pay cash in the amounts shown and reduce each member's equity in the cooperative accordingly.

Patron	Redeemed, YEAR 3
A	$ 832
B	416
C	1,040
D	499
E	582

The length of time equities are held in the cooperative before redemption is called the *revolving period*. Cooperatives balance their need for capital, net income from which patronage refunds ca be made, the cooperative's capital needs, and the members' need for cash in this process.

A shorter revolving period is desirable to better balance the current patronage with the total amount of equity each farmer has in the cooperative.

7. The Base Capital Plan

The *base capital plan* is a method some cooperative use to better match current patronage with current total equity each member has in the cooperative. The procedure is generally as follows:

1. The cooperative determines its capital needs;

2. It determines each patron's share of the capital needed;

3. Each member's actual capital in the cooperative is compared with the amount the member should have;

4. It then adjusts each member's equity to meet its needs.

Total capital needed does not differ from that estimated in the revolving fund method as described before.

Each member's share is related to patronage levels. This can be done in several ways. Examples are: Each farmer's share of business with the cooperative averaged over the three most recent years, or an estimate of business each patron expects to do with the cooperative in the following year. The cooperative determines a workable method.

Returning to the example, the following table shows the total equity each farmer has in the cooperative at the end of the three year period.

Patron	Equity, YEAR 1	Equity, YEAR 2	Equity, YEAR 3	Total
A	$1,235	$1,010	$ 960	$3,205
B	618	400	500	1,518
C	1,543	1,550	1,900	4,993
D	740	900	450	2,090
E	864	350	350	1,364
Total				13,370

The cooperative wishes each patron to have an amount of equity in proportion to the average business for YEARS 2 and 3. Those proportions are:

Patron	Percent of Business
A	24
B	11
C	41
D	16
E	8

Calculating each share of the $10,000 needed gives the amount of equity each should have.

Patron	Equity Desired
A	$2,400
B	1,100
C	4,100
D	1,600
E	800

The difference between actual and desired determines how much should be redeemed for each patron.

Patron	Actual Equity	Equity Desired	Amount Redeemed
A	$3,205	$2,400	$805
B	1,518	1,100	418
C	4,993	4,100	893
D	2,090	1,600	490
E	1,364	800	564

Many variations of the base capital plan are possible, but all have as their goal a good balance of the burden of equity financing placed on farmers and the benefits received by those same farmers from their patronage relationship with the cooperative.

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B. Revolving Fund Systems

"Revolving fund financing" is a term used for numerous systems. Generally, revolving funds are systems in which patrons make capital contributions on a regular basis, typically through retained patronage refunds or per unit retain allocations. The cooperative redeems such capital contributions on a regular basis. Redemption is usually on a first in, first out basis. The cooperative determines what its total capital requirements are and the excess is redeemed each year, the earliest or "oldest" equity being revolved out first.

One result of this method is a "revolving period" representing the period of time equity is held before redemption. A second result is that contributions are based on use, as suggested by cooperative principles. However, as the revolving period lengthens (the cooperative keeps equity for a longer period of time), the difference between the proportion of current business done with the cooperative and the proportion of total equity contributed by the patron may increase.

Most incorporation statutes do not describe a revolving fund system of financing. Revolving fund financing systems may be described in various ways, typically in the cooperative's bylaws. An example of a statutory description is found in the Iowa statute.

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Section 499.33. <u>Use of revolving fund</u>

The directors may use the revolving fund to pay the obligations or add to the capital of the association or retire its preferred stock. In such event the deferred patronage dividends credited to members shall constitute a charge on the revolving fund and future additions thereto, and on the corporate assets, subordinate to creditors and preferred stockholders then or thereafter existing. Deferred patronage dividends for any year shall have priority over those for any subsequent year. However, prior to any other payments of deferred patronage dividends or redemption of preferred stock held by members, the directors of cooperative associations, other than those cooperative associations which are public utilities defined in section 476.1 and other than those cooperative associations which are public utilities which are exempt from rate regulation as provided in that section, shall pay deferred patronage dividends and redeemed preferred stock, of deceased natural persons who were members, and may pay deferred patronage dividends to redeem preferred stock of members who became ineligible without reference to the order of priority. Directors of cooperative associations which are public utilities defined in section 476.1 and directors of cooperative associations which are public utilities exempt from rate regulation as provided in that

> section, may pay deferred patronage dividends and redeem preferred stock, of deceased natural persons who were members, and may pay deferred patronage dividends or redeem preferred stock of members who became ineligible without reference to priority. Payment of deferred patronage dividends or the redemption of preferred stock of ineligible members shall be carried out to the extent and in the manner specified in bylaws of the association.

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Bylaws usually describe a revolving fund system if used by the cooperative. One description is as follows:

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> If at any time, the board shall determine that the financial condition of the association will not be impaired thereby, the capital then credited to patrons' accounts may be retired in full or in part. Any such retirement of capital shall be made in order of priority according to the year in which the capital was furnished and credited, the capital first received by the association being first retired.
>
> Notwithstanding any other provision of these bylaws, the board, at its discretion, shall have the power to retire any capital credited to patrons' accounts on such terms and conditions as may be agreed upon by the parties in any instance in which the interests of the association and its patrons are deemed to be furthered thereby and funds are determined by the board to be available for such purposes.[5]

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C. Base Capital Plans

"Base capital plan" is a general term given to a financing system that focuses more carefully on the current proportion of capital a patron should have in the cooperative at any particular time, typically based on the degree of use.[6] The cooperative determines first what its total capital needs are. It then allocates the capital needs among its patrons based on various factors, with emphasis on current, average, or projected patronage. Each patron's contribution and redemption is adjusted to achieve the total equity goal. The desired balance can be achieved either by adjusting the amounts contributed, either by direct contribution, retained patronage refunds or per unit retain allocations, or by selected redemption methods.

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[5]*Sample Legal Documents*, U.S.D.A., FCS Information 100 (1974), p. 579.

[6]See Cobia, David W., *et al.*, *Equity Redemption: Issues and Alternatives for Farmer Cooperatives*, U.S.D.A., Agric. Coop. Service Research Rept. No. 23 (October, 1982), and Matthews, Mary Beth, *Financial Instruments Issued by Agricultural Cooperatives*, U.S.D.A., Agric. Coop. Service Research Rept. No. 68 (March, 1988), for descriptions.

Following is taken from Cobia, *et al*., *Equity Redemption: Issues and Alternatives for Farmer Cooperatives*, U.S.D.A., Agric. Coop. Service, ACS Research Rept. 23 (October, 1982).

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> With the *base capital plan*, each patron's equity requirement is readjusted annually according to the cooperative's capital needs and the proportion of its business done with the patron during a moving base period. Patrons who are underinvested continue to provide retained patronage refunds and per-unit capital retains. In addition, they may be required to make cash investments, pay an interest charge to the cooperative on the amount of their underinvestment, or purchase equity from overinvested patrons. Overinvested patrons generally are not required to continue contributing retained equity and begin to receive at least partial redemption of excess investments.
>
> The base capital plan is perhaps the most equitable one in that equity requirements are determined according to patronage. Because inactive patrons are generally cashed out in a relatively short time, use of the base capital plan reduces the need for special programs to handle estates and retired patrons. However, because of its complexity, the plan may be difficult to understand and to administer.

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The following two examples of bylaw provisions for base capital plans is taken from Cobia, *et al*., *Equity Redemption: Issues and Alternatives for Farmer Cooperatives*, U.S.D.A., Agric. Coop. Service, ACS Research Rept. 23 (October, 1982), appendix C.

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The following two sets of bylaw provisions are those used by a few successful cooperatives. They are <u>not</u> considered models. Any cooperative considering a base capital plan may wish to modify the provisions to fit its needs. Also, the cooperative should have its attorney check the base capital bylaw provisions for compatibility with other bylaw provisions and with the State statute under which it is incorporated.

The reader will notice that the bylaws, while establishing a base capital financing method, make reference to revolving fund certificates. If a cooperative considering these bylaws has no revolving fund certificates outstanding, then references to revolving fund certificates should be deleted.

Example 1

Section ___: *Establishment of Base Capital Fund*. Beginning with the ___ fiscal year, the Board of Directors shall establish a Base Capital (or Adjustable Capital) Fund as a method for active members to finance this Cooperative in proportion to their patronage or use of it. The Board shall determine annually at the beginning of the fiscal year the capital requirements of the Cooperative, which shall include the total allocated equity capital expected to be provided as Base Capital.

Such equity capital requirements shall include the approximate amount of overinvestments and underinvestments of members (and nonmembers, if applicable) to be adjusted so as to maintain member patron equity capital in proportion to use of the Cooperative.

a. *Base Capital Credits*. Each member and nonmember patron's share in the Base Capital Fund shall be evidenced by Base Capital Credits, and a record of all holders of such Credits shall be maintained by the Cooperative. Notices of Base Capital Credits to members and patrons shall only be in memorandum form and such memoranda need not be endorsed and returned to the Cooperative upon any payment thereon, or any redemption or cancellation thereof.

Such Credits shall be transferable only to the Cooperative or to an eligible member of the Cooperative on the books of the Cooperative in a manner established by the Board of Directors. Such Credits can be transferred from any member to another member provided the transfer is reported in writing.

No interest or dividend shall be paid on Base Capital Credits. All debts, both secured and unsecured, of the Cooperative shall be entitled to priority over all outstanding Base Capital Credits.

b. *Computation of Base Capital Credits*. A member or other patron's share of the Base Capital Fund shall be computed on the basis of the average volume of products he/she marketed through the Cooperative during a number of the most recent fiscal years of the Cooperative, not exceeding ten (10), as conclusively determined by the Board of Directors to be most appropriate.

[Alternative: Each patron's Base Capital share for each fiscal year shall be that proportion which the average economic value of the products he/she marketed through the cooperative during the immediate preceding base period (not less than 5 nor more than 7 fiscal or crop years and determined by the Board) bears to the average economic value of all products marketed for all patrons during that base period.]

c. *Adjustment of Base Capital Credits*. Each member's or patron's Base Capital Credits shall be adjusted at the beginning of each fiscal year on the basis of the average volume marketed through the Cooperative (or on the basis of the average economic value of that member's/patron's products accepted by the Cooperative) during the preceding number of fiscal or crop years fixed by the Board of Directors as the applicable base period. Thus, a member or a patron's Base Capital share at any time will depend upon his/her volume of marketings through the Cooperative.

d. *Composition of Base Capital*. Such capital may consist of per-unit capital retains or noncash deferred patronage refunds, or both. Such equities shall be credited to accounts of underinvested patrons, i.e., those who do not have their full share of Base Capital until they have accumulated their full shares. Such capital retains and patronage refunds may be either qualified or nonqualified. If the Base Capital Credits of any patron exceeds his or her share for any fiscal year, the excess shall be refunded to said patron in accordance with Section ___, paragraph e.

e. *Limitations on Annual Accumulation and Redemptions of Base Capital Credits*. The Board of Directors may establish a policy as to the maximum percentage of a member's or patron's underinvestment in Base Capital and he/she shall provide in any one year. Also, the Board may establish a policy as to the maximum percentage of a member's or patron's excess (overinvestment) in Base Capital Credits that it will redeem in any one year.

f. *Qualified Per-Unit Retains and Patronage Refunds*. The Board of Directors shall determine at the beginning of each fiscal year the per-unit retain deductions to be made during the year for Revolving Fund or Base Capital purposes, or both, and shall issue qualified Base Capital Credits or Revolving Fund Credits or Certificates for such retains within the time period (currently 8 1/2 months) required by the Internal Revenue Service to permit a Federal income tax deduction by the Cooperative.

Also, the Board shall make patronage refund distributions, under preexisting obligations, to member-patrons or all patrons after the close of the fiscal year, and shall issue qualified Base Capital Credits or Revolving Fund Credits or Certificates to the patrons within the prescribed time period.

g. *Nonqualified Per-Unit Retains and Patronage Refunds*. In lieu of the qualified retains covered in paragraph f, each member or patron may elect to have "handling fees" deducted by the Cooperative from all or a portion of such member's or patron's marketing proceeds. Such deductions shall not be considered as Federal income tax deductions by the Cooperative. In the event handling fees are elected by a member or patron, the amount shall be established at a per-unit rate which is ___ percent of the per-unit rate established by the Board for *qualified* Base Capital Credits or Revolving Fund Credits or Certificates to such member's products.

Also the Board shall determine and issue, under proper procedures and time limits, *nonqualified* Base Capital Credits or Revolving Fund Credits or Certificates for any portion of the patronage refunds for the preceding fiscal year which it deems advisable.

h. *Records and Procedures*. Computations and determinations under this Section shall be made on the basis of the Cooperative's accounts and records.

The Board of Directors may adopt from time to time any policies, procedures, or regulations appropriate to carry out the provisions of this Section; provided that they shall be applied uniformly to all members and consistent with cooperative methods of operation.

Example 2

Section ___: *Base Capital*. The Board of Directors shall determine annually the capital requirements of the Association and shall further determine annually an equitable allocation of such requirements among members of the Association and other patrons. Such allocation is to be computed on the basis of the average volume of product, by reasonably commercial units provided by each member during any number of prior consecutive fiscal years of the Association, not exceeding ten (10), as conclusively determined by the Board of Directors to be most representative. Each member shall maintain capital accounts in accordance with such allocations. The Board of Directors shall follow reasonable standards in setting such allocations, seeking in as practicable a manner as possible, to have members' capital accounts bear a percentage or pro-rata relationship to their overall patronage of the Association.

The Association, at the discretion of the Board of Directors, shall be entitled to continue as outstanding and not pay off any Revolving Fund Certificates in order to satisfy base capital requirements for any member or members, notwithstanding that similar Revolving Fund Certificates of the same year or years are refunded or paid off; provided, however, that outstanding Revolving Fund Certificates which have been retained to satisfy bases capital requirements shall have priority, except in dissolution, and shall be paid off and revolved, when no longer required to satisfy a member's base capital requirement, prior to the paying off and revolving of more recently issued revolving fund certificates. The Board of Directors is further empowered to prescribe other terms and conditions for the establishment and maintenance of base capital.

Section ___: *Capital From Members*. All capital furnished by each member to the Association, whether in the form of capital stock, qualified per-unit retains, or nonqualified per-unit retains, will be a part of such member's base capital requirement.

a. *Qualified Per-Unit Retains*. The Board of Directors shall determine on or before November 1 of each year the per-unit retain deductions to be made during or with respect to the current season's crop for revolving fund purposes. Such capital per-unit retains fixed without reference to net earnings as so established by the Board of Directors shall be allocated and disclosed to the members and other patrons within such time or dates as provided by the Internal Revenue Code and/or valid regulations issued pursuant thereto, and qualified revolving fund certificates shall be issued no later than eight and one-half (8 1/2) months after the end of each fiscal year, or within such other time as may be provided by the then current regulations of the Internal Revenue Service in order to give rise to a Federal income tax deduction by the Association pursuant to Section 1382(b)(3) of the 1954 Code.

b. *Nonqualified Per-Unit Retains*. In lieu of the per-unit retain deductions established pursuant to paragraph (a) of this Section, each member may elect to have "handling fees" deductions retained by the Association from all or a portion of such member's crop proceeds.

The term "handling fees" as used herein shall be deemed to mean deductions retained by the Association during or with respect to the member's current season's crop, which sums will not give rise to a Federal income tax deduction by the Association pursuant to Section 1382(b)(3) of the 1954 Internal Revenue Code, but which will be handled pursuant to Section 1382(b)(4) of the 1954 Code.

In the event handling fees are elected by a member, the amount thereof shall be established at a per-unit rate with is *double* the per-unit rate established by the Board of Directors for qualified revolving fund certificates pursuant to paragraph (a) hereof and the Association shall issue to such member a nonqualified revolving fund certificate evidencing credit to such member's capital amount in an amount equal to fifty percent (50%) of the handling fees deducted from such member's crop.

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D. Other Plans

Cobia, David, *et al.*, *Equity Redemption: Issues and Alternatives for Farmer Cooperatives,* USDA, Agric. Cooperative Service, ACS Research Rept. 23 (October, 1982), gives just one example of many alternatives cooperatives have devised to meet multiple objectives regarding finance.

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> Under the *percentage-of-all-equities plan*, a cooperative redeems a certain percentage of all equities held by patrons regardless of their age of allocation. The percentage to be redeemed

can be varied to accommodate a variety of operating results and growth objectives. This plan is also simple to understand and to administer and encourages the business of new patrons. There is less of a burden on new patrons as they can begin to participate in equity redemption immediately and do not have to wait the length of the revolving period for equity redemption to offset retained patronage refunds or per-unit capital retain deductions. Equity, however, is not supplied in proportion to patronage, and this method of redemption lengthens the time required to transfer ownership from inactive to active patrons.

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III. Equity Redemption

A. General Principle

Most cooperatives have articles of incorporation or bylaw provisions describing the basic principles of their equity redemption system. These are, of course, an integral part of the overall financing program. The following sample is that of a bylaw provision. Two options are given for the method of determining amounts.

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Section 1. Regular Redemption. (two options presented)

(Revolving Fund)
If at any time the board of directors determines that the financial condition of the association will not be impaired thereby, capital credited to members' accounts may be redeemed in full or in part. Any such redemption of capital shall be made in order of priority according to the year in which the capital was furnished and credited, the capital first received by the association being the first redeemed.

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(Percent of All Equities)
It shall be the policy of the association, when other redemption priorities set forth herein have been met, and when funds are available, to redeem in cash a percentage of each member patron's capital credits, rather than ratably by year. The time and method of any such redemption shall be determined by the board of directors.

Section 2. Discretionary Special Redemptions. Notwithstanding any other provision of these bylaws, the board, at its absolute discretion, shall have the power to retire any capital credited to members' accounts on such terms and conditions as may be agreed upon by the parties in any instance in which the interests of the association and its members are deemed to be furthered thereby and funds are determined by the board to be available for such purposes.

Section 3. Specified Special Redemptions. The association shall give priority to redemption of members' capital credits held by deceased persons for the settlement of their estate. The association shall thereafter grant priority redemption to capital credits of former members who have attained their 65th birthday and are no longer actively engaged in agricultural production as actual producers or landlords in share tenancy. The time and method of such redemption shall be determined solely by the board of directors, dependent upon the financial condition of the association. In the case of redemption of the equities of those persons who have attained age 65 and retired from farming, preference may be given to the oldest retirees in establishing the order of priority among those eligible.

In the case of a corporation or partnership holder of members' capital credits, such corporation or partnership shall be considered eligible for priority treatment to the same extent as the individual stockholders of such corporation or partners of the partnership would have qualified, if each individual stockholder or partner were an individual member-patron of this association. Any redemption shall be made to the corporation or partnership, and not to the individual stockholder or partner thereof.

Each corporation or partnership shall report to the association the percentage of ownership interest in the corporation or partnership of each of its stockholders or partners. Failure to report accurately the percentage of individual ownership interest shall disqualify any allocations made to the corporation or partnership by this association from redemption priority. If a corporation or partnership should dissolve, its capital credits in this association shall be prorated among, and transferred to, the individual stockholders or partners and considered for redemption on an individual ownership basis. The amount of any redemption or prorate related to a corporate or partnership member shall be determined by the percentage of ownership interest as reported by the corporation or partnership.

When two or more persons are holders of capital credits as tenants in common, without a designation of rights of survivorship, they shall be deemed by this association to be acting as partners and shall be subject to the same requirements as a partnership.

Capital credits held in joint tenancy with rights of survivorship shall be considered for priority of redemption according to the qualifying status of the youngest member of the joint tenancy or, in the event of death of one of the joint tenants, of the survivor.

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B. Equity Redemption Issues

The following is the article: Baarda, James R., "Farmer Cooperative Equity Conflicts: Judicial Decisions in the 1980s," 12 HAMLINE L. REV. 699 (1989).[7]

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[7] Numerous references address the equity redemption issue, practices and principles. A brief sampling includes: Cobia, David W., *et al.*, *Equity Redemption: Issues and Alternative for Farmer Cooperatives.* USDA, Agricultural Cooperative Service, Research Report 23 (October 1982); Rathbone, Robert C., and Roger A. Wissman. *Equity Redemption and Member Equity Allocation Practices of Agricultural Cooperatives*. USDA, Agricultural Cooperative

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This article identifies and discusses judicial decisions rendered from 1980 to the present that address, in some fashion, problems inherent the patron financing methods of farmer cooperatives. Two dozen decisions were reported during this period on a broad range of issues, some of which have been perennial, others of which appear to be fairly novel in this decade.

This article will identify important cases and categorize the decisions into a framework which demonstrates the variety of issues raised. Indepth issue analysis is not offered. Principles and methods of cooperative operation and finance are noted first, followed by discussion of the issues addressed by recent judicial decisions.

COOPERATIVE FINANCE AND THE EQUITY PROBLEM

Cooperatives are corporations operating according to certain cooperative principles.[8] A typical set of cooperative principles states:

1. Cooperatives are owned and democratically controlled by those who use their services.
2. Net margins are distributed to users in proportion to their use of the cooperative.
3. Returns on investment are limited.
4. Cooperatives are financed substantially by those who use their services.

The financing principle as stated in number four relates to the other principles as well and may be implemented in several ways, some of which are uniquely suited to the cooperative form of business enterprise. In addition to membership or membership stock, which is typically a small part of a cooperative's equity structure, a cooperative may receive investment from patrons as they conduct business wit the cooperative. Patronage refunds, the portion of net margins distributed to patrons in proportion to their use of the cooperative, may be paid part in cash and part in certificates evidencing investment. A set amount per unit of product may be set aside as patron investment.[9] As these funds grow, the cooperative may replace older equities with new contributions by redeeming the oldest equities. Because it may take a number of

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Service, ACS Research Report 125 (October 1993); Barton, David G., and Royce L. Schmidt, " An Evaluation of Equity Redemption Alternatives in Centralized Cooperatives," 3 J. AG. COOPERATION 39-58 (1988); Dahl, Wilmer A., and William D. Dobson, " An Analysis of Alternative Financing Strategies and Equity Retirement Plans for Farm Supply Cooperatives," 58 AM. J. AGRIC. ECON. 1980208 (1976); Erdman, Henry E., and Grace H. Larson. *Revolving Finance in Agricultural Cooperatives*. Madison, Wisc.: Mimer (1965); Royer, Jeffrey S., " Financial Impact of Mandatory Equity Programs on Farmer Cooperatives," 43 AG. FINANCE REV. 30-40 (1983).

[8] Principles are defined by authors in different ways. See, e.g., M. ABRAHAMSEN, COOPERATIVE BUSINESS ENTERPRISE (1976); Baarda, Cooperative Principles and Statutes: Legal Descriptions of Unique Enterprises, U.S.D.A. AGRIC. COOPERATIVE SERV. RES. REP. 54 (1986); Cobia, Equity Redemption: Issues and Alternatives for Farmer Cooperatives, U.S.D.A., AGRIC. COOPERATIVE SERV. RES. REP. 23 (1982); COOPERATIVES IN AGRICULTURE (D. Cobia ed. 1989); Savage & Volkin, Cooperative Criteria, U.S.D.A., FARMER COOPERATIVE SERV. REP. 71 (1965).

[9] Referred to as "per unit capital retain."

years to replace old equity with new,[10] former patrons may not be able to remove their equity immediately when they leave the cooperative, cease to patronize it, or encounter financial difficulties like bankruptcy. Legal issues relating to this aspect of cooperative financing are typically a demand for immediate payment or redemption of retained equity and are the subject of recent decisions discussed in this article.[11]

ISSUES

1980's case law addressed most issues generally associated with cooperative equity redemption and added new issues as well. The two dozen decisions reviewed cover a substantial number of steps in the equity formation, characterization, and redemption process which are unique to cooperatives as a form of business organization common to many farmer cooperatives.

The remainder of this article discusses issues, beginning with formation and acquisition of equity interests in a cooperative. Types of instruments involved in recent cases are noted, with a description of interests which conflict to bring about litigation. Characterization of financial instruments is of interest in some recent cases. Events and surrounding litigation lead to the redemption process itself, and finally to valuation of the interests to be redeemed.

ACQUISITION AND FORMATION OF EQUITY INTERESTS

Equity redemption is the final step of a process which begins with acquisition or formation of a financial interest in the cooperative. Equity is some cooperatives may be acquired by direct purchase either to gain membership rights through the purchase of membership or a share of membership stock, or through contribution to the cooperative's capital structure in some proportion to patronage. Finally, equity may be obtained or formed when the cooperative retains a portion of allocated net margins as a capital contribution or uses a pr unit capital retain based on units of product. Recent cases have involved all three major types of acquisition and formation, some circumstances of which are important to determine relative rights and obligations in the redemption process.

Purchase of membership stock or certificates was noted in several cases, but had little to do with litigated equity conflicts. Of somewhat more importance was the purchase of equity interests not related to membership status or the patronage relationship between purchaser and cooperative.

In Hicks[12] the manager of a cooperative purchased "certificates of preferred interest" from the cooperative. Similarly, direct purchase of an investment certificate was at issue in Gold Kist.[13] In both cases circumstances surrounding direct purchase determined the parties' redemption rights.[14] No membership or

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[10]Referred to as the "revolving period."

[11]Although not all cases deal with redemption, those that do not usually have something to do with an interest in "getting investment back."

[12]Hicks v. Polk County Farmers Coop., 51 Or. App. 699, 627 P.2d 890 (1981).

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

[14]See "Contract and Prior Conduct" infra text accompanying note 84 for discussion of the courts' decisions.

patronage rights attached to the certificates in either case. Direct purchase was also the equity acquisition method in two other cases in which redemption was not the central issue. In Arthur Young[15] and Williams[16] patrons and others purchased investment instruments directly with resulting significant consequences for the cooperative.

The most typically "cooperative" method of equity acquisition is that of retained patronage refunds. In this system, acquisition of an equity interest in the cooperative by a patron depends upon transformation of a net margin allocated to the patron from an interest in income to an equity investment. Until this transformation is complete, rights and obligations assigned equity interests may not fully determine issues at redemption.[17] In re Stinson[18] clearly defined the distinction. A bankrupt dairy farmer possessed "letters of advice"[19] issued by a cooperative. The letters of advice represented funds retained by the cooperative as patron equity. Applicable law[20] exempted ninety percent of an unpaid "milk proceeds" from application in satisfaction of money judgments. The court held that what may originally have possessed some of the attributes of an account due had been converted to either a loan to, or an investment in, the cooperative. The court did not decide which characterization was appropriate. Debtors rights evidenced by the letters of advice were not based on proceeds of milk marketed through the cooperative but on " the issuance of the \`letters\` sometime after the fiscal year to which they have reference."[21] Letters of advice did not represent current income from a milk check, the protection of which was the object of New York's exemption for milk proceeds.

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[15]Arthur Young & Co. v. Reves, 856 F.2d 52 (8th Cir. 1988). For a description of events leading to this litigation, see Wiggins, Cooperatives, Securities Violations, and Advisor Liabilities: A Case Study, 2 J AGRIC. COOPERATION 96 (1987).

[16]Williams v. Columbia Bank for Cooperatives, No. 86-913-CIV-5 (E.D. N.C., Nov. 18, 1988) (securities related case).

[17]See Southeastern Colo. Coop. v. Ebright, 563 P.2d 30 (Colo. Ct. App. 1977).

[18]In re Stinson, 59 Bankr. 914 (Bankr. W.D. N.Y. 1986).

[19]"Letters of advice" is a term taken from the Internal Revenue Code definition of written notices of allocation:

> For purposes of this subchapter, the term \`written notice of allocation\` means any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice, which discloses to the recipient the stated dollar amount allocated to him by the organization and the portion hereof, if any, which constitutes a patronage dividend.

I.R.C. Sec. 1388(b) (1986).

[20]N.Y. C.P.L.R. Sec. 5205(f) (McKinney 1977).

[21]59 Bankr. 914, 916 (Bankr. W.D. N.Y. 1986).

TYPES OF INSTRUMENTS

Financial instruments issued by cooperatives may be classified into three types; those representing membership rights, those representing only an investment in the cooperative, and those integrally associated with the patronage relationship.[22] All three were the subject of litigation in the recent cases analyzed.

Membership certificates or stock were the relevant instruments in only one case.[23] Instruments purchased from the cooperative for the purpose of investment, carrying no rights of membership and unrelated to the patronage process, were at issue in three cases.[24] The majority of recent cases dealt with patronage related equity interests. Twelve cases involved equity formed in retained patronage refund systems.[25] Five cases dealt with equity, based on some stated proportion of patronage, purchased as a requirement for that patronage with the cooperative. In recent cases the stock purchases were required as a condition to borrow from associations in the farm credit system.[26]

INTERESTS IN CONFLICT

There are a range of ways in which interests of parties can conflict. Such conflicts may lead to litigation when either (1) the status of a financial instrument or holder is in doubt and the choice of one classification or the other gives significantly different rights to the parties, or (2) when relative rights associated with a defined financial instrument are in dispute.

Recent cases offer several examples of conflicting rights that depend on how a financial instrument is classified. In re Stinson[27] describes a situation in which a bankrupt dairy farmer's "letters of advice" in a

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[22]For a complete analysis of cooperatives' financial instruments, see Matthews, Financial Instruments Issued by Agricultural Cooperatives, U.S.D.A. AGRIC. COOPERATIVE SERV. RES. REP. 68 (1968).

[23]Milton v. Aransas Shrimp Coop., 668 S.W.2d 735 (Tex. Ct. App. 1983). Its significance is discussed in the text accompanying note 23.

[24]Arthur Young & Co. v. Reves, 856 F.2d 52 (8th Cir. 1988); Williams v. Columbia Bank for Coop., No. 86-913-CIV-5 (E.D. N.C. Nov. 18, 1988). Christian County Farmers Supply Co. v. Rivard, 131 Ill. App. 3d 835, 476 N.E.2d 452 (1985); Gold Kist, Inc. v. Ford, 439 So. 2d 39 (Ala. 1983); Hicks v. Polk County Farmers Coop., 51 Or. App. 699, 627 P.2d 890 (1981).

[25]Atchison County Farmers Union Coop. Ass'n v. Turnbull, 241 Kan. 357, 736 P.2d 917 (1987); In re Axvig, 68 Bankr. 910 (Bankr. D. N.D. 1987); In re Cosner, 3 Bankr. 445 (Bankr. D. Ore. 1980); In re FCX, Inc., 96 Bankr. 49 (Bankr. E.D. N.C. 1989); In re FCX, 853 F.2d 1149 (4th Cir. 1988); In re Lamar Farmers Exch., 76 Bankr. 712 (Bankr. W.D. Mo. 1987); In re M.D.F. Inc., 39 Bankr. 16 (Bankr. S.D. Fla. 1984); Sanchez v. Grain Growers Ass'n of Cal. 123 Cal. App. 3d 444,, 176 Cal. Rptr. 655 (1981), reh'g denied, 126 Cal. App. 3d 665, 179 Cal. Rptr. 459 (1981); In re Schauer, 835 F.2d 1222 (8th cir. 1987); In re Shiflett, 40 Bankr. 493 (Bankr. S.D. Va. 1984); In re Stinson, 59 Bankr. 914 (Bankr. W.D. N.Y. 1986).

[26]Christian County, 131 Ill. App. 3d 835, 476 N.E.2d 452 (1985); In re Greseth, 78 Bankr. 936 (Bankr. D. Minn. 1987); In re Lamar Farmers Exch., 76 Bankr. 712 (Bankr. W.D. Mo. 1987); In re Massengill, 73 Bankr. 1008 (Bankr. E.D. N.C. 1987); In re Walker, 48 Bankr. 668 (Bankr. D.S.D. 1985).

[27]In re Stinson, 59 Bankr. 914 (Bankr. W.D. N.Y. 1986).

cooperative would be subject to judgment if equity or debt, but partially exempt from judgment if they were "milk proceeds" for purposes of New York law.[28]

A distinction of more general importance is the debt versus equity classification conflict. This distinction is of particular concern in setoff cases. In a typical situation a patron becomes a debtor to the cooperative in the normal course of patronizing it. Collection difficulties follow, and the farmer demands that the cooperative setoff the farmer's interest in the cooperative against the debt.[29]

A patron's or member's relative rights in a financial instrument may depend on his or her status with respect to the cooperative. Depending on that determination, the conflict may be defined and implications for equity redemption may follow from the nature of the instrument. In one example of this conflict definition,the residual value of a cooperative at dissolution was to be distributed to members at the time of dissolution.[30] The cooperative had terminated a membership prior to dissolution based on his nondelivery to the cooperative for a one year period. The bylaws required termination for nondelivery for one year, but specified a two-year period if nondelivery resulted from, inter alia, destruction of the fishing vessel. The court determined that the member fell within the two year rule and membership could not be terminated, thus the member retained rights to share in the residual at dissolution.

A conflict common to a substantial amount of litigation is between cooperatives holding retained equities and a former member desiring to have the equity redeemed. This conflict frequently includes a debtor setoff conflict as well. Rules for redemption defined by provisions of state cooperative incorporation statutes may depend on a characterization of the membership termination. A different set of rights may be given a member who is expelled than one who ceases membership voluntarily. The conflict in rights claimed will depend on definition of the termination status.[31]

Conflicts may be drawn in larger scope. Two of these broad conflicts involving public policy were found in recent cases. These issues were drawn in relief, because in many instances, bankruptcy of a cooperative member was a factor in much of the litigation in the decade. Of the two dozen recent decisions analyzed, ten involved bankruptcy of an individual member.[32] In four decisions the bankruptcy of a cooperative, itself a member of another cooperative, let to litigation.[33]

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[28]See supra text accompanying note 12.

[29]See "Setoff" infra text accompanying note 119.

[30]Milton v. Aransas Shrimp Coop., 668 S.W.2d 735 (Tex. Ct. App. 1983).

[31]See "Role of Statutes" infra text accompanying note 31.

[32]In re Axvig, 68 Bankr. 910 (Bankr. D. N.D. 1987); In re Cosner, 3 Bankr. 445 (Bankr. D. Ore. 1980); In re Greseth, 78 Bankr. 936 (Bankr. D. Minn. 1987); In re Lamar Farmers Exch., 76 Bankr. 712 (Bankr. W.D. Mo. 1987); In re Massengill, 73 Bankr. 1008 (Bankr. E.D. N.C. 1987); In re M.D.F. Inc., 39 Bankr. 16 (Bankr. S.D. Fla. 1984); In re Schauer, 62 Bankr. 526 (Bankr. D. Minn. 1986); In re Stinson, 59 Bankr. 914 (Bankr. W.D. N.Y. 1986); In re Walker, 48 Bankr. 668 (Bankr. D.S.D. 1985).

[33]In re Cooperativa Cafeteros de Puerto Rico, 19 Bankr. 732 (Bankr. D. P.R. 1982); In re FCX, Inc., 96 Bankr. 49 (Bankr. E.D.N.C. 1989); In re FCX, 853 F.2d 1149 (4th Cir. 1988); In re Lamar Farmers Exchange, 76 Bankr. 712 (Bankr. W.D. Mo. 1987).

The interest a cooperative has in a stable financial structure may conflict with the interest of the individual patrons in equity redemption. This conflict is usually discussed when a court must assess the validity of a board of directors' discretion not to redeem equity.[34] Courts assessing the argument for trustees rights to immediate redemption have reached conflicting results. Cooperatives fear that their financial condition may be weakened or jeopardized if the redemption decision is removed from the cooperative with respect to a bankrupt patron. One court has agreed that the cooperative and other patrons must be protected.[35] "In view of the economic turmoil affecting rural businesses and the farming community, an agricultural cooperative may well be deluged with requests by Chapter 7 trustees for immediate payment of capital stock."[36] The court also noted that a cooperative is allowed to deny redemption that would threaten or impair its capital, but otherwise would be required to redeem a bankrupt's equity which would still work to the disadvantage of other patrons whose equity redemption would be delayed.[37] The board of directors discretionary role in permitting or disallowing a member equitable redemption was part of a broader conflict in bankruptcy cases involving farm credit system associations. The policy underlying bankruptcy law may be opposed to federal farm credit system interests.

ROLE OF STATUTES

Statutes, in particular the statutes under which cooperatives are incorporated, play an important role in the equity formation and redemption process, although in few situations do statutes mandate specific actions with respect to equity formation, acquisition, retention, or redemption. Recent cases suggest five different ways statutes may be important.

First, statutes describe the general purposes of cooperatives,their important place in the economy, and generally establish the tenor of public policy toward cooperatives.[38] In Atchison,[39] public policy encouraging cooperative business was held to be an important factor in deciding that an individual member's interests were not paramount to those of the cooperative if redemption in a setoff could harm the "financial condition or life of the association."[40]

Second, the nonprofit nature of a cooperative may be important to help determine the relative weight of an individual member's interest in with drawing equity. Cooperatives were established "for the personal benefit of members only to the extent that the individual profited through the operation of the enterprise; and

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[34]See "Role of Director Discretion" infra text accompanying note 64.

[35]In re Axvig, 68 Bankr. 910 (Bankr. D. N.D. 1987).

[36]Id. at 917.

[37]Id.

[38]See Atchison County Farmers Union Coop. Ass'n v. Turnbull, 241 Kan. 357, 736 P.2d 917 (1987); Sanchez v. Grain Growers Ass'n of Cal., 123 Cal. App. 3d 444, 176 Cal. Rptr. 655, reh'g denied, 126 Cal. App. 3d 665, 179 Cal. Rptr. 459 (1981).

[39]Atchison County, 241 Kan. 357, 736 P.2d 917 (1987).

[40]736 P.2d at 922.

... the paramount concern was not the advancement of the individual as such."[41] The prime purpose of the cooperative is to provide service, not reward investors.

Third, statutes may authorize a revolving fund system of cooperative finance. They also recognize the cooperative's interest in retaining patronage refunds for periods that depend on the cooperative's interest in retaining patronage refunds for periods that depend on the cooperative's financial needs.[42]

Fourth, statutes usually assign responsibilities for cooperative management to the board of directors. The courts may refer to directors' statutory duties of management to justify directors' discretionary role inequity redemption.[43]

Finally, certain statutory provisions may relate directly to the equitable redemption process.[44] The court in Christian County[45] applied the Illinois cooperative incorporation statute[46] requiring the board of directors, upon withdrawal or expulsion of a member,[47] to "equitably and conclusively appraise his membership and/or common stock interests in the association" and pay the amount in money within one year after expulsion or withdrawal.[48] The court refused to apply the payment requirement to preferred stock,holding "membership stock" did not apply to "all stock."[49] The court held that the problems which might be caused by board of director discretionary powers were quite different for transferable preferred stock and nontransferable common stock, and the statute distinguished between the two.[50]

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[41]Id. See also In re Lamar Farmers Exch., 76 Bankr. 712 (Bankr. W.D. Mo. 1987) (for a more general principal).

[42]Atchison County, 241 Kan. 357, 736 P.2d 917 (1987); Sanchez v. Grain Growers Ass'n of Cal., 123 Cal. App. 3d 665, 179 Cal. Rptr. 459, reh'g denied, 126 Cal. App. 3d 665, 179 Cal. Rptr. 459 (1981). State cooperative incorporation statutes do not normally detail any particular system. See Baarda, State Incorporation Statutes for Farmer Cooperatives, U.S.D.A. AGRIC. COOPERATIVE SERV. INFOR. REP. 30 (1984) [hereinafter Baarda, State Incorporation Statutes].

[43]Atkinson County, 241 Kan. 357, 736 P.2d 917 (1987). See also Fee, Hoberg & McCormick, Director Liability in Agricultural Cooperative Services, U.S.D.A. COOPERATIVE INFO. REP. 34 (1984).

[44]For details comparing all cooperative incorporation statutes, see Baarda, State Incorporation Statutes supra note 35; Cobia, supra note 1.

[45]Christian County Farmers Supply Co. v. Rivard, 131 Ill. App. 3d 835, 476 N.E.2d 452 (1985).

[46]ILL. REV. STAT. ch. 32 Sec. 454.6 (1983).

[47]The court did not find the cooperative had formally terminated membership, but the farmer debtor did not qualify for membership because he no longer met delivery requirement, 131 Ill. App. 3d at _______, 476 N.E.2d at 453.

[48]Christian County, 476 N.E.2d at 453.

[49]Id. at 454.

[50]The former member urged the court to look to "evil sought to be remedied" and extend application to preferred stock. Christian County, 476 N.E.2d at 459.

State statutory provisions describing equity redemption for an expelled member were also at issue in Sanchez.[51] Requirements that the cooperative appraise and redeem equity within one year after expulsion were not applied because the court held the cooperative's bylaws provided a redemption "procedure" sufficient to remove the cooperative from the operation of the statute's mandate.

ROLE OF BYLAWS AND OTHER DOCUMENTS

Bylaws and certificates issued to evidence an equity interest are the most important documents upon which courts rely when assessing rights and obligations of equity interests. As with statutes, recent cases show cooperative bylaws to have several roles in the equity acquisition, retention, and redemption process.

First, bylaws describe the financial structure of the cooperative, giving directors and member-patrons the blueprint for cooperative financing. Bylaws "provide the means to obtain the necessary funds or capital to pay the expense of operations and acquire property necessary to carry out its purposes."[52]

Second, bylaws describe the characteristics of financial instruments. Of special importance, as noted in recent cases are provisions on redemption,[53] on transfer,[54] on the establishment of security interests in a patron
s equity by the cooperative,[55] and on the deferral of redemption decisions to the discretion of the board of directors.[56]

Third, a cooperative's bylaws may specifically describe rights of redemption. Bylaw provisions of this type have commonly been analyzed in recent cases. The most significant role played by the bylaws is when they describe what happens upon termination of membership, particularly if termination is a result of

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[51]Sanchez v. Grain Growers Ass'n of Cal., 123 Cal. App. 3d 444, 176 Cal. Rptr. 655, reh'g denied, 126 Cal. App. 3d 665, 179 Cal. Rptr. 459 (1981).

[52]Atchinson County, 241 Kan. 357, 736 P.2d 917, 920 (1987). See generally In re Cosner, 3 Bankr. 445 (Bankr. D. Or. 1980); In re FCX, Inc., 96 Bankr. 49 (Bankr. E.D. N.C. 1989); In re FCX, 853 F.2d 1149 (4th Cir. 1988); Sanchez, 123 Cal. Ct. App. 3d 444, 176 Cal. Rptr. 655, reh'g denied, 126 Cal. App. 3d 665, 179 Cal. Rptr. 459 (1981); In re Schauer, 835 F.2d 1222 (8th Cir. 1987).

[53]Atchison County, 241 Kan. 357, 736 P.2d 917 (1987); In re Axvig, 68 Bankr. 910 (Bankr. D. N.D. 1987); In re FCX, Inc., 96 Bankr. 49 (Bankr. E.D. N.C. 1989); In re FCX, 853 F.2d 1149 (4th Cir. 1988); Sanchez, 123 Cal. Ct. App. 3d 444, 176 Cal. Rptr. 655, reh'g denied, 126 Cal. App. 3d 665, 179 Cal. Rptr. 459 (1981); In re Shiflett, 40 Bankr. 493 (Bankr. S.D. Va. 1984).

[54]In re Axvig, 68 Bankr. 910 (Bankr. D. N.D. 1987); In re Schauer, 62 Bankr. 526 (Bankr. D. Minn. 1986); In re Schauer, 835 F.2d 1222 (8th Cir. 1987).

[55]In re Axvig, 68 Bankr. 910 (Bankr. D. N.D. 1987); In re Cosner, 3 B.R. 445 (Bankr. D. Ore. 1980). Such provisions in articles of incorporation were discussed in re Axvig, 68 Bankr. 910 (Bankr. D. N.D. 1987); In re FCX, Inc. No. S-85-01754-5 (Bankr. E.D. N.C. June 23, 1987); In re FCX, 853 F.2d 1149 (4th Cir. 1988).

[56]Atchison County, 241 Kan. 357, 736 P.2d 917 (1987); In re Axvig, 68 Bankr. 910 (Bankr. D. N.D. 1987); In re FCX, Inc., 96 Bankr. 49 (Bankr. E.D. N.C. 1989); In re FCX, 853 F.2d 1149 (4th Cir. 1988); Sanchez, 123 Cal. Ct. App. 3d 444, 176 Cal. Rptr. 655, reh'g denied, 126 Cal. App. 3d 665, 179 Cal. Rptr. 459 (1981); In re Shiflett, 40 Bankr. 493 (Bankr. S.D. Va. 1984).

member expulsion. Bylaws and statutes often play related roles. The bylaws of the cooperative described in Sanchez[57] described in some detail the cooperative's retained patronage refund system. In Sanchez, the bylaws stated that membership in the cooperative had no intrinsic value. Thus upon membership termination, the cooperative was not obligated to pay anything to the terminating member. As to retained patronage refunds, termination was to give no rights beyond those the member would have enjoyed absent termination.[58] The California cooperative incorporation statute mandated certain repayments in the absence of bylaw provisions.[59] The court held that the

> necessary `procedure' clearly is provided for in the bylaws. The association determined, and, upon joining, the members agreed, that a membership was to be without financial value and retains were to be distributed to all persons in a like manner, regardless of termination .... [S]uch a system promotes financial stability, and we feel, adequately deals with an expelled member's interest.[60]

Fourth, it is common practice for bylaws to assign redemption discretion to the board of directors.[61]

Fifth, bylaw provisions on other aspects of the cooperative's structure and operation may have an impact on equity redemption. Bylaw provisions most likely to be relevant in equity cases are those describing membership termination or conditions of eligibility for membership. In Milton[62] the member's interest in cooperative dissolution depended on his status as a member at the time of dissolution. The court held the cooperative could not have terminated membership prior to dissolution because conditions for membership termination contained in the bylaws were not met.

Finally, bylaws bind the parties as a contract. A member is a party to a contract that defines rights and obligations in the cooperative's financial structure. Membership applications and marketing agreements,

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[57]Sanchez, 123 Cal. App. 3d 444, 176 Cal. Rptr. 655, reh'g denied, 126 Cal. App. 3d 665, 179 Cal. Rptr. 459 (1981).

[58]"It is intended that the Association shall conduct its business with moneys withheld for or invested in the Revolving Funds or other fund or funds, and said withheld or invested moneys shall be repayable in accordance with the provision hereof, regardless of the termination of membership. Sanchez, 123 Cal. App. 3d ______, 176 Cal. Rptr. at 658.

[59]In the case of expulsion of a member and where the bylaws do not provide andy procedure or penalty, the board of directors shall equitably and conclusively appraise his property interest in the association and shall fix the amount paid of his property interest in money, which hall be paid to him within one year after such expulsion. Sanchez, 123 Cal. App. 3d 444, 449, 179 Cal. Rptr. 655, 657 (quoting Food and Agricultural Code Sec. 54122), reh'g denied, 126 Cal. App. 3d 665, 179 Cal. Rptr. 459 (1981).

[60]Sanchez, 123 Cal. App. 3d 444, 449, 179 Cal. Rptr. 655, 657, reh'g denied, 126 Cal. App. 3d 665, 179 Cal. Rptr. 459 (1981).

[61]See, e.g., Atchison County, 241 Kan. 357, 736 P.2d 917 (1987); In re Axvig, 68 Bankr. 910 (Bankr. D. N.D. 1987); In re FCX, Inc., 96 Bankr. 49 (Bankr. E.D. N.C. 1989); In re FCX, 853 F.2d 1149 (4th Cir. 1988); Sanchez 123 Cal. App. 3d 444, 176 Cal. Rptr. 655, reh'g denied, 126 Cal. App. 3d 665, 179 Cal. Rptr. 459 (1981); see "Role of Director Discretion" infra text accompanying notes 63, 64.

[62]Milton v. Aransas Shrimp Coop., 668 S.W.2d 735 (Tex. Ct. App. 1983).

among other documents, may state that the parties are bound by bylaws.[63] A plea that equities should be redeemed out of turn for "equitable reasons" may be countered with a contractual obligation to accept the redemption system to which the member is bound in the bylaws.[64] Cooperative agreements "are not simply agreements entered into with an agent . . . [they] are essentially to and with all the other members of the . . . association and the interests of every member rest upon the same foundation, and no member can be advantaged to the detriment of any other member."[65]

Certificates evidencing an equity interest may also describe holder's rights and limitations on those interests. Rights and obligations are often contained in certificates which include: a cooperative's right to redeem,[66]assignment of redemption discretion to the board of directors,[67]and restrictions on transfer.[68] As with bylaws, a certificate evidencing investment may contain terms establishing contractual relations between cooperative and investor, and its interpretation will follow contract principles.[69]

ROLE OF DIRECTOR DISCRETION

Director discretion is a key element in most cases that deal with equity redemption litigation. The most common sources of director discretion in redemption decisions are the applicable bylaws and the certificates evidencing an equity interest. Recent cases describe the financial instrument definition role of director discretion, noting limits on director discretion. Moreover, the opinions enunciate under what circumstances director discretion is removed from the redemption process.

When a financial instrument is redeemable only at the discretion of the cooperative's board of directors, that fact alone helps define the instrument. The argument has been made that because redemption of revolving fund equities are subject to the board of directors' discretion, such interests are thereby rendered

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[63]Id.; see also Sanchez, 123 Cal.App.3d 444, 176 Cal.Rptr. 655, reh'g denied, 126 Cal.App.3d 665, 179 Cal.Rptr. 459 (1981).

[64]Atchison County, 241 Kan. 357, 736 P.2d 917 (1987).

[65]Sanchez, 123 Cal.App.3d 444, 176 Cal.Rptr. 655 (quoting Cal.C.P. Growers v. Downey, 76 Cal.App. 1, 15, 243 P. 679 (1925)), reh'g denied, 126 Cal.App.3d 665, 179 Cal.Rptr. 459 (1981).

[66]Christian County Farmers Supply Co. v. Rivard, 131 Ill.App.3d 835, 476 N.E.2d 452 (1985); Gold Kist, Inc. v. Ford, 439 So.2d 39 (Ala. 1983); Hicks v. Polk county Farmers Coop., 51 Or.App. 699, 627 P.2d 890 (1981); In re M.D.F., 39 Bandr. 16(Bankr. S.D. Fla. 1984).

[67]Christian County, 131 Ill.App.3d 835, 476 N.E.2d 452 (1985); Gold Kist, Inc. v. Ford, 439 So.2d 39 (Ala. 1983); In re M.D.F., 39 Bankr. 16 (Bankr. S.D. Fla. 1984).

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

[69]Gold Kist, Inc. v. Ford, 439 So.2d 39 (Ala. 1983); Hicks v. Polk County Farmers Coop., 51 Or.App. 699, 627 P.2d 890 (1981). See "Contract and Prior Conduct" infra text accompanying note 87.

illusory. Two courts have specifically rejected the argument when raised by an equity holder,[70] and by a cooperative in an attempt to prevent transfer of revolving fund certificates to a trustee in bankruptcy.[71]

The contingency attached to the instrument also indicates it is not an indebtedness payable immediately. Thus setoff arguments comparing the patron's debt immediately payable to the cooperative, with member equity payable only at the board's discretion, do not meet criteria for setoff.[72]

The fact that redemption of an equity is subject to director discretion is determinative of the nature of the interest for other persons. In MDF,[73] the attempt of a garnishor to collect a debtor's revolving fund certificates from a cooperative garnishee failed. The garnishor's failure was attributable to the board of directors' failure to authorize retirement or transfer of the certificate. "The indebtedness of the garnishee to the debtor, was, therefor[e], contingent and nothing was payable to the garnishor."[74] In Shiflett,[75] a bank claimed to have a secured interest in a bankrupt debtor's retained equities calling them an "account" with the cooperative. The court held that under Virginia law, an "account" requires a right to payment. Under the terms of the cooperative's bylaws, the retained patronage refund redemption was conditionally payable at the discretion of the board of directors. Therefore, redemption was always undetermined until the board decided to redeem the equities, rendering the interest a general intangible free of any security interest as against the rights of the trustee in bankruptcy.

A second aspect of director discretion relates to limits on discretion or abuse of discretion by boards of directors. A board's discretion is not unlimited. In general, "the actions of the board are subject to good faith and reasonable business judgment."[76] In a few recent cases, equity holders argued that several kinds of behavior by boards of directors should justify courts' forcing redemption. One standard discussed was an "arbitrary and capricious" standard noted by the court in Cosner.[77] A related but more specific standard noted in recent cases was a "discriminatory treatment" measure. In this case and equity holder pleaded that a cooperative had redeemed equity of similarly situated holders. The court in Schauer[78] declined to find

[70]"The actions of the board are subject to good faith and reasonable business judgment." Sanchez, 123 Cal.App.3d 444, 452, 176 Cal.Rptr. 655, 659, reh'g denied, 126 Cal.App.3d 665, 179 Cal.Rptr. 459 (1981).

[71]In re Cosner, 3 Bankr. 445 (Banker.D.Or. 1980).

[72]See "Setoff" infra text accompanying note 119.

[73]In re M.D.F., 39 Bankr. 16 (Bankr.W.D.Fla. 1984).

[74]Id. at 18 (applying Florida law).

[75]In re Sheflett, 40 Bankr. 493 (Bankr.S.D.Va. 1984). The security interest was described as "all accounts and accounts receivable, now existent or hereafter created; proceeds of collateral are also covered. Proceeds of products of collateral are also covered."

[76]Sanchez, 123 Cal.App.3d 444, 176 Cal.Rptr. 655, 659 reh'g denied, 126 Cal.App.3d 665, 179 Cal.Rptr. 459 (1981).

[77]In re Cosner, 3 Bankr. 445 (Bankr.D.Or. 1980) (no such behavior was found).

[78]In re Schauer, 62, Bankr. 526 (Bankr.D.Minn. 1986)m aff'd, 835 F.2d 1222 (8th Cir. 1987).

"arbitrary and capricious" refusal to redeem absent a showing of "particularized discrimination" by the cooperative. The equity holder in Lamar [79]argued the cooperative was arbitrary and capricious in its refusal to redeem patronage equity in light of its past history of allowing other members redemption. The court, citing Claassen,[80] treated director decisions as business judgments. this characterization did not necessitate deciding whether the cooperative acted reasonably.

Finally, legal principles may remove the role of board's discretion from the redemption decision. Instead, redemption may be based on legal principles in which discretion plays no role. Statutory provisions on redemption of equities under specified circumstances may apply, as when procedures and payment is required at withdrawal or expulsion. Conditions placing former members in a position to demand redemption must be met before a board's discretion is bypassed.[81]

The most significant opinions relating to a director's discretion, outside the redemption process, occurred where public policy, inherent in bankruptcy law, was found to supersede provisions of the Farm Credit Act assigning discretionary powers to boards of directors of Federal Land Banks and Production Credit Associations. The redemption provisions of the Farm Credit Act[82] and the associated regulations[83] were discussed in re Massengill, when a bankrupt wanted to surrender stock in a Federal Land Bank and Production Credit Association in satisfaction of a debt to those organizations.[84]

The Bankruptcy Court in Massengill, cited In re Walker[85] where the court held that to permit a debtor to retire or cancel Production Credit Association stock as part of Chapter 11 plan would "alter the structure of the PCA" and "seriously undermine the functioning of the whole farm credit system as envisioned by Congress under the Farm Credit Act."[86] The court rejected that approach, relying instead on a Fourth Credit Circuit Court of Appeals decision.[87] In that 1966 case the issue was first impression for the fourth circuit. The Court removed the process from directors' discretion stating that when the court directed setoff it did not cause a retirement of redemption of stock. "[W]e need not substitute our judgment for that of the Board

[79]In re Lamar Farmers Exch., 76 Bankr. 712 (Bankr.W.D.Mo. 1987).

[80]Claassen v. Farmers Grain Coop., 208 Kan. 129, 490 P.2d 376 (1971).

[81]Christian County Farmers Supply Co. v. Rivard, 131 Ill.App.3d 835, 476 N.E.2d 452 (1985) (mandatory redemption of "membership stock" did not apply to preferred stock).

[82]12 U.S.C. § 2034(a) (1988).

[83]12 C.F.R. § 615.5260(b) (1988).

[84]In re Massengill, 73 B.R. 1008 (Bankr.E.D.N.C. 1987).

[85]In re Walker, 48 B.R. 668 (Bankr.D.S.D. 1985).

[86]Id. at 670.

[87]Columbia Band for Coop. v. Lee, 368 f.2d 934 (4th Cir. 1966), cert. denied, 386 U.S. 992 (1967).

of Directors [of the bank] as to retirement of stock, since we do not order retirement. Nor do we consider offset equivalent to redemption since the bank can reissue the stock at part to other borrowing cooperatives.[88]

The court in Massengill seemed to accept the Fourth Circuit's result but with a somewhat more appropriate rationale. It held the bankruptcy law "controls, [though it] is indeed true that redemption limitations imposed on the stock of lank banks and production credit associations were designed to enhance their capital structure."[89] The court relied on purposes of Chapter 12, and the "greater flexibility" granted by Chapter 12. More specifically, the court noted a Chapter 12 provision that a plan may "provide for the sale of all or any part of the property of the estate *or the distribution of all or any part of the property of the estate among those having an interest* in such property."[90] Weighing the interests of the Farm Credit Act of 1971 and bankruptcy law, the court concluded "[a] debtor's ability to return land bank or production credit association stock to land banks and production credit associations to satisfy or reduce secured claims should not be frustrated by the Farm Credit Act."[91] It should be noted that director discretion is removed only to the extent the equity is collateral for debt. Director discretion was never removed to require complete redemption of equity.

CONTRACT AND PRIOR CONDUCT

Many recent decisions applied elements of contract law which were inherent in the cooperative's bylaws. In some cases, contract law was applied directly to determine rights and obligations with respect to equity interests, including conduct surrounding the investment's sale and prior cooperative redemption practices.

Gold Kist[92] described an investment security not related to membership or patronage. The certificate was sole subject to terms and conditions including a provision that "This Certificate may be prepaid at any time, without premium or penalty, in whole or in part, at the discretion of the Board of Directors."[93] When the cooperative refused to redeem the certificate prior to its stated maturity date, equity holders brought action claiming breach of contract and misrepresentation by mistake. The plaintiffs claimed they had been assured when they purchased the certificates there would be no problem in obtaining redemption at any time.

The Alabama Supreme Court held there was no breach of contract cause of action. Overturning the trial court's finding that the contract was written in part and verbal in part, the court held the certificate was unambiguous and contained the complete terms of contract on redemption rights and restrictions based on

[88]Id. at 938 n. 10.

[89]In re Massengill, 73 Bankr. 1008, 1012 (Bankr.E.D.N.C. 1987). "It is not uncommon that the Bankruptcy Code will prevail over a conflicting federal law." Id.

[90]11 U.S.C. § 1222(b)(8) (1988) (emphasis in original).

[91]In re Massengill, 73 Bankr. 1008, 1012 (Bankr.E.D.N.C. 1987). This holding foreshadows In re FCX, 853 F.2d 1149 (4th Cir. 1988), discussed infra.

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

[93]Id. at 41.

director approval. The case was remanded for a determination of the tortious misrepresentation claim against the cooperative.[94]

On the other hand, terms of redemption on the face of a financial instrument may be ambiguous, especially if read in conjunction with articles of incorporation which confuse the character of the instrument. In Hicks[95] a cooperative not permitted by its articles to issue preferred stock sold "certificates of preferred interest." The court found that statements within the four corners of the certificates, "this certificate had no maturity date" and that the certificates were to be "callable serially in order of their issuance," were sufficiently ambiguous to necessitate admission of parol evidence.

The court in Hicks gave "great weight" to the conduct of the other certificate holders and the cooperative to construe the certificate's contractual meaning. It found that in many past instances the cooperative had redeemed certificates on demand. The certificate holder, himself the cooperative's former manger, had redeemed certificates on reasonable notice, and certificate purchasers were routinely told such was the case unless the cooperative was financially unable to pay. The court concluded the cooperative and the certificate holder treated the certificates as redeemable on demand and ordered their redemption.

STATED INVESTMENT REQUIREMENTS

In most situations where a cooperative maintains member-patron equity as part of its financial structure, and where the cooperative must decide how much equity is required, no dollar figures are placed on the total equity required for successful operation. Redemption decisions are not merely administrative determinations but are fundamental business judgments essential to the cooperatives's success and financial survival.

In other circumstances the amount to be invested in the cooperative is related to a determinable figure. An example is a base capital plan in which the cooperative typically requires equity in some stated proportion to the amount of business done with the cooperative. An analogous situation exists for some borrowers from associations in the Farm Credit System. In the case of Federal Land Banks[96] and Production Credit Associations[97] borrowers are required to purchase and maintain stock in the FLB or PCA equal to a stated percentage of the amount borrowed. When the loan amount decreases the stock investment requirement may decrease. The excess may then be available for redemption.[98]

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[94] The trial court found such misrepresentation on the part of the cooperative's selling agent, but the agent did not appeal.

[95] Hicks v. Polk County Farmers Coop., 51 Or. App. 699, 627 P.2d 890 (1981).

[96] In re Greseth, 78 Bankr. 936 (Bankr. D. Minn. 1987).

[97] In re Massengill, 73 Bankr. 1008 (Bankr. E.D. N.C. 1987); In re Walker, 48 Bankr. 668 (Bankr. D.S.D. 1985).

[98] "In the case of liquidation or dissolution of a present or former borrower, the bank may, but shall not be required to, retire and cancel...all or part of the capital stock...owned by or allocated to such borrowers" 12 C.F.R. § 615.5260.

One bankruptcy court has recently held that the right to cancel PCA stock upon the borrower's default is discretionary with the PCA.[99] The court said the exercise of the setoff right was not automatic, normally occurring only when the debt was determined to be uncollectible. It said practical considerations underpinned the policy, noting the stock was nontransferable because it was only available to active borrowers, and the PCA was required to maintain a like amount of stock in an Intermediate Credit Bank which, in turn, determined the amount of money available for the PCA to make additional loans.

In other cases, however, courts have permitted bankrupt borrowers to surrender stock in excess of that required as a percentage of borrowed funds. In Greseth[100] the court weighed the interests of bankrupt farmers and the Federal Farm Credit System and held that the "federal interest in maintaining the farmer credit program is...substantially outweighed by Congress' intent to aid family farmers through Chapter 12."[101] The FLB argued forced retirement of capital in excess of borrowing percentages would weaken the FLB financial structure. The court tied the forced redemption to the loan reduction amounts. It said the stock surrendered related only to the portion of the farmer's loan written off because of the reduced value of the farmer's land. "It appears that the negative effects felt by the FLB in reality related more to the falling land and commodity prices than to mass surrender of stock."[102]

A similar result was reached for a non-Farm Credit System cooperative that established a similar lending and investment system, basing stock ownership requirements on amounts borrowed.[103] The court found the stock was ordinarily retired as the amount of loan was reduced, and the lending cooperative made specific oral and written promises to the borrower that such was the case. The borrower-equity holder was permitted to retire the excess of stock over that required by the loan amount, though cancellation of the excess was supposed to be discretionary with the cooperative.

TRANSFER AND TRANSFEREE RIGHTS

Two issues related to transfer of equity interests have been addressed primarily in bankruptcy cases in which the trustee's rights are drawn into question.[104] These issues arise where the cooperative prohibits transfer of equity by those to whom it is originally issued; thus the cooperative may object to its transfer from the bankrupt patron to the trustee, and from the trustee to others. When a transfer is actually made to the trustee in bankruptcy, the trustee may assert rights of redemption, either in general for the amount of the equity or as a setoff against the amount to which the bankrupt was indebted to the cooperative holding the equity.

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99 In re Walker, 48 Bankr. 668, 669 (Bankr. D.S.D. 1985). The setoff right was based on a lien given by statute to PCA's in borrower equity.

100 In re Greseth, 78 Bankr. 936 (Bankr. D. Minn. 1987).

101 Id. at 943.

102 Id.

103 In re Lamar Farmers Exch., 76 Bankr. 712 (Bankr. W.D. Mo. 1987).

104 Under some circumstances someone other than the named owner of the equity interest may receive the equity upon its redemption, though not exactly a transfer. See State ex. rel. Baker v. Intermountain Farmers Ass'n, 668 P.2d 503 (Utah 1983) (Utah escheat laws where an equity owner could not be located).

Cooperatives have not been successful in preventing transfer of a patron's equity interest to a trustee in bankruptcy. generally, all equity held by the debtor becomes property of the estate.[105] The cooperative in Cosner[106] argued the bankrupt patron's equity interest in the cooperative was not an asset of the patron because a security interest existed. It also argued that equity was "illusory," dependant on future business expenses and profits, and distribution is delayed and not payable until a dividend is declared. After finding the secured interest not perfected, the court held the fact capital reserve accounts were not immediately payable did not "remove them from the category of property in which the trustee has an interest." Discretionary restrictions on alienability and postponement of enjoyment don not divest the asset of its nature as property though value and marketability may be affected.[107]

A second approach has been taken by cooperatives attempting to prevent transfer to a trustee. The argument was made that though the retained patronage refund is property, specific prohibition on its transfer from the patron holder to anyone else applies as well to a trustee in bankruptcy. This argument has been rejected in a recent case[108] holding that bankruptcy law is clear that the bankrupt's property passes to the estate.

When a trustee receives an equity interest, the trustee may want to do one of two things with the equity interest. The trustee may want to transfer it to another, other than back to the cooperative, or the trustee may want to force the cooperative to redeem the equity either in its entirety or as a setoff against debts the bankrupt owed the cooperative.

A cooperative may object to transfer by the trustee to another, basing its argument on cooperative policy to make retained patronage refunds nontransferable. Holding that the trustee and estate "succeed only to the title and rights in property which the debtor had; the mere commencement of a bankruptcy case does not vest the trustee with property rights which the debtor could not himself wield,"[109] the court in Schauer held the cooperative's transfer restrictions on retained patronage refunds limited the trustee as it had limited the patron at the time of bankruptcy.[110]

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105 In re Axvig, 68 Bankr. 910 (Bankr. D.N.D. 1987); In re Cosner, 3. Bankr. 445 (Bankr. D.Or. 1980); In re FCX, Inc., 96 Bankr. 49 (Bankr. E.D. N.C. 1989); In re FCX, 853 F.2d 1149 (4th Cir. 1988); In re Schauer, 62 Bankr. 525 (Bankr. D. Minn. 1986); In re Schauer, 835 F.2d 1222 (8th Cir. 1987).

106 In re Cosner, 3. Bankr. 445 (Bankr. D. Or. 1980).

107 Id. at 447.

108 In re Schauer, 835 F. 2d 1222, 1225 (8th Cir. 1987), aff'g, In re Schauer, 62 Bankr. 526 (Bankr. D. Minn. 1986).

109 In re Schauer, 62 Bankr. 526, 530 (Bankr. D. Minn. 1986). Expressions of the general rule are also noted in In re Axvig, 68 Bankr. 910 (Bankr. D. N.D. 1987); In re FCX, Inc., 96 Bankr. 49 (Bankr. E.D. N.C. 1989); In re FCX, 853 F.2d 1149 (4th Cir. 1988).

110 The Schauer court also found no arbitrary, capricious, or discriminatory behavior by the cooperative against the trustee, and found no compelling equitable considerations justifying transfer over the cooperative's objections.

A trustee may assert a right to redemption to liquidate the estate's property and pay creditors. Generally, the trustee's interest in the cooperative's equity is governed by state law, the cooperative's articles, and the bylaws.[111] The trustee obtains no greater rights in property than the debtor had at the date of filing.[112]

Several arguments have been advanced for giving a trustee in bankruptcy rights not possessed by the bankrupt. However, the "happenstance of bankruptcy is an insufficient reason to compel cooperatives to redeem or retire capital stock in advance of a cooperative's normal schedule for capital stock redemption."[113]

LIENS

Cooperatives frequently protect themselves from the possibility of loss from nonpayment of patrons' debts by placing a lien on any equity interest a patron may have in the cooperative. Courts in recent cases discuss methods cooperatives used to establish a security interest and some consequences of the security interest. The most common method is that of an article or bylaw provision giving the cooperative a security interest in any equity held in the cooperative by a debtor patron.[114] A lien for the benefit of a cooperative organization may also be established by statute as in the cases of Federal Land Banks[115] and Production Credit Associations.[116]

Two courts have found the bylaw provision method, standing alone, inadequate to establish a perfected secured interest.[117] Axvig[118] applied North Dakota requirements for either debtor signature of a security agreement or cooperative possession of the collateral. No security interest was signed, and the debtor's "capital stock" was only reflected on the cooperative's books, not as a financial instrument in the cooperative's possession. As a general intangible, "in the absence of a stock certificate evidencing the stock, capital stock is not capable of being reduced to possession."[119]

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111 In re Axvig, 68 Bankr. 910, 915 (Bankr. D. N.D. 1987).

112 In re FCX, 853 F.2d 1149, 1153 (4th Cir. 1988).

113 In re Axvig, 68 Bankr. 910, 916, 917 (Bankr. D. N.D. 1987).

114 Bylaw provisions were used in In re Axvig, 68 Bankr. 910 (Bankr. D. N.D. 1987); In re Cosner, 3 Bankr. 445 (Bankr. D. Or. 1980), articles of incorporation provisions in In re Axvig, 68 Bankr. 910 (Bankr. D. N.D. 1987); In re FCX, Inc., 96 Bankr. 49 (Bankr. E.D. N.C. 1989); In re FCX, 853 F.2d 1149 (4th Cir. 1988).

115 Discussed in In re Greseth, 78 Bankr. 936 (Bankr. D. Minn. 1987); In re Massengill, 73 Bankr. 1008 (Bankr. E.D. N.C. 1987).

116 Discussed in In re Massengill, 73 Bankr. 1008 (Bankr. E.D. N.C. 1987).

117 In re Axvig, 68 Bankr. 910 (Bankr. D. N.D. 1987); In re Cosner, 3 Bankr. 445 (Bankr. D. Or. 1980).

118 In re Axvig, 68 Bankr. 910 (Bankr. D. N.D. 1987).

119 Id. at 917. Accord In re Cosner, 3 Bankr. 445 (Bankr. D. Or. 1980) (Oregon Law). The court stated:

> The assertion of defendant that the capital reserve account is subject to a security interest because of its bylaws which are authorized by statute appears sound, but no basis has been shown by the defendant of the requirement of the Uniform Commercial Code that to be enforceable security interests must be perfected.

One case involving a lien has led to a result perplexing to cooperatives using liens on patron equity as a routine operating method, something of a catch-22 situation.[120]The articles of incorporation granted the cooperative a first lien on members' patronage certificates as security for any indebtedness to the cooperative.

The court applied a two step analysis to determine the trustee's rights. First, the court found the trustee's rights in retained patronage refunds to be limited by state law as found by other courts. The members' interests were limited, and certificates were not currently due and payable on the bankrupt cooperative's demand. The certificates in the hands of the trustee were similarly limited. These rights and limitations were dependent on state law and contractual arrangements in bylaws.

The second step in the analysis is to determine if any conflicting bankruptcy law would override the directors' discretionary power to redeem equity only at some future time.[121] Section 1123(a)(5)(D) of the bankruptcy code provides for distribution of collateral which is property of the estate to a party holding a security interest in the collateral in satisfaction of that party's secured claim. Relying on the opening clause "Notwithstanding any otherwise applicable bankruptcy law, a plan shall...," the court found by "its plain language...Sec.1123(a)(5)(D) overrides nonbankruptcy law restrictions on the distribution of collateral to satisfy a claim secured by the same."[122] The bankrupt member could force the cooperative to accept patronage certificates in which the cooperative had a collateral interest as satisfaction of the debt owed the cooperative.

The FCX decision is one of the latest decisions in which a trustee has argued a right to setoff. All other elements of the circumstances leading the Fourth Circuit Court of Appeals to its decision (a bankrupt member-debtor, retained patronage refunds held by the cooperative of a security interest by the cooperative in equities held by a debtor member) have existed in other cases, but FCX was the first to apply section 1123(A)(5)(D) to give a trustee greater power to demand redemption than those given by State law and the contractual arrangements between cooperative and patron. FCX was probably no all that surprising given the fact that the Bankruptcy Court was the same court that decided Massengill.[123]

In re Cosner, 3 Bankr. at 448.

120 In re FCX, Inc., 96 Bankr. 49 (Bankr. E.D. N.C. 1989); In re FCX, 853 F.2d 1149 (4th Cir. 1988).

121 The court said this two step analysis was applied by the bankruptcy court in In re Schauer, 62 Bankr. 526 (Bankr. D. Minn. 1986), the Eighth Circuit Court of Appeals in In re Schauer, 835 F.2d 1222 (8th Cir. 1987), and, with respect to the Farm Credit Act, in In re Walker, 48 Bankr. 668 (Bankr. D.S.D. 1985). In each of those decisions, no overriding bankruptcy provision was found.

122 In re FCX, 853 F.2d 1149, 1154 (4th Cir. 1988).

123 In re Massengill, 73 Bankr. 1008 (Bankr.. E.D. N.C. 1987), discussed in "Role of Director Discretion" supra text accompanying note 64. The Fourth Circuit Court of Appeals decided Columbia Bank for Coop. v. Lee, 368 F.2d 934 (4th Cir. 1966), cert. denied, 386 U.S. 992 (1967). See also In re Greseth, 78 Bankr. 936 (Bankr. D. Minn. 1987).

SETOFF

One of the most common sources of litigation concerning equity redemption in the 1980's was the attempt of a debtor patron or former patron to set his or her equity interest in the cooperative off against the debt.[124] This circumstance was common to ten of the recent cases.[125]

The success or failure of the setoff demand depends largely on the classification of the farmer's interest in the cooperative as debt or equity. As a general rule, to be subject to setoff both interests must be due and currently enforceable. If the farmer's interest in the cooperative is determined to be debt, then setoff may be possible. If, however, the farmer's interest is in the form of equity, not due and payable at the farmer's demand, the farmer cannot demand setoff and will be required to pay the debt though the farmer has an equity interest in the cooperative which cannot be presently removed. Thus, in a setoff claim, the relative rights of the farmer and the cooperative with respect to equity redemption will be determined by the classification of the financial instrument as debt or equity.[126]

The courts addressed the debt versus equity issue in two ways, though in substance the result was generally the same. In one approach the courts characterized the farmers' financial interests, usually retained equity contributed as part of the patronage process, as debt or equity, then applied setoff rules. The second approach focused directly on the right of the cooperative to refuse redemption, without a full analysis of the debt versus equity issue.

Courts making the later analysis have found the contingency feature of retained patronage refunds systems sufficient to make the interests in the cooperative something other than an indebtedness subject to setoff against patron indebtedness. This latter approach was taken in Atchison[127] and Lamar[128] The courts directed attention to the right of the member to demand redemption. Applying principles developed in prior cases in which setoff was not at issue[129] the court in Atchison held that equity credits are contingent on board decisions and are not "vested" until the board mandates redemption. The court held a member or stockholder

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[124] See Hamilton, Coop. Member Relations and Members' Rights in Retained Equity-Setoffs and Other Approaches, 6 J. AGRIC. TAX. & LAW 603 (1984).

[125] Atchison County Farmers Union Coop. Ass'n v. Turnbull, 241 Kan. 357, 736 P.2d 917 (1987); In re Axvig, 68 Bankr. 910 (Bankr. D. N.D. 1987); Christian County Farmers Supply Co. v. Rivard, 131 Ill. App. 3d 835, 476 N.E. 2d 452 (1985); In re Cooperativa Cafeteros de Puerto Rico, 19 Bankr. 732 (Bankr. D. P.R. 1982); In re Cosner, 3 Bankr. 445 (Bankr. D. Or. 1980); In re FCX, Inc., 96 Bankr. 49 (Bankr. E.D. N.C. 1989); In re FCX, 853 F.2d 1149 (4th Cir. 1988); In re Lamar Farmers Exch., 76 Bankr. 712 (Bankr. W.D. Mo. 1987); In re Massengill, 73 Bankr. 1008 (Bankr. E.D. N.C. 1987); In re Walker, 48 Bankr. 668 (Bankr. D.S.D. 1985).

[126] The criteria applied in recent cases are also noted in "Liens" supra notes 115-16 and accompanying text.

[127] Atchison County, 241 Kan. 357, 736 P.2d 917 (1987).

[128] In re Lamar Farmers Exch., 76 Bankr. 712 (Bankr. W.D. Mo. 1987).

[129] Claassen v. Farmers Grain Coop., 208 Kan. 129, 490 P.2d 376 (1971); Clarke County Coop. v. Read, 243 Miss. 879, 139 So. 2d 639 (1962); Evanenko v. Farmers Union Elevator, 191 N.W.2d 258 (N.D. 1971); and Howard v. Eatonton Coop. Feed Co., 226 Ga. 788, 177 S.E. 2d 658 (1970).

cannot contend that when equity credits are allocated on the cooperative's books, an indebtedness is created capable of offsetting the member's debt to the cooperative.[130]

Setoff was tied even more directly to the rights of redemption by the court in Lamar.[131] It held that "while it may under certain circumstances order patronage equity credits in a cooperative to be used to setoff a member's or former member's debt to the cooperative, such exercise of power should be restricted to those cases wherein there has been a clearly evidenced abuse of the otherwise sole discretion of the co-op's board of directors."[132]

The same principles that may prevent a patron debtor from forcing setoff of debt against retained patronage refunds may also prevent a cooperative from making full use of its own system devised as a self-protection measure. The cooperative in Cosner[133] could not offset a patron's equity to recover debt, though the articles of incorporation provided for the right of setoff of a patron's indebtedness against any money becoming payable to the patron with respect to allocation. The court held that no current funds were available upon which to base offset.[134]

VALUATION

A dollar value must be assigned to equities redeemed. Among values that can be assigned, the most common are face value, book value, and fair market value. In addition, the time value of money may suggest a present value analysis if equities are to be redeemed out of sequence.

Present value analysis was applied as a measure of fair market value in In re Cooperativa Cafeteros de Puerto Rico.[135] A bank for cooperatives agreed to redeem equity of a bankrupt cooperative member. By statute the bank could redeem stock at "fair market value."[136] Noting the difficulties of determining fair market value of "a stock that is not transferable and is really a compulsory investment required of all borrowers from the bank," the court accepted the bank's present value calculation as one proper and fair method of determining "fair market value."[137]

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[130] Atchison County, 241 Kan. 357, 736 P.2d 917 (1987); see also In re Lamar Farmers Exch., 76 Bankr. 712 (Bankr. W.D. Mo. 1987).

[131] In re Lamar Farmers Exch., 76 Bankr. 712 (Bankr. W.D. Mo. 1987).

[132] Id. at 716

[133] In re Cosner, 3 Bankr. 445 (Bankr. D. Or. 1980).

[134] Id.

[135] In re Cooperativa Cafeteros de Puerto Rico, 19 Bankr. 732 (Bankr. D. P.R. 1982).

[136] "In any case where the debt of the borrower is in default, or in any case of liquidation or dissolution of a present or former borrower from a bank for cooperatives, the bank may, but shall not be required to, retire and cancel all or part of the stock...at the fair market value thereof not exceeding par." 12 U.S.C. § 2131(d) (1971), amended by 94 Stat. 3445 (1980).

[137] In re Cooperativa Cafeteros de Puerto Rico, 19 Bankr. 732, 734 (Bankr. D. P.R. 1982).

The court in Massengill[138] addressed the valuation issue and an argument by cooperatives that a "discount factor should be applied to the valued of the stock [to be setoff against a debt owed to the cooperative] because typically the stock is not redeemed until the loan is paid in full."[139] The court denied discounting from the stock's face value. It said the cooperatives had the right in their discretion to immediately redeem the stock, and whether they did so was not relevant. Without further clarification, the court stated "if [the cooperatives] elect not to exercise that right then they, not the debtors, should bear any economic loss which arises from that decision."[140]

OBSERVATIONS

A summary assessment of this decade's equity related judicial decisions suggests several observations. The most striking feature of the collection of cases is the substantial role of farmers' financial distress. Indebtedness, setoff, and bankruptcy account for a majority of conflicts culminating in litigation between farmers (or their trustees in bankruptcy) and their cooperatives. Not only was this often the initial reason for conflict, it has shaped the kinds of issues presented and the interests to be balanced in farmer versus cooperative situations.

Another notable characteristic of the two dozen decisions in the 1980's was the variety of conflicts presented. Most important equity related issues were addressed in some fashion by one or more decisions. conflicts ranged from a simple dispute between a former patron and a cooperative to debates over relative superiority of national public policies with respect to bankruptcy laws and the farm credit structure in rural America. New parties, in particular bankruptcy trustees, also played an emerging role in recent cases.

Farmers' interests in their cooperatives' financial strength and stability retained their importance, as they have in the body of equity cases for many years. The importance and function of discretion on the part of cooperatives to determine and adjust for changing financial needs, including redemption decisions, remained firmly established. Standards for making redemption decisions were not changed. On the other hand, a significant trend toward removing redemption from the pale of cooperative discretion was evident, most notably in debt setoff situations. Even in these situations, however, courts intervened only with respect to amounts of equity necessary to satisfy the debt in question, and even then only that portion in excess of stated equity requirements. No general redemption requirement was introduced.

Finally, cooperatives may conclude that they face two challenges. The first is to establish effective responses to patron indebtedness and bankruptcy, balancing the need to devise collection methods against corresponding risk to their financial structure. The FCX decision, in which the cooperative's own effort to reduce its risk led to loss of control over equity, must be carefully considered. Second, some decisions with the most potentially damaging implications for cooperatives, directors, officers, and professional advisors

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138 In re Massengill, 73 Bankr. 1008 (Bankr. E.D. N.C. 1987)

139 Id. at 1013. Stock in a Federal Land bank and Production Credit Association were being redeemed in satisfaction of debts. The stock was to be redeemed at book value not to exceed par or the face value. 12 U.S.C. § 2034(d) (1988); 12 U.S.C. § 2094(k) (1988).

140 In re Massengill, 73 Bankr. 1008, 1013 (Bankr. E.D. N.C. 1987). The significance of time value of money and present value calculation to make decisions with respect to revolving fund financing systems is noted in Cobia, supra note 1; Royer, Equity Redemption: Issues and Alternatives, 35 THE COOP. ACCNT. 19 (1981); Royer, Financial Impact of Mandatory Equity Programs of Farmer Cooperatives, 43 AG. FINANCE REV. 30 (1983).

resulted from financing techniques foreign to traditional cooperative methods. It seems clear that when cooperatives venture into nontraditional corporate structure and financing, they are entering into a new and more hazardous arena.

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HAJMM Co. v. House of Raeford Farms, Inc.
379 S.E.2d 868 (N.C. App. 1989)

COZORT, Judge

Plaintiff sued defendants House of Raeford Farms, Inc. (Raeford), and E. Marvin Johnson for their refusal to retire a revolving fund certificate issued to plaintiff by Raeford in exchange for stock plaintiff sold to Raeford. Plaintiff asserted claims of relief alleging that defendants: (1) violated Raeford's by-laws by refusing to retire plaintiffs certificate after retiring other certificates in the same series as plaintiff's; (2) breached a fiduciary duty owed plaintiff; and (3) committed an unfair or deceptive trade practice. The trial court granted defendants' motion to dismiss the unfair or deceptive trade practice claim for failure to state a claim upon which relief can be granted. The other issues went to the jury, which found for plaintiff. The judge awarded plaintiff $387,500 in actual damages, and the jury awarded plaintiff $100,000 in punitive damages. Plaintiff and defendants appeal. The primary issues submitted on appeal by defendants are: (1) whether defendants' motions for directed verdict and judgement notwithstanding the verdict were properly denied and the issues properly submitted to the jury; (2) whether there was sufficient evidence to create a jury issue on partial redemption; (3) whether defendants owed plaintiff an fiduciary duty; (40 whether plaintiff's expert testimony on breach of fiduciary duty was properly admitted; and (5) whether there was sufficient evidence to submit to the jury on the issue of punitive damages. The plaintiff contends that the trial court erred in granting defendants' motion to dismiss plaintiff's unfair or deceptive trade practice claim. In defendant's appeal; we find no error. In plaintiff's appeal, we find the trial court erred in dismissing the unfair or deceptive trade practices claim, and we remand for a new trial on that issue.

The HAJMM Company, plaintiff herein, is a limited partnership engaged in the business of agricultural marketing. Defendant Raeford is an agricultural cooperative engaged in processing turkeys and other poultry. Defendant Johnson is President and Chairman of the Board of Raeford. Raeford was formed in 1975 when plaintiff and two other turkey producers, Stone Brothers and Nash Johnson and Sons, Inc. (NJS), sold their stock to Raeford Turkey Farms, Inc. (RTF), to defendant Raeford. Plaintiff held at 25% share, Stone Bros. held a 25% share, and NJS held a 50% share in RTF. For its stock plaintiff was issued a "Class B-Series 1975 Revolving Fund Certificate" in the amount of $387,500. Raeford issued a Class B-- Series 1975 certificate to Stone Bros. in the amount of $387,500 for it 25% share of RTF and issued a Class B -- Series 1975 certificate to NJS in the amount of $750,000 in exchange for its 50% share in RTF. In the same year, Raeford also issued Class A -- Series 1975 certificates to other turkey producers at the same time the three Class B certificates were issued.

In 1978 Raeford redeemed and canceled the Class A -- Series 1975 certificates. The same year, Raeford retied the Class B -- Series 1975 certificate originally issued to Stone Bros., who negotiated its certificate to FCX, Inc. In its 1984 financial statement Raeford discounted to zero value the Stone Bros./FCX certificate and the certificate to NJS. Raeford subtracted the value of the Stone Bros./FCX and NJS Class B -- Series 1975 certificates from the total amount owed on other certificates, thereby reducing stockholders equity. Plaintiff's Class B -- Series 1975 certificate was not redeemed at that time and continues to be shown as part of stockholder's equity in Raeford's financial statements. On or about 4 February 1986 Plaintiff made a formal demand to defendants to redeem plaintiff's certificate for $387,500. Citing provisions in Raeford's by-laws giving them the sole discretion to decide whether to retire plaintiff's certificate, defendants refused plaintiff's request. Plaintiff filed suit in March of 1986.

The trial court submitted seven issues to the jury, which were answered as follows:

1. Did the defendant, House of Raeford Farms, Inc. breach its bylaws refusing to retire the revolving fund certificate of the plaintiff, HAJMM, in the reasonable exercise of its discretion?

Yes.

2. Did the defendant, House of Raeford Farms, Inc., breach its bylaws by retiring any of the revolving fund certificates in the same annual series as that of the plaintiff, HAJMM, and refusing to retire that of the plaintiff, HAJMM?

Yes.

3. Do the defendants, E. Marvin Johnson and Raeford Farms, Inc., owe a fiduciary duty to the plaintiff, HAJMM?

Yes.

4. If so, was their refusal to retire HAJMM;s revolving fund certificate an open, fair and honest transaction?

No.

5. In what month and year did the breach or violation occur?

March 1986.

6. In your discretion, what amount of punitive damages, if any, should be awarded to the plaintiff, HAJMM from the defendant E. Marvin Johnson.

None.

7. In your discretion what amount of punitive damages, if any, should be awarded to the plaintiff, HAJMM from the defendant, House of Raeford Farms, Inc.?

$100,000.

The trial court determined that plaintiff should recover the full amount of the certificate, $387,500, from both defendants. The court entered judgment for $387,500 actual damages against both defendants and $100,000 punitive damages against Raeford. Defendants and plaintiff entered timely notices of appeal. We consider defendants' appeal first.

We initially consider defendants' argument that the trial court erred in denying defendants' motion for directed verdict and defendants' motion for judgment notwithstanding the verdict. Defendants' motion for directed verdict should be granted only if the trial judge concludes that no reasonable juror could find for plaintiff. West v. Slick, 313 N.C. 33, 40, 326 S.E.2d 601, 606 (1985). In considering the defendants' motion all conflicts in the evidence must be resolved in favor of plaintiff and the evidence must be viewed in a light most favorable to plaintiff. Id. The standard of review is the same for a motion for judgment notwithstanding the verdict. Bryant v. Nationwide Mut. Fire Ins. Co., 313 N.C. 362, 369, 329 S.E.2d 333, 337 (1985).

Defendants contend that plaintiff offered insufficient evidence to prove that Raeford breached its by-laws by retiring certificates in the same series as plaintiff's while refusing to retire plaintiff's certificate. In the alternative, defendants argue that even if the certificates were of the same series, the trial court should have submitted to the jury an issue on whether Raeford retired other certificates for full or partial value. We reject both arguments.

Plaintiff's evidence tended to show that defendant Raeford issued identical "Class B-Series 1975" Revolving Fund Certificates to plaintiff and to Stone Brothers when it was formed in 1975. Both certificates were in the amount of $387,500. The remaining 50% of RTF was owned by NJS. Defendant Johnson owned 80% of NJS and served as its president. Defendant Johnson is also Chief Executive Officer of defendant Raeford, a post he has held since 1978. NJS is one of defendant's largest turkey suppliers. In exchange for NJS's 50% share of RTF, defendant Raeford issued the same "Class B--Series 1975" certificate to NJS that had been issued to plaintiff and Stone Brothers, except NJS's certificate was in the amount of $750,000. Defendant Raeford also issued "Class A -- Series 1975" certificates to other turkey producers in 1975.

Plaintiff's evidence also tended to show that Raeford refused plaintiff's demand to pay its certificate even though Raeford paid an identical Stone Brothers certificate in 1978. Raeford was less solvent in 1978 than in 1986 when plaintiff made its demand. Moreover, Raeford discounted NJS's $750,000 certificate on its books to zero value in 1984, even though that certificate was nearly twice the amount of plaintiff's. The Class A -- Series 1975 certificates were also paid off in 1978. Defendants argue that the Class A certificates were of a different series than the Class B certificates because the Class A certificates were issued at a different time and to a different class of people, patron members of Raeford, not former owners of RTF which held the Class B certificates.

Raeford's by-laws support plaintiff's argument that the Class A and Class B certificates are of the same series. The by-laws provide as follows:

> Such certificates shall be issued in annual series, each certificate in each series upon its face being identified by the year in which it is issued; and each series shall be retired fully or on a prorata (sic) basis, only at the discretion of the board of directors of the association, in the order of issuance by years as funds are available for that purpose. (Emphasis supplied).

The by-laws require designation of certificates by "annual series". Both Class A and Class B certificates are identified with the caption "Series 1975". Class A and B certificates were, therefore, the same series. We find the evidence sufficient to support plaintiff's claim that defendants breached Raeford's by-laws.

Defendants contend alternatively that the trial court erred in failing to instruct the jury that they should determine whether Stone Bros., NJS, and the Class A certificates were retired at full value or on a pro rata basis. Defendants maintain that the trial court's decision to enter judgment for the full amount of the certificate, rather than permitting the jury to consider the amount, amounted to an improper directed verdict on damages.

Defendant Raeford's by-laws require that the retirement of each series must be either in full or on a pro rata basis. Thus if the Class A and B holders received full value, then plaintiff was entitled to receive full value. The evidence is clear that Class A holders received $100 each, plus cancellation of their promissory notes to Raeford in exchange for Raeford taking back the certificates. Moreover, Raeford discounted the entire value of all Series 1975 certificates, except plaintiff's in its 1987 Financial Statement. For the purposes of Raeford's books, the entire 1975 Series was considered paid in full, except plaintiff's certificate. Finally, concerning the certificates of Stone Bros./FCX and NJS, Raeford paid FCX $950,000 in 1978 for the certificate and other obligations and passed a corporate resolution providing that the actions would "thus retire, all interests of FCX in the association..." FCX then transferred "all its right, title and interest" in the Class B instrument to Raeford. As for the NJS certificate, Raeford discounted the certificate's full value on its books. In short, there is simply no evidence that Class A and B holders, except plaintiff, received anything but full value. The jury was therefore properly instructed to find that plaintiff should receive full value if it found defendants violated Raeford's bylaws or defendants unreasonably denied plaintiff's demand.

Next defendants challenge the sufficiency of plaintiff's evidence on whether Raeford acted unreasonably in exercising its discretion not to redeem plaintiff's certificate. The certificates were redeemable, if at all, defendants contend, in the sole discretion of Raeford's board as the by-laws provided. Defendants note the cyclical nature of the poultry business and the Board's desire to become more competitive by purchasing new plant and equipment as factors they considered in declining plaintiff;s demand for payment. Similarly, defendants point out that the certificates by their terms were junior and subordinate to all other corporate debtors. Defendants argue that Raeford had to consider the effect on other creditors of paying a junior creditor's debts, as well as a balance sheet showing current liabilities and long-term debts exceeding $5,000,000.

On the issue of the subordinate nature of the debt, plaintiff offered expert testimony from Dr. James Baarda that the "junior and subordinate" language meant that when the cooperative dissolves, all other debts are paid before the certificates. Defendants expert agreed with Dr. Baarda that the "subordinate" language did not mean payment of the certificate was to be withheld if the corporation had other debts. Defendants' argument seems disingenuous in light of the payment to the Class A holders, the redemption of the Stone Brothers certificate, as well as the bookkeeping cancellation of the NJS certificate. The total value of these certificates far exceeded plaintiff's certificate.

Plaintiff's evidence of Raeford's strong financial position, together with testimony of defendant Johnson that Raeford may never pay the certificate, supported plaintiff's claim that the Board unreasonably exercised its discretion in refusing to pay plaintiff's certificate. Plaintiff's evidence showed that Raeford's net worth nearly quadrupled in five years from $6.8 million in 1983 to $27 million in 1987. In 1986, the year plaintiff demanded payment, plaintiff's net earnings were $6.1 million. While Raeford spent $6.5 million in 1987 on a new plant and equipment, Raeford was able to loan defendant Johnson $394,000 and invest #3.4 million of excess cash in a securities portfolio in 1987. Nevertheless, defendant Johnson testified that he hold Mr. Hervey Evans, one of plaintiff;s principals, "I might not never pay it (the certificate)." An attorney for the Federal Land Bank testified that Mr. Johnson told him, "It's not bearing any interest, so there's really no reason to pay it. It's sort of like owing money to yourself>" Likewise, at the director's meeting discussing plaintiff;s request to pay the certificate, Mr. Johnson stated that the Board "decided that we didn't need to bother with it; it shouldn't be paid, it wasn't good business..." As to Raeford's by-laws governing the certificates, Mr. Johnson states: "The by-laws wasn't (sic) that important to me. I, I've never read them all the way through. I just glanced at them, that's about it."

We agree with defendants that the mere financial ability of a corporation to pay is insufficient to prove an abuse of discretion. See, e.g. Claassen v. Farmers Grain Co-Op, 208 Kan. 129, 490 P.2d 376 (1971). We are also mindful that the business judgment rule protects corporate directors from being judicially second guessed when they exercise reasonable care and business judgment. The directors "are not guarantors that they will make no mistakes in the management of corporate business." R. Robinson North Carolina Corporation Law and Practice § 12-6 at 178 (3d ed. 1983). Nevertheless, on the facts of this case, we find that plaintiff's evidence was sufficient to go to the jury on the question of whether Raeford unreasonably exercised its discretion in refusing to pay plaintiff's certificate.

Next defendants maintain that the trial judge erred in submitting the issue of breach of Raeford's by-laws because by-laws are intracorporate rules of governance which cannot serve as a basis for plaintiff's cause of action. We note initially that defendants requested that the jury be instructed to address whether defendants abused their discretion in refusing to retire plaintiff's certificate. The trial court instructed the jury as defendants requested. Defendants cannot now complain because the trial court granted their request. Jennings Glass Co. v. Brummer, 88 N.C. App. 44, 50, 362 S.E.2d 578, 582 (1987) disc. review denied, 321 N.C. 473, 364 S.E.2d 921 (1988). Second plaintiff's certificate constituted a contract between plaintiff and Raeford upon which Raeford conditionally promised to pay plaintiff $387,500 in consideration for the stock plaintiff held in Raeford's predecessor corporation, RTF. See e.g. Mezzanotte v. Freeland, 20 N.C. App. 11, 17, 200 S.E.2d 410, 414 (1973), cert. denied, 284 N.C. 616, 201 S.E.2d 689 (1974). Raeford's by-laws were incorporated into plaintiff's certificate. Those by-laws constituted additional terms of the parties' contract and therefore more than internal rules for defendant Raeford. Defendants' argument is without merit.

Defendants also contend the trial court erred in submitting to the jury the issue of whether defendants owed plaintiff a fiduciary duty. According to defendants the certificate held by plaintiff was an instrument of debt. They maintain that no fiduciary duty exists in a debtor-creditor relationship.

A fiduciary duty " 'exists in all cases where there has been a special confidence reposed in one who in equity and good conscience is bound to act in good faith and with due regard to the interests of the one reposing confidence.' " Stone v. McClam, 42 N.C.App. 393, 401, 257 S.E.2d 78, 83, cert. denied, 298 N.C. 572, 261 S.E.2d 128 (1979) (citation omitted). We find the facts of this case sufficient to show that plaintiff placed a special confidence and trust in Raeford and its directors. Plaintiff accepted the certificate as partial consideration for the 25% share plaintiff held in RTF. Plaintiff's interest was in turn transferred to Raeford as successor interest to RTF, and Raeford recognized the certificate as a capital contribution on its balance sheet. Furthermore, since the certificate was redeemable at Raeford's discretion and since Raeford refused to reveal financial information about itself to plaintiff, plaintiff had the right to expect Raeford to exercise its discretion in good faith.

Also, we are unpersuaded that the certificate was a pure debt instrument. The existence of a fiduciary relationship is not contingent upon a technical or legal relationship. Moore v.Bryson, 11 N.C.App. 260,265, 181 S.E.2d 113, 116 (1971). Shareholders of a corporation are owed a fiduciary duty by that corporation's officers and directors. NC.Gen.Stat. § 55-35 (1982). The issuance of the revolving fund certificate has some characteristics of a corporation/shareholder relationship. First, the certificate was originally issued in exchange for stock held in Raeford's predecessor, RTF, as partial consideration for plaintiff's capital contribution to Raeford. Plaintiff's certificate, along with similar certificates to Stone Bros. and NJS, was part of Raeford's original capitalization. See First Citizens Bank and Trust Co. v. Parker, 225

N.C. 480, 485, 35 S.E.2d 489, 492 (1945), ("The fiduciary character of the debt does not depend upon its form but the manner of its origin and the acts by which it is incurred..."). Second, Raeford listed the certificates under stockholder's equity on its balance sheet as it did for common stock. Finally, like common stock, the certificate was junior and subordinate to all other debts of Raeford, secured or unsecured. It is fundamental to corporate law that if the corporation dissolves, the common stockholders receive a distribution, if at all, after all the debts have been paid. 19 Am.Jur.2d Corporations §2866 at 648 (1986).

Defendants next challenge the instruction given to the jury on the fiduciary duty issue on the grounds that the trial court erred in shifting the burden of proof to defendants to prove that a breach of that duty did not occur. We find no error. Once plaintiff established a prima facie case that defendants owed plaintiff a fiduciary duty and that duty was breached, which amounted to constructive fraud, the burden of proof shifted to defendants to p[rove that they acted in an open, fair and honest manner, and the court so instructed the jury. See Sanders v. Spaulding & Perkins, Inc., 82 N.C.App. 680,681, 347 S.E.2d 866, 867 (1986).

We turn now to defendants' contention that the trial court erred in admitting plaintiff;s expert testimony from Dr. James Baarda. Defendants contend Dr. Baarda's testimony embraced ultimate legal conclusions and thus amounted to an impermissible instruction to the jury and usurpation of the jury's duty.

N.C.Gen.Stat. § 8C-1, Rule 704 (1986) provides that "testimony in the form of an opinion or inference is not objectionable because it embraces an ultimate issue to be decided by the trier of fact." Our Supreme Court has stated that "an expert may not testify that a particular legal conclusion or standard has or has not been met, at least where the standard is a legal term of art which carries a specific legal meaning not readily apparent to the witness." State v. Ledford, 315 N.C. 599, 617, 340 S.E.2d 309, 321 (1986) (emphasis added).

Defendants first argue that the trial court should have excluded Dr. Baarda's testimony that the directors abused their discretion in failing to redeem plaintiff's certificate. We do not believe the testimony at issue constituted testimony on a legal conclusion or standard for which there is a specific legal meaning such that exclusion was required. The existence or nonexistence of a fiduciary duty was a question of fact for the jury. The jury had to determine whether plaintiff had placed special confidence and faith in defendants to act in plaintiff;s interests. See Stone, 42 N.C. App. at 401, 257 S.E.2d at 83. We further find that the trial judge instructed the jury, in part, as follows: "You should consider the opinion of an expert witness, but you are not bound by it." He also instructed, "You must...apply the facts as you find them to be to the law as I am about to give it to you." Accord, 3 Weinstein's Evidence 704(02) at 704-16 (1988) and United States v. Fogg, 652 F.2d 551, 556-67 (5th Cir. 1981), cert. denied, 456 U.S. 905, 102 S.Ct. 1751, 72 L.Ed.2d 1962 (1982). (Applying Federal Rule 704 -- which is identical to North Carolina's Rule 704 -- the court held that no error occurred where an IRS agent stated a legal conclusion on defendant's culpability because of the court's precautionary instructions to the jury on the weight to be afforded expert testimony.) We also believe that the complexity of this case and the specialized knowledge necessary to understand the use of revolving fund certificates in agricultural cooperative distinguishes this case from those relied on by defendants. See Fogg, 652 F.2d at 557 (5th Cir.1981) (the court considered the complexity of the case in affirming the use of expert testimony even though it embraced a legal conclusion). The cases relied on by defendants involve less complex issues such as gross negligence, (Murrow v. Daniels, 85 N.C.App. 401, 355 S.E.2d 204 rev'd on other grounds, 321 N.C. 494, 364 S.E.2d 392 (1988)); the construction and interpretation of a right-of-way agreement, (Board of Transportation b. Bryant, 59 N.C.App. 256, 296 S.E.2d 814 (1982)); and whether an easement by implication existed (Williams v. Sapp, 83 N.C.App. 116, 349 S.E.2d 304 (1986)). We find no error in the admission of Dr. Baarda's testimony.

Defendants next contend that the trial court erred in submitting a punitive damages issue to the jury because plaintiff failed to show aggravated or tortious conduct other than defendants' mere refusal to pay. We disagree. In answering the third and fourth issues "Yes", the jury found that defendants had a fiduciary duty to plaintiff and their refusal to retire plaintiff's certificate was not an open, fair or honest transaction. Defendants' breach of their fiduciary duty to plaintiff, which also amounted to evidence sufficient to prove constructive fraud, justified punitive damages. See Sanders, 82 N.C.App. at 681, 347 S.E.2d at 868 (1986). Defendants' assignment of error is overruled.

Defendants have raised several other issues on appeal. We have carefully reviewed those arguments, and we find they entitle defendants to no relief and no not merit further discussion. See State v. Tomblin, 276 N.C. 273, 277, 171 S.E.2d 901, 904 (1970).

We not turn to plaintiff's cross appeal. Plaintiff's sole assignment of error alleges the trial court erred in the dismissal of its unfair or deceptive trade practices claim for failure to state a claim upon which relief can be granted. Moreover, plaintiff contends that the jury's factual determination that defendants' refusal to redeem was not an open, fair or honest transaction established an unfair or deceptive trade practice as a matter of law. We agree that the trial judge erred in dismissing plaintiff's unfair or deceptive trade practice claim. We do not agree, however, that plaintiff has established that claim as a matter of law.

The standard of review for the granting of defendants' N.c.Gen.Stat. § 1A-1, Rule 12(b)(6) motion requires us to test the legal sufficiency of plaintiff's claim. The allegations in plaintiff's complaint are treated as true. White v. White, 296 N.C. 661, 667, 252 S.E.2d 698, 702 (1979). In its complaint plaintiff alleged that defendants owed plaintiff a fiduciary duty and that defendants breached that duty when they refused to redeem plaintiff's certificate. Plaintiff alleged that the refusal was unreasonable. Plaintiff alleged that defendants manipulated Raeford's income to the benefit of defendant Johnson's family and to the detriment of plaintiff's interest. Plaintiff alleged that defendants' actions were inequitable, arbitrary, in bad faith, were an abuse of discretion, and a violation of Raeford's by-laws. Plaintiff further alleged that defendants' acts were in or affecting commerce. These allegations, though not denominated as such, are sufficient to allege constructive fraud. Therefore, the allegations were sufficient to allege a claim of unfair or deceptive trade practice. Spence v. Spaulding and Perkins, Ltd., 82 N.C.App. 665, 668, 347 S.E.2d 864, 866 (1986).

We do not agree, however, with plaintiff’s argument that we should find that, in the case below, the unfair or deceptive trade practice has been established as a matter of law. Plaintiff urges this Court to treble the damages and remand the cause only for consideration of attorney fees. In rejecting this argument, we note initially that the case was not tried below with any consideration given to an unfair or deceptive trade practice claim. Had the claim been present during trial, it could have profoundly affected defendants' preparation for trial and the tactics pursued during trial. It would be manifestly unfair to declare, at this stage of the proceedings, that the claim was proven as a matter of law with no contrary result possible, even though the claim was not prosecuted or defended as such below.

We also reject plaintiff's argument because the jury made no findings concerning whether defendant's practices were in or affecting commerce and whether the acts had an impact on plaintiff. N.C.Gen.Stat. § 75-1.1(1988); Wilder v. Squires, 68 N.C.App. 310, 319, 315 S.E.2d 63, 68, disc. review denied, 311 N.C. 769, 321 S.E.2d 158 (1984).

> Ordinarily it would be for the jury to determine the facts, and based on the jury's finding, the court would then determine as a matter of law whether the defendant engaged in unfair or deceptive acts or practices in the conduct of trade or commerce.

Hardy v. Toler, 288 N.C. 303, 218 S.E.2d 342, 346-47 (1975). Since the jury has not made the requisite findings, we will not speculate, based on the findings made on plaintiff's other claims, whether plaintiff has established its claim as a matter of law.

On remand the trial court must consider the factual findings already made by the jury together with additional factual findings the jury will make under proper instructions in accordance with the statutes and case law relative to unfair or deceptive trade practice claims. Then the trial court must determine whether defendants engaged in unfair or deceptive trade practices. If the trial court finds that defendants engaged in an unfair or deceptive trade practice, plaintiff is entitled to have its actual damages trebled and may be entitled to attorney fees in the trial court's discretion, if the court finds that defendants' act or practice was willful and their refusal to resolve the matter was unwarranted. N.C.Gen.Stat. §§ 76-16 and 76-16.1 (1988). Plaintiff would then elect to recover either punitive damages or treble damages. Plaintiff is not entitled to recover both treble and punitive damages under § 75-16. Jennings Glass Co. v. Brummer, 88 N.C.App. 44, 53, 362 S.E.2d 578, 584 (1987), disc. review denied, 321 N.C. 473, 364 S.E.2d 921 (1988).

In summary, in defendants' appeal we find no error. In plaintiff's appeal we vacate the order granting defendants' Rule 12(b)(6) motion as to unfair or deceptive trade practices, and we remand for a new trial on that claim.

No error in part; vacated and remanded in part.

PHILLIPS, J. Concurs.

GREEN, J. dissents

GREENE, Judge dissenting.

I dissent from the majority's ruling on the admissibility of Dr. Baarda's testimony that the defendants "abused their discretion" and "breached" certain "fiduciary duties." Despite the adoption of Rule 704, Dean Brandis has stated the continuing validity of state precedent that an expert may not opine on whether a legal standard has or has not been fulfilled in a specific case:

> In attempting to relate the facts it often happens that a witness will use words which, though familiar to the layman's vocabulary, also have a legal meaning. Whether such usage will violate the opinion rule depends upon the sense in which the words are used and the nature of the issues in the case. Thus a witness may state that he was in 'possession' of land or chattel...or that the prosecutrix was 'raped'...if the words are employed in a popular sense to describe the facts rather than their legal consequences. Where the legal relations growing out of the facts are in dispute, and the witness's words appear to describe the relations themselves, the same words may be objectionable. Under these circumstances it is improper for a witness to testify, whether a transaction was 'bona fide' or induced by 'fraud'...or whether he was an 'agent'...and a witness may not testify to the legal effect of a contract or to its meaning when that is a question for the court to decide from the writing itself; but he may testify to his own intention and understanding where they are relevant.

1 H. Brandis, Brandis on North Carolina Evidence Sec. 130 at 579-82 (3rd ed. 1988) (emphasis added).

It is true that the federal courts have been generally reluctant to overrule a trial judge who allows expert opinion that arguably states relevant legal standards have been met. E.g. Specht v. Jensen, 832 F.2d

1516, 1527 (10th Cir. 1987) (en banc) (permitting constitutional expert to state opinion on dispositive issue whether "search" occurred under Fourth Amendment). However, even after this state's adoption of Rule 704, our own Supreme Court and this court have followed a more conservative course which confirms Dean Brandis's observation. See e.g. State v. Weeks, 322 N.c. 152, 167, 367 S.E.2d 895, 903 (1988) (psychiatric testimony that defendant did not act in "cool state of mind" and was unable to conform behavior to legal requirements improperly stated legal standard had not been met); State v. Ledford, 315 N.C. 599, 340 S.E.2d 309 (1986) (expert precluded from stating that injuries were "proximate cause" of death); State v. Smith, 315 N.C. 76, 337 S.E.2d 833 (9185) (dictum) (court noted it would bar expert testimony that defendant "raped" victim in rape trial); Murrow v. Daniels, 85 N.C.App. 401, 355 S.E.2d 204, rev'd on other grounds, 321 N.c. 494, 364 S.E.2d 392 (19987) (expert's opinion that defendant's lack of security was "gross negligence" was improper legal conclusion) (cited with approval by Supreme Court in Weeks); Williams v. Sapp, 83 N.C.App. 116, 349 S.E.2d 304 (1986) (error to allow attorney to give expert opinion that plaintiff was legally entitled to easement by implication); but see State v. Franks, 262 N.C. 94, 136 S.E.2d 623 (1964) (where defendant charged with selling unregistered securities, expert could state that debentures must be registered under state securities law.)

Dr. Baarda testified as an expert with degrees in law and agricultural economics. He testified extensively concerning the nature of agricultural cooperatives and the use of revolving certificates for their financing. The majority summarizes Dr. Baarda's testimony as "testimony that the directors abused their discretion in failing to redeem plaintiff's certificate." That simple paraphrase does not do justice to the breadth of Dr. Baarda's extensive testimony concerning the legal effect of key provisions of the certificates, as well as Dr. Baarda's opinion that defendants abused their discretion and breached their fiduciary duties to plaintiff in failing to redeem the certificates:

> Q: All right. I am trying to deal with the subject of discretion, Dr. Baarda. What discretion is available to the Board under this Section (of the certificate) that you are reading from?
>
> A: That this cooperative gives the discretion to the Board of Directors to redeem.
>
> Q: I'd like to ask whether you have an opinion as to whether there is an additional type of discretion permissible to the Board of Directors?
>
> A: (Reading over paragraph.) Yes, there is an additional discretion.
>
> Q: What is that discretion?
>
> A: (The) discretion...to revolve (the certificates) out of order...under some extraordinary circumstances...spelled out in the by-laws (such as) to compromise or settle the dispute between the owner thereof and the association, and then for other purposes such as settling an estate or when an owner moves from the territory.
>
> Q: Based upon your experience, and your review of materials which you have previously testified to, do you have an opinion satisfactory to yourself as to whether the Board of Directors of Raeford abused its discretion in failing to redeem HAJMM's Class B revolving fund certificate?
>
> A: My opinion is that the Board of Directors did abuse its discretion in failing to redeem this equity.

Q: Do you have an opinion satisfactory to yourself as to when the abuse of discretion occurred?

A: In my opinion the abuse occurred when demand was made on the cooperative to pay it back and the cooperative refused to do so.

Q: Do you have an opinion satisfactory to yourself as to whether the abuse of discretion is a continuing matter?

A: Yes, this decision can be made at any time, so it is a continuing problem.

Q: Do you have an opinion satisfactory to yourself as to whether there was a fiduciary duty both by Raeford and the defendant, Marvin Johnson, to the HAJMM Company?

A: In my opinion...there was such a relationship.

Q: Do you have an opinion satisfactory to yourself as to whether the fiduciary duty was breached?

A: I believe that the fiduciary duty was breached.

Q: Do you have an opinion satisfactory to yourself as to when the fiduciary duty was breached?

A: I believe it was reached when the Evans family made demand on the cooperative to pay it back, and the cooperative refused to do so.

Q: Do you have an opinion satisfactory to yourself as to whether this breach is continuous?

A: Yes, this, this is a continuing duty.

The court submitted issues to the jury concerning whether defendant breached its by-laws by refusing to retire the certificates in the reasonable exercise of its discretion, and whether defendants breached a fiduciary duty by refusing to retire the certificates. Contrary to the majority's assertion, this case may not be distinguished from the state precedents cited earlier: irrespective of how complex the factual issues were in those cases, they did not involve legal standards which were necessarily less complex than those relevant to this case. Once Dr. Baarda clarified the admittedly complex facts concerning the operation and financing of this agricultural cooperative and stated criteria pertinent to judging its financial transactions, the jury was in as good a position as Dr. Baarda to apply the relevant legal standards given by the trial judge to the facts of this case. I question the helpful "expert" nature of the conclusion that defendants breached their "fiduciary" duties to plaintiff since the legal meaning of the term "fiduciary" is nearly identical to its meaning to laymen. Compare Webster's Third New Int'l Dictionary at 845 (1968) with Black's Law Dictionary at 753-54 (1968). Thus, given the minimal helpfulness of the specific legal conclusions stated above, the unfair prejudice to defendants of Dr. Baarda's weighty legal conclusions warrants their exclusion under Rule 403.

Although the federal courts would arguably apply the rules of evidence to permit these opinions under these facts, we are bound by the unqualified state precedents cited earlier. Given those authorities, the erroneous admission of Dr. Baarda's opinions was not cured by the trial judge's pattern instructions on credibility and expert testimony. As I believe there is a reasonable likelihood a different result might have been reached had Dr. Baarda's legal conclusions been excluded, I would grant defendants a new trial of the issues embraced by his testimony.

Furthermore, by establishing defendants' breach of fiduciary duty (and therefore their constructive fraud), Dr. Baarda's testimony also significantly affected plaintiff's deceptive trade claims. Thus, while I agree with the majority that the trial court erroneously dismissed plaintiff's deceptive trade claims, I would remand for a new trial of all claims, including the deceptive trade claims.

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HAJMM Co. v. House of Raeford Farms, Inc.

403 S.E.2d 483 (N.C. 1991)

Exum, Chief Justice.

This is an action seeking compensatory, punitive and treble damages for breach of fiduciary duty, breach of corporate bylaws, and unfair or deceptive acts or practices in or affecting commerce (unfair practices) based on defendants' allegedly improper refusal to redeem a certain "revolving fund certificate" issued by he corporate defendant (Raeford) to plaintiff. The trial court dismissed the claim for unfair practices under Rule 12(b)(6) of the North Carolina Rules of Civil Procedure.[141] The other claims were tried before a jury,[142] which returned a verdict granting compensatory damages against both defendants and punitive damages against Raeford. From judgment entered on the verdict defendants appealed. Plaintiff appealed from the dismissal of its unfair practices claim.

The Court of Appeals found no error in the trial, but reversed the dismissal of plaintiff's unfair practices claim and remanded it for trial. Judge Greene dissented, believing that during the jury trial the court improperly admitted certain expert testimony to the prejudice o defendants. Defendants' appeal to us is based on this dissent and raises the question of the admissibility of the expert testimony. We allowed in part defendants' petition for discretionary review to consider only the question whether the court of Appeals correctly concluded that plaintiff stated a claim for unfair practices under N.C.G.S. §75-1.1.

We conclude that the challenged expert testimony should not have been admitted ut the error in admitting it was harmless. We also conclude that N.C.G.S. §75-1.1 was not intended to apply to the transaction in question and plaintiff has not, therefore, stated a claim for unfair practices. We consequently modify and affirm in part and reverse in part the Court of Appeals decision.

Evidence at trial tends to show the following:

Plaintiff is a North Carolina limited partnership engaged in agricultural marketing. The partnership is composed of members of the Evans family from Laurinburg. HAJMM is an acronym formed from the first names of five Evans siblings - Hervey, Ann, John, McNair and Murphy.

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[141]This claim was dismissed at the 4 August 1986 session of Superior Court, Scotland County, Hairston, J. presiding.

[142]The trial was conducted at the 14 December 1987 session of Superior Court, Scotland County, Philips, J., presiding.

Defendant Raeford is an incorporated North Carolina agricultural cooperative engaged in the business of processing turkeys and other poultry. Defendant Johnson is president and chairman of its board of directors. He runs the company. According to his testimony, "[t]he final decision is mine" with regard to Raeford's business.

Raeford was formed in 1975. It was capitalized in part when plaintiff and two other turkey producers sold to Raeford all heir stock in Raeford turkey Farms, Inc. (RTF). The other two selling turkey producers were Stone Brothers, Inc. (Stone Brothers), and Nash Johnson and Sons, Inc. (NJS). Defendant Johnson and his sisters own NJS, which provides over ninety percent of raeford's turkeys.

As part of the consideration for selling their interests in RTF to Raeford, plaintiff and the other turkey produces received "Class B-Series 1975" revolving fund certificates issued by Raeford. The certificates became part of Raeford's capital structure and are shown as stockholder's equity on Raeford's balance sheet.

Plaintiff's certificates recites that plaintiff "has furnished $387,500 ... in value to [Raeford]." The certificate also recites that it "shall bear no interest," is "junior and subordinate to all debts" of the company, is subject to the company's bylaws, which are incorporated by reference, and is "retirable in the sole discretion of the board of directors, either fully or on a pro rata basis." The certificate bears no maturity date.

An identical certificate was issued to Stone Brothers for its RTF stock. NJS received a certificate with like terms but with a face value of $750,000.

With regard to the revolving fund certificates, Raeford's bylaws provide in part: "Funds arising from the issue of such certificates shall be used for creating a revolving fund for the purpose of building up such an amount of capital as may be deemed necessary by the board of directors from time to time and for revolving such capital." The bylaws also provide that "[s]uch certificates shall be issued in annual series ... and each series shall be retired fully or on a prorata basis, only at the discretion of the board ... in the order of issuance by years as funds are available for that purpose."

During 1978 Raeford retired the revolving fund certificate originally issued to Stone Brothers but which Stone Brothers had by then transferred to FCX, Inc. No value was placed on the certificate when it was retired. This retirement was a component of Raeford's purchase of all interest FCX then held in Raeford and was shown on Raeford's books by discounting the certificate to zero value.

Some time later Raeford retired the NJS certificate. Retirement of this certificate was also shown on Raeford's books by discounting the certificate to zero value.

Plaintiff's certificate was not retired and continued to e carried on Raeford's books as part of Raeford's capital structure. In March 1986 plaintiff demanded payment on the certificate and Raeford refused.

According to plaintiff's evidence defendant Johnson told Hervey Evans that Raeford would never pay the certificate. Johnson told an attorney representing the Federal Land Bank, "[i]t's not bearing interest, so there's really no reason to pay it. It's sort of like owing money to yourself." According to defendant Johnson, Raeford had refused to pay off the certificate because it wasn't good business." He conceded he had said he might never pay the certificate.

Plaintiff's evidence also showed that Raeford had been profitable throughout the mid-1980's. For example, the fiscal year ending 31 May 1986 yielded Raeford $6.1 million in net income and brought its net worth to over $18 million. Raeford's net worth had been only $6.8 million in 1983.

As of 1986 Raeford had loaned $375,000 to Johnson and over $1.1 million to other businesses owned by the Johnson family. In fiscal year 1987 Raeford purchased a jet airplane for over $800,000. By the end of the year, Raeford held $3.4 million in outside securities and had $922,000 cash on hand. Despite these loans, purchases, and liquidity, defendant Raeford refused to retire plaintiff's $387,500 revolving fund certificate.

Defendant's evidence sought primarily to justify the refusal to pay plaintiff's revolving fund certificate.

At the close of the evidence, the trial court submitted issues to the jury and received the following answers.

1. Did the defendant, House of Raeford Farms, Inc., breach is bylaws refusing to retire the revolving fund certificate of the plaintiff, HAJMM, in the reasonable exercise of its discretion?

   Yes.

2. Did the defendant, House of Raeford Farms, Inc., breach its bylaws by retiring any of the revolving fund certificates in the same annual series as that of plaintiff, HAJMM, and refusing to retire that of the plaintiff, HAJMM?

   Yes.

3. Do the defendants, E. Marvin Johnson and Raeford Farms, Inc., owe a fiduciary duty to the plaintiff, HAJMM?

   Yes.

4. If so, was their refusal to retire HAJMM's revolving fund certificate an open, fair and honest transaction?

   No.

5. In what month and year did the breach or violation occur?

   March, 1986.

6. In your discretion what amount of punitive damages, if any, should be awarded to the plaintiff, HAJMM from the defendant E. Marvin Johnson?

   None.

7. In your discretion, what amount of punitive damages, if any, should be awarded to the plaintiff, HAJMM from the defendant, House of Raeford Farms, Inc.?

   $100,000

Upon this verdict the trial court entered judgment ordering defendant, jointly and severally, to pay plaintiff $387,500 as compensatory damages and ordering defendant Raeford to pay plaintiff $100,000 inn punitive damages.

On defendants' appeal a majority of the Court of Appeals panel found no error in the trial. Judge Greene dissented, believing that the trail court erred by allowing an expert witness to testify that Raeford's Board of Directors "abused its discretion" and that defendants owed plaintiff a "fiduciary duty," which they breached. Defendants appeal to us as of right on he basis of the dissent.

On plaintiff's appeal, the Court of Appeals reversed and vacated the trial court's order granting defendants' Rule 12(b)(6) motion to dismiss the unfair practices claim and remanded for trial on that issue.

We granted defendants' petition for discretionary review to consider only the unfair practices claim issue.

II.

The first question we address is whether there was reversible error in the admission of certain expert testimony. The Court of Appeals concluded there was no error. We conclude there was error but that it was not so prejudicial as to warrant a new trial.

Dr. James Baarda was qualified as an expert witness on equity redemption by agricultural cooperatives. Defendants made timely objections to the following portions of his direct testimony:

Q. [By plaintiff's counsel] Based upon your experience and your review of the materials as to what you have previously testified and identified, do you have an opinion satisfactory to yourself, as to whether the Board of Directors of Raeford, abused their [sic] discretion in failing to redeem HAJMM's Class B Revolving Fund Certificate?

A. [By Dr. Baarda] Yes, I do have an opinion.

Q. What is that opinion?

A. [M]y opinion is that the Board of Directors did abuse its discretion in failing to redeem this equity.

Q. Do you have an opinion satisfactory to yourself, as to whether there was a fiduciary duty [owed] both by Raeford and the defendant, Marvin Johnson, to the HAJMM Company?

A. Yes, I do.

Q. What is that opinion?

A. In my opinion ... there was such a relationship.

Q. Do you have an opinion satisfactory to yourself as to whether the fiduciary duty was breached?

A. Yes

Q. What is that?

A. I believe that the fiduciary duty was breached.

Q. Do you have an opinion satisfactory to yourself, as to when the fiduciary duty was breached.

A. I believe it was breached when the Evans family made demand on the cooperative to pay it back, and the cooperative refused to do so.

Q. Do you have an opinion satisfactory to yourself as to whether this breach is continuous?

A. Yes, this, this is a continuing duty.

(Objections and objections to the line of questioning omitted.)

Defendants contend that Dr. Baarda should not have been permitted to give his opinion that they were plaintiff's fiduciary.

We now turn to the legal standards and jural relationship in this case. A fiduciary relationship "may exist under a variety of circumstances; it exists in all cases where there has been a special confidence reposed in one who in equity and good conscience is bound to act in good faith and with due regard to the interests of the one reposing confidence." Stone v. McClam, 42 N.C. App. 393, 401, 257 S.E.2d 78, 83 disc. rev. denied, 298 N.C. 572, 261 S. E.2d 128 91979) (quoting Abbitt v. Gregory, 201 N.C. 577, 598, 160 S.E. 896, 906 (1931)). Business partners, for example, are each others' fiduciaries as a matter of law. Casey v. Grantham, 239 N.C. 121, 79 S.E.2d 735 (1954). In less clearly defined situations the question whether a fiduciary relationship exists is more open and depends ultimately on the circumstances. Courts have historically declined to offer a rigid definition of a fiduciary relationship in order to allow imposition of fiduciary duties were justified. Abbitt v. Gregory, 201 N.C. 577, 160 S.E. 896. Thus, the relationship can arise in a variety of circumstances, id., and may stem from varied and unpredictable factors.

A qualified expert such as Dr. Baarda should be permitted under Evidence Rule 704 to give an expert opinion regarding the existence of these factors. For example, the expert witness may give an opinion that under the circumstances one party has reposed special confidence in an other party, or that one party should act in good faith toward another party, or that one party must act with due regard to the interests of another party. However, the witness may not opine that a fiduciary relationship exists or has been breached. The trial judge should instruct the jury with regard to factors which give rise to the relationship, The jury so instructed is then in as good a position as the expert to consider the factors and determine whether the fiduciary relationship exists.

Likewise, the discretion vested in a board of directors arises from a variety of sources and circumstances, including statutes, corporate charters, bylaws, resolutions and agreements. Whether such discretion has been abused depends on numerous factors. One such factor prominent in the case before us was the availability of funds with which to retire plaintiff's certificate. Experts may give opinions regarding the existence of these underlying factors, such as, for example, the availability of funds, but they may not opine whether a board abused its discretion. Again the trial court should instruct on the legal significance of the underlying factors to which testimony has been offered. The jury so instructed is then in as good a position as the expert to consider the factors before it and determine whether the abuse of discretion standard has been satisfied.

Applying the foregoing principles to Dr. Baarda's challenged testimony, we conclude that he should not have been permitted to give his opinion that there was a fiduciary relationship between plaintiff and defendants, that the defendants breached their fiduciary duty, and that the Raeford board abused its discretion. Whether there was a fiduciary relationship was the ultimate jural relationship at issue. Whether the fiduciary duty was breached was the ultimate legal conclusion, and whether the board abused its discretion involved the satisfaction or not of the ultimate legal standard. The jural relationship, the legal conclusion and the legal standard each have various underlying factual components, the existence of which were the proper subject of expert opinion testimony. The jury heard this fact-oriented testimony and, having been properly instructed on the legal significance of the underlying factual components, was in as good a position as the expert to determine whether the jural relationship existed, whether the legal conclusion should be drawn, and whether the legal standard was satisfied.

Though the Court of Appeals incorrectly determined that Dr. Baarda's challenged testimony was admissible, we conclude that its admission was harmless error. In civil cases, "[t]he burden is on the appellant not only to show error but to enable the court to see that he was prejudiced or the verdict of the jury probably influenced thereby." Board of Education v. Lamm, 276 N.C. 487, 492, 173 S.E. 2d 281, 285 (1970). Erroneous admission of evidence is not prejudicial when its import is established by other, admissible testimony, or where the erroneously admitted testimony is merely cumulative or corroborative. Lamm, 276 N.C. 487, 173 S.E. 2d 281. To establish prejudice and be entitled to a new trial, the appellant must show there is a reasonable probability that he would have received a favorable verdict had the error not occurred. Gregory V. Lynch, 271 N.C. 198, 155 S.E.2d 488 (1967); Mayberry v. Coach Lines,, 260 N.C. 126, 131 S.E. 2d 671 (1963).

Applying These principles, we conclude defendants have failed to establish that Dr. Baarda's inadmissible testimony was prejudicial. The substantial admissible testimony of Dr. Baarda, Hervey Evans, and others, together with the documentary evidence, is compelling in favor of plaintiff on the existence of a fiduciary relationship, breach of fiduciary duty and abuse of discretion. It also provides a solid basis for the award of punitive damages.[143]

The jury's determination on the fiduciary relationship issue rested on substantial and compelling competent evidence that plaintiff placed special confidence and trust in defendants when it agreed to accept the revolving fund certificate in return for its interest in RTF and that with regard to the certificate, plaintiff justifiably expected defendants to deal fairly. It rested also on the factual characteristics of the certificate itself, about which there is little or no dispute. The dispute regarding the certificate has revolved around the legal effect to be given its characteristics. Plaintiff has contended the certificate evidences enough of an

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We note the jury's answer to issue number 2 provides a sufficient, independent basis for sustaining the award of compensatory damages. Dr. Baarda's challenged testimony did not bear on this issue. We discuss its prejudicial effect nevertheless on he other issues because they are all intertwined with and may have affected the punitive damages award.

equity interest in Raeford to lease as a matter of law to the creation of a fiduciary relation between the parties. Defendant has contended the certificate evidences merely a credit-debtor relation out of which no fiduciary relation can arise. The Court of Appeals resolved these conflicting legal contentions favorably to plaintiff. We elected not to review this aspect of the Court of Appeals' opinion; it thus becomes the law of the case.

The upshot is that Dr. Baarda's conclusion that there was a fiduciary relation between the parties, standing alone, had little or nothing to do with the ultimate determination of this issue for plaintiff. This determination rested more directly on other competent and compelling evidence favorable to plaintiff and the legal effect of the revolving fund certificate's characteristics.

With regard to breach of fiduciary duty and abuse of discretion issues, there was also substantial and compelling evidence that defendant Raeford abused its discretion and that both defendants breached their fiduciary duties by not retiring the certificate.[144] Dr. Baarda was properly determined by the trial court to be an expert in cooperative financing. He gave five guiding reasons for a cooperative to retire its revolving fund certificates at a given time and five reasons not to retire them. He testified that all five reasons favoring retirement were present in this case, and that none of the reasons against retirement were present.

Dr. Baarda testified, largely without contradiction, that of great importance to determinations about retirement of revolving fund certificates is the financial status of the cooperative. During the time plaintiff demanded that defendants retire plaintiff's certificate, Raeford was enjoying financial success. Raeford had enough financial wherewithal to loan over $1 million to defendant Johnson and his family's other businesses. It had the ability to make large purchases, such as a corporate jet. Raeford's net worth had increased from $6.8 million in 1983 to over $18 million by 31 May 1986. By the end of fiscal year 1987, Raeford had $3.4 million invested outside securities and $922,000 cash on hand Raeford's liquidity was extremely high. The evidence regarding Raeford's financial circumstances during the period in question was largely uncontradicted.

Defendants' evidence did not challenge plaintiff's version of Raeford's objective financial condition. It tended in more conclusory fashion to justify defendants' refusal to retire plaintiff's certificate. Even defendants' own expert, improperly as we have shown, gave his opinion that defendants' refusal to retire the certificate was not an "abuse of discretion."

Given this state of the evidence, we are confident the jury did not base its verdict on conflicting, conclusory and improperly admitted expert opinions regarding whether a legal standard had been satisfied, but rather based its verdict on the largely uncontradicted facts regarding Raeford's objective financial condition and its financial ability to retire plaintiff's certificate.

The state of the evidence is such that we are confident the challenged expert testimony had little bearing not only on the liability issues but also on the award of punitive damages. To make the award, the jury under the trial court's instruction must have considered Raeford's conduct to be "outrageous." The jury was undoubtedly moved in plaintiff's favor by Johnson's testimony that after plaintiff made demand, Johnson

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[144]No issue specifically using the term "breach of fiduciary duties" was submitted to the jury. However, the jury was asked to determine whether defendants owed plaintiff a fiduciary duty. If the jury so found, it was then required to determine whether defendants had engaged in an "open, fair and honest" transaction. Given the context of the issues, the latter question is the equivalent of asking the jury whether defendants had breached their fiduciary duties.

and other Raeford directors, including Johnson family members, "had us a little meeting and decided that we didn't need to bother with it; it shouldn't be paid, it wasn't good business and we didn't do it." Johnson even acknowledged that he said he might never pay the certificate.

Defendants, therefore, have failed to establish a reasonable probability that the verdict would have been favorable to them had the error in admitting Dr. Baarda's challenged testimony not been committed. Because the error was harmless, we modify accordingly and affirm the decision of the Court of Appeals on this issue.

III.

We now consider whether the trial court properly dismissed plaintiff's unfair practices claim under Civil Procedure Rule 12(b)(6). Plaintiff contends defendants' refusal to retire plaintiff's revolving fund certificate constitutes unfair practices under N.C.G.S. § 76-1.1 (the Act), entitling it to treble damages, N.C.G.S. § 75-16, and attorneys' fees, N.C.G.S. § 75-16.1. We disagree and conclude this claim was properly dismissed.

The Act provides: "Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are declared unlawful." N.C.G.S. §75-1.1(a). The Act was clearly intended to benefit consumers, Pearce V. American Defender Life Ins. Co., 316 N.C. 461, 343 S.E.2d 174 (1986), but its protections extend to businesses in appropriate contexts. See United Laboratories, Inc. v. Kuykendall, 322 N.C. 643, 370 S.E.2d 375 (1988). Thus, plaintiff's status as a business partnership does not remove it from the Act's protection.

For plaintiff to be entitled to the Act's remedies, it must show that defendants' conduct falls within the statutory framework allowing recovery. Plaintiff must first establish that defendants' conduct was "in or affecting commerce" before the question of unfairness or deception arises. Johnson v. Insurance Co., 300 N.C. 247, 266 S.E. 2d 610 (1980).

This rule requires the Court to interpret the word "commerce." The Act provides that "[f]or purposes of this section, 'commerce' includes all business activities, however denominated, but does no include professional services rendered a member of a learned profession." N.C.G.S. § 75-1.1(b). Although this statutory definition of commerce is expansive, the Act is not intended to apply to all wrongs in a business setting. For instance, it does not cover employer-employee relations, Buie v. Daniel International, 56 N.C. App. 445, 289 S.E.2d 118, disc. rev. denied, 305 N.C. 759, 292 S.E. 2d 574 (1982), or securities transactions, Skinner v. E.F. Hutton & Co., 314 N.C. 267, 333 S.E.2d 236 (1985).

In Skinner we held that "securities transactions are beyond the scope of N.C.G.S. §75-1.1." Id. at 275, 333 S.E.2d at 241. Skinner relies on Lindner v. Durham Hosiery Mills, Inc., 761 F.2d 162 (4th Cir. 1985). In Lindner the fourth Circuit Court of Appeals concluded that the Act did not apply to securities transactions, in part because no court had interpreted the Federal Trade Commission Act, 15 U.S.C.A. §45(a)(1), upon which N.C.G.S.§75-1.1 was modeled, to apply to securities transactions. Cf. Stephenson v. Paine Webber Jackson & Curtis, Inc., 839 F.2d 1095 (5th Cir. 1988) (construing similar provision in Louisiana's statute as not providing coverage to securities transactions); Spinner Corp. v. Princeville Development Corp., 849 F.2d 388 (9th Cir. 1988) (same result in construing similar provision in Hawaii's statute).

Skinner and Lindner gave another reason for not applying the Act to securities transactions. This was that to extent the Act to securities transactions would create overlapping supervision, enforcement, and liability in this area, which is already pervasively regulated by state and federal statutes and agencies. The courts concluded there is enough legislative apparatus already in place to govern securities transactions without also applying the Act. Cf. Bache Halsey Stuart, Inc. v. Hunsucker, 38 N.C. App. 414, 248 S.E.2d 567 (1978), disc. rev. denied, 296 N.C. 583, 254 S.E.2d 32 (1979) (holding for similar, though not identical, reasons that commodities transactions are not covered by the Act).

These cases are pertinent because we believe revolving fund certificates are, in essence, corporate securities. Their purpose is to provide and maintain adequate capital for enterprises that issue them. Raeford's bylaws provide that the purpose of issuing the certificates was to "build up ... capital." This is the same function served by issuing more convention corporate securities. Our conclusion in Skinner that the Act does not apply to corporate securities should also extend to revolving fund certificates unless there is good reason to treat the certificates differently.

There is one important difference that bears consideration between this revolving fund certificate and more conventional corporate securities. According to the evidence, revolving fund certificates are not subject to the same extensive statutory provisions and administrative regulation that govern more conventional corporate securities. Federal involvement with a cooperative's issuance of revolving fund certificates is only incidental to the United States Department of Agriculture's other work. The USDA involvement is largely advisory rather than mandatory.

But pervasive regulation by other sources is not the only basis for refusing to apply the Act to securities transactions. Another reason is that the legislature simply did not intend for the trade, issuance and redemption of corporate securities or similar financial instruments to be transactions "in or affecting commerce" as those terms are used N.C.G.S. § 75-1.1(a). Subsection (b) of this section of the Act defines the term "commerce" to mean "business activities." "Business activities" is a term which connotes the manner in which businesses conduct their regular, day-to-day activities, or affairs, such as the purchase and sale of goods, or whatever other activities the business regularly engages in and for which it is organized.

Issuance and redemption of securities are not in this sense business activities. The issuance of securities is an extraordinary event done for the purpose of raising capital in order that the enterprise can either be organized for the purpose of conducting its business activities or, if already a going concern, to enable it to continue its business activities. Subsequent transfer of securities merely works a change in ownership of the security itself. Again, this is not a business activity of the issuing enterprise. Similarly, retirement of the security by the issuing enterprise simply removes the security from the capital structure. Like issuance and transfer of the security, retirement is not a business activity which the issuing enterprise was organized to conduct.

Securities transactions are related to the creation, transfer, or retirement of capital. Unlike regular purchase and sale of goods, or whatever else the enterprise was organized to do, they are not "business activities" as that term is used in the Act. They are not therefore, "in or affecting commerce," even under a reasonably broad interpretation of the legislative intent underlying these terms.

Revolving fund certificates are cooperative's functional equivalent of traditional corporate securities. They are capital raising devices. We conclude, therefore, that, like more conventional securities, issuance or redemption of revolving fund certificates are not "in or affecting commerce" and are not subject to the Act.

We reverse the Court of Appeals decision on the issue and reinstate the order of dismissal entered by the trial court.

IV.

In sum, we affirm, for different reasons, the result reached by the Court of Appeals in concluding there was no error in the trial. We reverse the Court of Appeals' reversal and vacation of the trial court's dismissal of plaintiff's unfair practices claim.

Modified and Affirmed In Part.
Reversed in part.

Martin, Justice, dissenting in part.

I respectfully dissent from the majority opinion on the issue of unfair commercial practices. I conclude that plaintiff has made out a claim sufficient to survive defendant's motion under Rule 12(b)(6).

As the majority points out, N.C.G.S. § 75-1.1 project businesses as well as consumers. This Court has recognized that "unfair trade practices involving only businesses affect the consumer as well." United Laboratories, Inc. v. Kuykendall, 322 N.C. 643, 665, 370 S.E.2d 375, 389 (1988); see also Manufacturing Co. v. Manufacturing Co., 38 N.C. App. 393, 396, 248 S.E.2d 739, 742 (1978), disc. rev. denied and cert. denied, 296 N.C. 411, 251 S.E.2d 469 (1979) ("G.S. 75-1.1(b) speaks in terms of declaring and providing civil means of maintaining ethical standards of dealings 'between persons engaged in business,' as well as between such persons and the consuming public").

As stated by the majority, it is the law of the case on this appeal that the certificate at issue represented an equity interest in Raeford and created a fiduciary relationship between the parties. It has been further established that defendants breached that fiduciary relationship when they did not act in an "open, fair and honest" manner when they refused to redeem plaintiff's certificate. There is no dispute that Raeford had the financial resources to easily redeem the certificate. The company "loaned" more than a million dollars to Johnson, acquired an $800,000 airplane, and had a net income of $6.1 million in fiscal year 1986. Defendants do not attempt to refute the evidence of Raeford's ability to redeem the certificate.

The majority relies heavily upon cases involving securities transactions. However, these cases are inapposite, because they were decided upon the theory that securities transactions were already subject to extensive regulation under state and federal law, and the application of N.C.G.S. §

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C. Setoff and Equity Redemption Policies

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Atchison County Farmer Union Co-op Ass'n v. Turnbull
736 P.2d 917 (Kan. 1987).

LOCKETT, Justice:

Plaintiff Atchison County Farmers Union Cooperative Association (Co-op) appeals the Atchison County District Court decision allowing the defendant, Raymond Turnbull, to set off his Co-op equity credit account against an open account indebtedness he owed to the Co-op.

The Co-op is a non-profit association organized under K.S.A. 17-1601 et seq. Headquartered in Atchison, Kansas, the Co-op provides services to approximately 2,000 members. Turnbull has been a member of the Co-op since 1965 and regularly purchased farm goods and materials on an open account.

Profits made by the association from member businesses are returned to the individual member on a pro rata basis of his business to that of the total membership. The profit allocations are either cash patronage refunds or are credited to the member's equity credit account. As a member, Turnbull received both cash patronage refunds and credits to his equity credit account. In 1983 his equity credit balance with the Co-op was $17,332.98. In early 1983, Turnbull ceased farming operations and applied for liquidation of his equity account, but his request was denied by the Co-op Board of Director.

In May of 1985, the Co-op filed suit to collect Turnbull's unpaid open account debt of $11,673.04, with interest at the rate of 18 percent per annum. Turnbull counterclaimed, suggesting that his $17,732.98 in patronage dividends be set off against the balance due on his open account. Turnbull also claimed that the interest charged by the Co-op was usurious.

At trial, the general manager of the Co-op testified as to the structure of the Co-op and relevant provisions of the articles and bylaws. He stated that at the time Turnbull applied for payment of his equity account, there were no bylaw provisions or policies of the Board allowing liquidation, although the bylaws allowed the payment of equities at the death or retirement of a member.

The trial court granted the Co-op judgment of the open account debt and, based on the equitable principle of unjust enrichment, allowed Turnbull a setoff of his equity credits up to the amount of the Co-op's judgment. The Co-op appeals, contending Turnbull's equity credit account cannot be set off against the indebtedness owed.

The purpose of cooperative marketing is to promote the intelligent and orderly marketing of agricultural products through cooperation. It is designed to eliminate speculation and waste and to make distribution of agricultural products as direct as possible between producer and consumer. K.S.A. 17-1601. The paramount concern of such associations is to provide a means of marketing the products of their members, not the advancement of the individual members. Claassen, Executrix v. Farmers Grain Cooperative, 208 Kan. 129, Syl. para. 3, 490 P.2d 376 (1971).

Nonprofit cooperative associations are organized under the provisions of the Kansas Cooperative Marketing Act, K.S.A. 17-1601 et seq., to make profit for their members as producers. K.S.A. 17-1602. The affairs of cooperative associations are managed by boards of directors. K.S.A. 17-1611. The articles of incorporation and bylaws of an association provide the means to obtain the necessary funds or capital to pay the expense of operations and acquire property necessary to carry out its purposes. The bylaws may state the amount of annual dividends which may be paid on stock and the manner in which the remainder of the association's profits shall be prorated in the form of patronage dividends to its stockholders. K.S.A. 17-1609.

Section 3 of Article IX of the Co-op's bylaws provide that "the balance of the allocation due all members and associate members may be paid in cash, common stock, preferred stock, non-voting associate membership certificates, equity credits or any combination thereof at the discretion of the board of directors."

Section 8 of Article IX of the bylaws allows the establishment of an equity credit fund. Every patron eligible to receive a patronage allocation is required to contribute to the fund the net savings remaining in his credit after the payment in cash to the fund and used as capital for the continued operation of the association.

The bylaws of the Co-op provide for the retention of up to 80 percent of the operating profits that are allocated to Co-op members in order to furnish capital for the Co-op. Each member of the Co-op is credited with his proportionate share of furnished capital in the books of the Co-op. This deferred patronage allocation is termed "equity credits" and may be paid out or redeemed only at the discretion of the board of directors.

Equity credits are not an indebtedness of a cooperative association which is presently due and payable to the members, but represents an interest which will be paid to them at some unspecified later date to be determined by the board of directors. Such equity credits represent patronage dividends which the board of directors of a cooperative, acting under statutory authority, has elected to allocated to its patrons, not in cash or other medium of payment, which would immediately take such funds out of the working capital of the cooperative, but in such manner as to provide or retain capital for the cooperative and at the same time reflect the ownership interest of the patron in such retained capital. 18 Am.Jur.2d, Cooperative Associations § 23.

There are no Kansas cases discussing the right of a member of a cooperative association to set off equity credits against the member's debts. In Claassen, Executrix v. Farmers Grain Cooperative, 208 Kan. 129, 490 P.2d 376, the executrix sought to recover a money judgment against Farmer's Grain based on credits earned by the deceased during his lifetime as a member and patron of the cooperative association. The court noted that patronage ledger credits were different form stock purchased by a member and that their characteristics made them capital investments, as distinguished from debts. The court concluded since neither the articles of incorporation nor the bylaws of the defendant provided for a mandatory payment of the patronage ledger credits to a decedent's estate, it was a matter of discretion with the board of directors whether to pay such. The executrix pointed out that the board had paid such credits to other estates. This court determined, however, that it could not substitute its judgment for the judgment of the board of directors and declined to become involved in the financial structure of the cooperative to determine whether the board of directors acted reasonably. For similar cases from other jurisdictions, see Howard v. Eatonton Co-op. Feed Co., 226 Ga. 788, 177 S.E.2d 658 (1970); Clarke County Co-op (AAL) v. Read, 243 Miss. 879, 139 So.2d 639 (1962); and Evanenko v. Farmers Union Elevator, 191 N.W.2d 258 (N.D.1971). We have also refused to interfere on behalf of a dissatisfied stockholder with the discretion of the boards of directors of other types of corporations on questions of corporate management, policy, or business. Sampson v. Hunt, 233 Kan. 572, 584-85, 665 P.2d 743 (1983).

Bylaws of a cooperative association organized under K.S.A. 17-1601 et seq. are a contract between the cooperative and its members or stockholders and govern transactions between them. Equity credits constitute an interest of a stockholder of a cooperative association which is contingent and not immediately payable. The interest becomes vested when the board of directors, following the bylaws, exercises its sound discretion and determines that such payments can be made without causing undue financial hardship to the association. A member or a stockholder of a cooperative associations bound by the bylaws and cannot contend that when the equity credits are allocated upon the books of the association hat an indebtedness is created which can be used as a setoff against a debt the member or stockholder owes the association.

The bylaws of the Co-op provide that equity credit accounts of members may be retired for estate settlement purposes to those members attaining age 65 or to those members removing their farm operation from the Co-op's trade territory. Turnbull argues, however, that principles of equity require that he be allowed to set off his credits against his debts because he last produced agricultural products in 1981. Prior to trial, Turnbull had lost his home and all of his farmland. His farm equipment was sold in March 1982.

The Kansas Code of Civil Procedure modified the general rule that, in order to be available as a setoff or counterclaim, a claim or demand of a defendant against a plaintiff must be due and owing at the commencement of the action. 20 Am.Jur.2d, Counterclaim, Recoupment, Et. § 57; 809 C.J.S., Set-off and Counterclaim § 29. A claim which either matured or was acquired by the pleader after serving the pleading may, with the permission of the court, be presented as a counterclaim by supplemental pleading. K.S.A.1986 Supp. 60-213(e). This is based on the principle that all issues between the parties should be determined in one action. To allow a debt not maturing during an action to be set off against one already due would be to change the contract and advance the time of payment. Equitable setoffs of unmatured obligations may be allowed under special circumstances, such as insolvency of the obligor or probable difficulty in collecting the obligation at maturity, but such setoffs are largely within the court's discretion.

An equitable setoff will be allowed when the party seeking it shows some equitable ground therefor, and it is necessary to promote justice, to avoid or prevent wrong or irremediable injustice, or to give effect to a clear equity of the party seeking it. There is some authority to the effect that the equitable grounds which will warrant overriding the statutory law have been limited to insolvency or nonresidence, but it is generally held that these are not the sole grounds. 80 C.J.S., Set-off and Counterclaim § 5.

The trial judge found it was inequitable for the Co-op to sue Turnbull on his debt and allow the Co-op to refuse to set off Turnbull's equity credits against that debt. Adopting the principle of equitable setoff due to insolvency, the trial judge overrode the Co-op's bylaws and the statutory law and allowed Turnbull to set off his equity credits against his debt to the Co-op. It is therefore necessary to determine whether the legislature has made a statement of public policy which prohibits the trial judge from overriding the statutory law and applying equitable principles.

In giving and withholding relief, courts of equity go much further in promoting of the public interest than when only private individuals are involved. Accordingly, the granting or withholding of relief properly depends upon considerations of public interest. If the granting of relief to an individual will be prejudicial to the public interest, the public interest must be protected. "Public policy" is that principle of law which holds no individual can lawfully do that which has a tendency to be against the public good.

Permeating each of the conclusions in Claassen, Executrix v. Farmers Grain Cooperative, 208 Kan. 129, 490 P.2d 376, was the statement of public policy that cooperative marketing associations are fostered and encouraged by legislative enactment and judicial construction; that the inception of these organizations was deemed to be for the personal benefit of member only to the extent that the individual profited through the operation of the enterprise; and that the paramount concern was not the advancement of the individual interest as such. Furthermore, a members's demand for service is responsible for the creation of a cooperative association and as a means of marketing his produce during the period of his membership, and there is no logical ground upon which a member should be permitted to withdraw his interest at the expense of disturbing the financial condition or the life of the association. 208 Kan. at 134, 490 P.2d 376.

It is the declared public policy of this state to encourage cooperative marketing associations. The trial judge could neither grant an equitable set off to Turnbull nor substitute his judgement for the Co-op's board of directors.

Affirmed in part, reversed in part, and remanded with directions for the district court to enter judgment in accordance with this opinion.

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Following is the article Baarda, James R., "Current Cooperative Topics, Setoff and Cooperative-Patron Conflicts," 11 J. AG. TAXATION & LAW 367 (1990)

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Financial stress quite naturally affects cooperatives owned and used by farmer-patrons. For example, farmers' indebtedness to their cooperatives has led to disputes involving the unique dual nature of the cooperative-patron relationship-the farmer is both owner and user of the cooperative.

In a typical situation, a farmer purchases a farm input or service under a credit arrangement and becomes indebted to the cooperative. For a cooperative whose service is lending money, the farmer's very patronage is borrowing from the cooperative. In either case, the farmer also holds an equity interest in the cooperative, built up either by direct investment or by capital additions associated with patronage, such as retained patronage refunds or per unit capital retains. An identical relationship exists when the member is also a cooperative in a federated structure.

Upon the farmer-debtor's failure to satisfy obligations to the cooperative, either by nonpayment or by filing for bankruptcy, interests are drawn into conflict. The cooperative may take legal action to collect the debt, and the patron may respond by demanding that equity held in the cooperative be applied as a setoff. Similarly, a trustee in bankruptcy may make a setoff demand upon receipt of the patron estate's equity interest in the cooperative. Sometimes the cooperative itself may want a setoff, though usually cooperatives resist setoffs initiated by patrons.

Setoff cases in the last few years have addressed several issues of considerable interest to cooperatives and farmer-patrons. A threshold issue is that of setoff between a debt and an equity interest. This mismatch leads to a second issue-the role of equity redemption principles in setoff cases. The growth of bankruptcy proceeding has presented conflicts between bankruptcy rules and other laws in setoff disputes. Cooperatives' attempts to protect their interests by placing liens on patron equity or demanding setoff have met with mixed results.

Debt-Equity Setoff

The general rule in setoffs is that the interest to be set off against the debt must be a mutual debt owed by the creditor to the debtor.[145] The debtor's claim against the cooperative must be due and owing before setoff can be demanded.[146] This rule has led courts to investigate the characteristics of the equity interest held in the cooperative by farmer-debtors.

Courts have had little trouble characterizing patrons' interests as true equity lacking the "due and payable" feature required for setoff. As one court has explained,[147] a cooperative member's patronage credits are an interest in the cooperative association that is contingent and not immediately payable. The interest becomes due and payable only when the board of directors exercises its discretion and concludes that such payments may be made without causing undue financial hardship to the association. In other words, patronage credits are not an indebtedness of a cooperative association that is presently due and payable to the members. Instead, they represent an interest that may be paid at some unspecified later date to be determined by the board of directors. Thus, before setoff of patron debt against equity in the cooperative is possible, a fundamental change in the equity's character is necessary. The cooperative must take some action to convert the interest to a debt due and payable, whether that action is voluntary or forced.

Setoff as Equity Redemption

This change in the character of the equity interest is similar to, or the same as, what is usually referred to as equity redemption. Such redemption is a cooperative's specific action to redeem outstanding equities in which the equity holder receives payment in money for the equity interest, an action normally within the discretion of the board of directors.[148] Thus, when a setoff is demanded, equity redemption is in effect demanded, and if setoff is ordered, the cooperative will be forced to take actions constituting redemption of patron equity, in whole or in part.

Although an older Fourth Circuit decision denied that setoff is tantamount to stock redemption,[149] most recent cases recognize that setoff is indeed equivalent to such a redemption.[150] When a setoff is treated

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[145] Atchison County Farmers Union Co-op. Ass'n v. Turnbull, 241 Kan. 357, 736 P.2d 917 (1987); *In re* Axvig, 68 Bankr. 910 (Bankr. D.N.D. 1987); *In re* Beck, 96 Bankr. 161 (Bankr. C.D. Ill. 1988).

[146] Atchison, note 1 *supra*.

[147] *In re* Lamar Farmers Exch., 76 Bankr. 712, 716 (Bankr. W.D. Mo. 1987). *Accord*, Atchison, Axvig, and Beck, note 1 *supra*, and *In re* Cosner, 3 Bankr. 445 (Bankr. D. Ore. 1980).

[148] See Cobia, *et al.*, Equity Redemption: Issues and Alternatives for Farmer Cooperatives, U.S.D.A., ACS Research Rep. 23 (1982).

[149] Columbia Bank for Coops. v. Lee, 368 F.2d 934 (4th Cir. 1966). "[W]e do not order retirement. Nor do we consider offset equivalent to redemption since the bank can reissue the stock at par to other borrowing cooperatives." 368 F.2d at 938.

[150] Atchison, Axvig, and Beck, note 1 *supra*. See also Cosner, note 3 *supra*. Christian County Farmers Supply Co. v. Rivard, 131 Ill. App. 3d 835, 476 N.E.2d 452 (1985); *In re* Eisenbarth, 77 Bankr. 228 (Bankr. D.N.D.

as a redemption, and when it is opposed by the cooperative, the plaintiff must convince the court to override the general rule that boards of directors have discretion to make redemption decisions, which are judgments not generally overturned by the courts.

The plaintiff in *Atchison*[151] asked for equitable setoff. The court concluded that an equitable setoff is allowed when some equitable ground is shown "and it is necessary to promote justice, to avoid or prevent wrong or irremedial in justice, or to give effect to a clear equity of the party seeking it."[152] Equitable relief is founded in public policy considerations. If a public policy argument is offered to force redemption, public policy may also be urged by the cooperative to prevent redemption. Thus, in *Atchison*, the court considered the express state policy to encourage farmer cooperatives in Kansas, analyzed the financial structure of such organizations, and concluded that equitable setoff was not justified.

A board of directors' refusal to redeem may also be challenged as an abuse of its discretion, thus allowing a court to substitute its judgment for the board's. The argument has been used at various times over the years in non-setoff equity redemption cases and has not met with much success. Refusal to redeem in setoff situations does not seem to have changed the standards usually applied. In *Lamar*,[153] the patron debtor, itself a cooperative, contended the cooperative was arbitrary and capricious in reusing to redeem equity when it had done so for other members. The court applied equity redemption standards and said, "[W]hile [courts] may under certain circumstances order patronage equity credits in a cooperative to be used to set-off a member's or former member's debt to the cooperative, such exercise of power should be restricted to those cases wherein there has been a clearly evidenced abuse of the otherwise sole discretion of the co-op's board of directors."[154]

The court in *Beck*[155] reserved judgment on whether the cooperative's refusal to redeem was an abuse of discretion. The cooperative's policy was to redeem upon the patron's retirement. The bankrupt debtor patron, according to a letter from the cooperative to the trustee in bankruptcy, would be eligible to receive these funds upon demand, but the cooperative refused to redeem in setoff nevertheless.

Bankruptcy and Other Statutes

Debtor patron bankruptcy introduces a new set of rules in the relationship of the debtor-patron to the cooperative. Some apply principles drawing on patron-cooperative relationships established outside bankruptcy law. For example, in setoff cases debts to be offset must be mutual in nature according to both

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1987); *In re* FCX, Inc., 853 F.2d 1149 (4th Cir. 1988); *In re* Lamar Farmers Exch., 76 Bankr. 712 (Bankr. W.D. Mo. 1987); *In re* Massengill, 100 Bankr. 276 (E.D.N.C. 1988); *In re* Walker, 48 Bankr. 668 (D.S.D. 1985).

151 Atchison, note 1 *supra*.

152 736 P.2d at 921.

153 Lamar Farmers Exch., note 6 *supra*.

154 76 Bankr. at 716.

155 Beck, note 1 *supra*.

bankruptcy and nonbankruptcy rules, thus requiring an investigation of the equity redemption process when patron debt is sought to be offset against patron equity.[156]

Several recent setoff cases have compared purposes and specific provisions of bankruptcy and federal laws governing cooperative lending institutions in the Farm Credit System to determine setoff rights of bankrupt patrons. Borrowers from production credit associations, banks for cooperatives, and the Federal Land Bank are required to make stock purchases in the lending institution as part of the borrowing process.

Statues relied upon by both lenders and borrowers specify the lenders' right of setoff to protect the loan, but the statutes also make redemption discretionary.[157] Interpretation of these statutes has yielded opposing conclusions for borrower setoff demands in recent years.

Earlier decisions in the 1980s held that statutes gave lenders the option to redeem stock of the bankrupt, but the bankrupt, or trustee, had no right to force redemption in setoff.[158] Interests of Farm Credit System lending institutions were drawn from the Supreme Court's statement in *Mississippi Chemical*:[159]

> It must be remembered, however, that the stock was intentionally given these characteristics by a Congress with definite goals in mind. The legislative history of the Farm Credit Act of 1955 indicates that Congress placed much of the blame for the Bank's inability to repay the capital extended by the Government and to retain private capital to the provision in the 1933 legislation which permitted borrowers to redeem their stock for cash upon paying off their loans. The restrictions on redemption and transferability and the dividend prohibition were designed to obviate this difficulty and to provide both a stable membership and permanent capital, two necessities for the success of any cooperative venture.[160]

Purposes of bankruptcy laws were held insufficient to override the specific congressional intent in enacting the Farm Credit Act.[161]

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156 *Id*. See also *In re* Cooperativa Cafeteros, 19 Bankr. 732 (Bankr. D.P.R. 1982); Cosner, note 3 *supra*; and FCX, note 6 *supra*.

157 For banks for cooperatives, for example, "in any case where the debt of a borrower is in default, or in any case of liquidation or dissolution of a present or former borrower from a bank for cooperatives, the bank may, but shall not be required to, retire and cancel all or part of the stock....In no event shall the bank's equities be retired or canceled if the retirement or cancellation would adversely affect the bank's capital structure." 12 U.S.C. § 213 (d).

158 *In re* Cooperativa Cafeteros, note 12 *supra*. (Since the bank had agreed to setoff, the dispute focused on valuation.) See also *In re* Walker, note 6 *supra* (Production Credit Assn, citing Cooperativa); *In re* Eisenbarth, 77 Bankr. 228 (Bankr. D.N.D. 1987) (Federal Land Bank case, citing *Walker*).

159 United States v. Mississippi Chemical Corp., 465 U.S. 298 (1972).

160 465 U.S. at 301.

161 Walker, note 6 *supra*.

An opposite conclusion was reached in 1987 with respect to a chapter 12 bankruptcy proceeding.[162] The court in *Massengill* discussed the Fourth Circuit's decision in *Columbia Bank*[163] and the special features of chapter 12 bankruptcy. Because chapter 12 was "designed to give family farmers facing bankruptcy a fighting chance to reorganize their debts and to keep their land,"[164] the court concluded that a debtor's ability to return land bank or production credit association stock to satisfy or reduce secured claims should not be frustrated by the Farm Credit Act of 1971. This decision was followed by *Greseth*.[165]

Massengill was subsequently reversed.[166] Emphasizing the important policy inherent in the Supreme Court's statement in *Mississippi Chemical*, the district court held that the general provisions of the bankruptcy law could not supersede the specific provisions of Farm Credit legislation. With respect to the older *Columbia Bank* decision, the court said that the importance of the transfer and retirement restrictions placed on the stock under the Farm Credit Act should not be dismissed in light of the Supreme Court's subsequent pronouncement in *Mississippi Chemical*.

Cooperative Liens and Setoff Attempts

Cooperatives may protect their loans by themselves demanding setoff in cases of nonpayment or, in anticipation of problems, placing liens on patrons' equity to the extent of any debt incurred. Statutory basis for setoff for Farm Credit System institutions was discussed above. Other cooperatives use setoff and liens based on internal policy and documentation.

Cooperatives attempting to set patron equity off against patron indebtedness to the cooperative have met the same obstacles imposed where the setoff demand originates in the patron. Three bankruptcy cases addressing cooperative setoff demands have held that the bankruptcy law requirement that setoff applies only to mutual debts precluded cooperatives from setoff demands because the interest of the patron in the cooperative was one of equity, not debt.[167]

Many cooperatives, in the articles of incorporation and bylaws, place a lien on all equity a patron may have in the cooperative to the extent the patron is indebted to it. the adequacy of these liens has been tested where the patron goes bankrupt, the equity is transferred to the bankruptcy estate, and the cooperative argues that the transfer is subject to its lien.

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162 Massengill, note 6 *supra*.

163 Columbia Bank for Coops., note 5 *supra*.

164 H.R. Rep. No. 99-958, 99th Cong., 2d Sess. 48 (1986).

165 *In re* Greseth, 78 Bankr. 936 (Bankr. D. Minn. 1987).

166 Massengill, note 6 *supra*.

167 Axvig and Beck, note 1 *supra*; Cosner, note 3 *supra*.

Cooperatives' interests have not fared well in recent cases. In *Axvig*, *Beck*, and *Cosner*,[168] liens were held to be liens on general intangibles that were not capable of perfection by the cooperative's possession, absent some certificate in addition to book entries on the cooperatives' books. Though a security interest in such property may be perfected by filing a financing instrument, none of the cooperatives in the cases noted above had done so, and the trustees took equity free of any cooperative lien.

The FCX Case

A recent decision from the Fourth Circuit has caused concern among cooperatives that seek to protect themselves by placing a lien on patron equity but at the same time wish to defend their capital structure against patron setoff demands.[169] There the patron was a cooperative member of a federated cooperative. The situation was typical in that the patron was indebted to the cooperative at the time of its bankruptcy, the patron held equity in the federated cooperative, and the federated cooperative had a secured interest in the patron's equity.

The court applied a section of the Bankruptcy Code[170] that provides:

> Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall...[provide for] sale of all or any part of the property of the estate, either subject to or free of any lien, or the distribution of all or any part of the property of the estate among those having an interest in such property of the estate.

The court held that surrender of patronage equity on which the cooperative had a lien was the distribution of collateral, which is property of the estate, to a party holding a security interest in the collateral (the cooperative) in satisfaction of that party's secured claim. According to the court, the Bankruptcy Code overrides nonbankruptcy law restrictions on the distribution of collateral to satisfy a claim secured by the same. Accordingly, the provision supersedes the discretionary power over surrender of the patronage certificates bestowed on the federated cooperative's board by its bylaws.

Conclusion

Recent decisions concerning setoff of patron debt and equity suggest cooperatives and patrons alike need to assess a rather large collection of cooperative rules, statutes, practices, and recent judicial decisions. Cooperatives' efforts to protect their interests from loan losses and protect the integrity of their equity structure may lead to a tightrope act in which current law provides a slightly unstable anchor for the rope.

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168 Liens were also noted in FCX, inc., note 6 *supra*, and Lamar Farmers Exch., note 3 *supra*, where validity was not at issue.

169 FCX, Inc., note 6 *supra*.

170 12 U.S.C. § 1123(a)(5)(D).

IV. Vested Interests

The following decision suggests caution when designing programs that may need changing in the future and when modifying existing programs. Combined with above information, the decision further defines the relative rights and obligations of member and cooperative.

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Lambert v. Fishermen's Dock Cooperative
297 A.2d 566 (N.J. 1972)

MOUNTAIN, J.

In this action plaintiff sought a recovery of the value of his stock or membership interest in the defendant cooperative as well as an accounting for patronage dividends to which he claimed to be entitled. The trial judge, sitting without a jury, fixed the value of his stock interest at $15,092.10 and his claim for patronage dividends in the amount of $3,406.76 for a total judgment of $18,498.86. On defendant's appeal to the Appellate Division, that court reduced the value of the stock interest to $125 and the dividend claim to $2,309.04. 115 N.J.Super. 424, 280 A.2d 193 (App.Div.1971). We granted plaintiff's petition for certification. 59 N.J. 434, 283 A.2d 533 (1971).

At oral argument the issue concerning patronage dividends was withdrawn, leaving only for our review the question of the value of his stock interest.

The underlying facts are set forth fully in the opinion of the Appellate Division and we summarize them only briefly here. Defendant is a fishermen's cooperative association, incorporated in 1953 under the provisions of N.J.S.A. 34:17-1 et seq. Plaintiff joined the association in 1957, purchasing two shares of stock for $125. In July, 1965, his membership in the association was terminated by defendant's board of directors because he was no longer engaged in the fishing industry and hence did no business with defendant. At the time, plaintiff made no real objection to the fact of his expulsion, nor does he now claim it to have been improper. The by-laws provided that as a continuing condition of membership, a stockholder must be a producer of aquatic products, and it is undisputed that at the time of expulsion plaintiff no longer met this requirement. His objection is that he did not receive the amount to which he was justly entitled upon the redemption of his shares. This poses the only real issue before the court.

In 1957, the time plaintiff became a stockholder, a by-law of the association stated that upon termination of membership a stockholder was entitled to receive the "fair book value" of his shares. In 1962, this by-law was amended to provide that henceforth, instead of "fair book value," a retiring member would be entitled to a return only of the price he had originally paid for his stock. Plaintiff strongly objected to this amendment a the time of its adoption. Both the certificate of association and the by-laws at all times contained provisions authorizing the amendment of the by-laws by majority vote of the membership.

The trial court agreed with plaintiff that the amended by-law, altering the consideration to be received upon the redemption of shares from fair book value to original purchase price, was invalid as violating a contract, infringing upon a vested right, and exceeding such authority as was bestowed upon the majority by its reserved power to amend by-laws. The Appellate Division disagreed, holding that the power reserved to the majority to amend the by-laws of the association was ample to support the questioned amendment and therefore the amendment became binding upon the plaintiff upon its adoption. Upon this crucial point we find ourselves in agreement with the trial judge.

It is the law generally that a reserved right to amend the by-laws of an association, whether to be exercised by the majority or, in some cases, a larger proportion of stockholders, members or directors, is a limited rather than an absolute right, even though the reservation is expressed in broad and general terms. It is often said that such a right to amend may not be extended so as to impair or destroy a contract or vested right, that it does not authorize the adoption of an amendment which will have such an effect, and that in general the exercise of such a right should be confined to matters touching the administrative policies and affairs of the corporation, the relations of members and officers with the corporation and among themselves, and like matters of internal concern. 8 Fletcher, Cyclopedia Corporations (Perm. Ed.) § 4177; 1 Hornstein, Corporation Law and Practice, (1959) § 269.

In New Jersey this rule, that a reserved power to amend by-laws may not affect basic rights, has found expression in a number of cases; interestingly, most of these deal with societies and associations which are similar to the defendant cooperative in that they were created to foster some kind of mutual benefit.

In *O'Neill*, the defendant organization had issued a benefit certificate to the plaintiff, one of its members. By the terms of the certificate, the defendant agreed that, in consideration for the receipt of a stated monthly assessment, it would pay, upon plaintiff's death, the sum of $5,000 to his named beneficiaries. By the terms of the arrangement plaintiff agreed to be bound by all by-laws of the defendant then existing or thereafter adopted. A later by-law fixed $2,000 as the most that would be paid under any benefit certificate, and at the same time reduced the monthly assessments proportionately. Plaintiff's challenge to this action was sustained. Announcing the pertinent rule, Justice Pitney said,

> But it is very generally, if not universally, held that these benefit certificates, like other contracts, confer a vested interest upon the member, which may not be impaired by a subsequent amendment, even though the power to amend be reserved in general terms. If the member's stipulation to comply with all by-laws thereafter enacted could be construed to relate to a by-law that reduced the benefit from $5,000 to $2,000, it must also relate to a by-law canceling the benefit certificate entirely-a result wholly unjust and absurd. The stipulation must be construed as referring only to reasonable by-laws and amendments adopted in furtherance of the contract, and not to such as would overthrow it or materially alter its terms. [O'Neill v. Supreme Council, American Legion of Honor, 70 N.J.L. 420-421, 57 A. 463 (1904)]

The *Sautter* case presented a very similar issue. Plaintiff was the beneficiary named in a benefit certificate issued to her late husband by defendant. The certificate provided that, upon the death of the insure, satisfactory proof thereof, and the surrender of the certificate, the defendant would pay $1,000 to the insured's designated beneficiary. The decedent had expressly agreed that he would abide and be bound by all by-laws and other appropriate regulation of the defendant, including those adopted thereafter. Later the defendant association adopted a by-law denying benefits in those cases where the insured died by suicide. Subsequently the insured committed suicide and defendant refused payment. The court held that the amended by-law in no was affected plaintiff's rights. It said,

> The plea demurred to sets forth no facts which constitute a bar to this action. It does not aver any violation by the insured of any law, rule, or regulation of the association enacted by it for its government or for the government of its funds; but, by way of argument, asserts that he, by entering into the stipulation which it recites, agreed that the association might, at will, so change the

> contract of insurance as to relieve it, to a material extent, from the liability created thereby. We think such a construction of the stipulation is not warranted by its language. To say that it confers upon the association the power to so alter the contract of insurance by an after adopted by-law as to destroy the right of the beneficiary to be paid the amount called for by the certificate in case the insured shall die by his own hand, is equivalent to saying that it authorized the association to limit its liability to such an extent as it chose, for instance, by providing that no benefit shall be paid in case the death of the insured shall result from an accident occurring through his own negligence, or from a disease which is epidemic in its character, or from any other cause or causes which it may designate. An agreement, by a person applying for membership in one of these fraternal organizations, and for insurance therein, that he will comply with such rules and regulations as the association may thereafter enact for its own government, or the government of its death fund, cannot be construed into a stipulation conferring any such power as has been suggested, without disregarding the plain meaning of the words of the agreement. [Sautter v. Supreme Conclave Improved Order of Heptasophs, 72 N.J.L. 326-327, 62 A. 529 (1905)]

In *St. John's Baptist Society*, it appeared that defendant, a parent organization, had, by the terms of its by-laws and by the terms of charters issued to local branch organizations, accorded such branches a right of representation at its national conventions with the privilege of sending delegates at defendant's expense. Defendant had reserved the right to amend its by-laws, which were declared to be binding upon all local branches. A later amendment of these by-laws had the effect of depriving many branches of this privilege of delegate representation. The court held the amendment to be an improper and invalid violation of the charter rights of such branches. It pointed out that "[s]uch vested rights may not be impaired by subsequent amendment of the by-laws under a power to amend reserved in general terms" and concluded that "[t]he reserved right to amend must be construed as referring only to reasonable amendments and not to such as would materially alter the charter contract." 105 N.J.Eq. at 72-73, 146 A. 886, 887.

Elsewhere the general rule limiting the exercise of the reserved right to amend by-laws to such matters as will not substantially affect basic rights of stockholders or members has been applied to cooperatives like the defendant. In Whitney v. Farmers Co-op. Grain Co., 110 Neb. 157, 193 N.W. 103 (1923), at the time plaintiff became a stockholder-member, a by-law of the defendant provided that it would repurchase his stock at a designated price in the event that he should later move out of the marketing area. This by-law was later rescinded. Plaintiff thereafter moved from the area so that he was no longer able to avail himself of defendant's services, whereupon he requested the defendant to repurchase his stock in accordance with the original by-law. This the defendant refused to do, pointing out that the by-law had been rescinded and that plaintiff had originally agreed to be bound by all defendant's by-laws, both those then in existence and those thereafter adopted. The court found for the plaintiff, holding that the reserved right to amend, even though coupled with plaintiff's original agreement to be bound by any subsequent exercise thereof, did not justify defendant's abrogation of its contract to repurchase. For an identical holding upon substantially the same facts, see Loch v. Paola Farmers' Union Co-op Creamery & Store Association, 130 Kan. 136, 285 P. 523 (1930); reh. den. 130 Kan. 522, 287 P. 269 (1930).

Accordingly we hold that the amended by-law adopted in 1962 by Fishermen's Dock Cooperative was ineffective to divest the plaintiff of the right given him under the by-law in effect when he purchased his stock, namely, to receive upon the termination of his membership, the fair book value of his shares.

This brings us to a consideration of what is meant here by "fair book value." Plaintiff urges, and the trail court substantially agreed, that this was to be determined by finding the present *market* value of the corporation's assets, subtracting existing liabilities, and dividing the difference, or net worth, by the number of shares outstanding. Accordingly the court received in evidence the testimony of an expert witness that the present market value of defendant's physical plant-land and buildings-is about $500,000. Placing substantial reliance upon this testimony, the court determined that each of plaintiff's two shares was worth $7,575.

Defendant's accountant, on the other hand, testified that book value is a reflection of the corporation's net worth as determined from its books of account, assuming that these have been kept accurately and in accordance with recognized accounting practices. As to the books that defendant had kept, he testified that assets were initially entered at cost, depreciable assets were thereafter depreciated, and inventory and accounts receivable were periodically adjusted downward to reflect, respectively, decreased market value and uncollectibility. As so calculated he fixed book value at about $455 per share.

Most courts have agreed that there is no single definition of book value that can be automatically applied in all cases. See Annotation, "Meaning of `Book Value' of Corporate Stock," 51 A.L.R.2d 606 (1957). The intention of the parties to the contract or other arrangement wherein the concept of book value has significance must always be sought. Thus, as an example, although generally the element of good will is excluded from a calculation of book value, it will nevertheless be included where it can be clearly demonstrated that such was the intention of the parties. Bernheim v. Duane, 209 Ky. 744, 273 S.W. 458 (1925); Re Lindsay's Estate, 210 Pa. 224, 59 A. 1074 (1904). In this case we determine fair book value, as of the date of plaintiff's expulsion, to mean the value of defendant's assets as set forth in its books at that time, after subtracting liabilities, without reference to then present market value. Parenthetically we note that this was the meaning apparently attributed to these words by the defendant itself in redeeming shares of expelled or retiring members prior to the enactment of the 1962 amendment. Our conclusion is based upon the assumptions-which plaintiff may challenge on remand-that the books have been kept accurately and in accordance with sound and recognized accounting practices. Although nothing in any of the documents before us suggests that fair book value was to be equated in any way with market value, we are the more convinced that such should not be the case here, in view of the fact that defendant is a cooperative venture, created to serve its members rather than to make money. Should a retiring or expelled shareholder be entitled to payment based on market value, it might be impossible to meet such payment without in effect bringing about the dissolution of the corporation. Clearly there was never any such intention.

Although not raised as an issue before us, we deem it advisable to comment upon the problem that will be presented if defendant undertakes liquidation.[171] Several alternatives present themselves. The members (stockholders) of the cooperative may be entitled to a distribution of the proceeds of the assets, after the payment of debts, in accordance with their share holdings. Such a method of liquidation has met with approval elsewhere. Shroeder v. Meridian Improvement Club, 36 Wash.2d 925, 221 P.2d 544 (1950); Avon Gin co. v. Bond, 198 Miss. 197, 22 So.2d 362 (1945) (statute); Packel, Organization and Operation of Cooperatives (4th ed.) 203. At least one court has held that the assets of a particular non-stock cooperative should be distributed by an exercise of the *cy pres* power, as if it were a charitable organization. Attinson v. Consumer-Farmer Milk Coop., 197 Misc. 336, 94 N.Y.S.2d 891 (1950). In an early case in this state it was held, with respect to an unincorporated association, that distribution must be made, not only to those persons who were members at the time of liquidation, but to past members as well, since they had all helped to create the assets to be apportioned. Smith v. Hunterdon County Mutual Fire Insurance Co., 41 N.J.Eq. 473, 4 A. 652 (Ch.1886). We express no view at this time as to how this issue should ultimately be resolved

[171] The record reveals that following plaintiff's expulsion, and at the same meeting of the directors, a resolution to dissolve was formally adopted. Apparently no further action has been taken toward this end.

with respect to this defendant, but liquidation should not take place except with court approval. In proceedings seeking such approval the Commissioner of Labor and Industry should be made a party. We say this because the statute under which defendant has been incorporated required the Commissioner's approval of the original certificate of association, N.J.S.A. 34:17-3, and further provides for the annual submission to him of a rather detailed report. N.J.S.A. 34:17-12. In view of this allocation by the Legislature of the responsibility of supervision, the Commissioner's views would obviously be of great interest to the court.

We deem a remand necessary to insure that justice is afforded the plaintiff. It is true that he had an opportunity to present evidence as to the fair book value of his stock at the original trial, and in fact did so. But the view of the matter entertained by the trial judge necessarily precluded the plaintiff from challenging book value as developed by the defendant or from offering independent proofs looking to a determination of book value in the manner set forth above.

The judgement of the Appellate Division is modified accordingly and the case remanded to the Law Division for further proceedings not inconsistent herewith.

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V. Non-Traditional Financing

The hazard of identifying a particular financing method as “non-traditional” lies in the difficulty of defining “traditional.” Previous material described the basic systems that cooperatives have used for a long period of time, but cooperatives have been creative in arranging their financial affairs to meet members’ needs.

In keeping with the emphasis on policy issues rather than technicalities, this part addresses two aspects of financing that are relatively new in their application and that challenge the concepts of the cooperative character – “new generation” cooperatives and financing that includes equity from non-members. No body of knowledge or literature exists to provide guidance or critical analysis given the limited experience with either concept. Other methods of obtaining capital resources have been tried over the years. Some have been reasonably successful, others were flawed in design from their inception, and still others were a good idea at the time but were discovered to have defects under unanticipated circumstance.

A fairly clearly defective design was inherent in a method several cooperatives tried beginning in the mid-1980s. “Patron demand deposit” financing was based on patron’s investment in the cooperative that had the callable characteristics of a demand deposit. The system had two problems. When these amount provide anything other than a minor portion of a cooperative’s financial needs, the cooperative was at risk of having experiencing a run on its capital. This problem was exacerbated when cooperatives did not carry the capital on its books as callable but rather classified a portion as long-term despite the call provision. The second problem was the appearance of such instruments as being securities and the cooperative being a bank. A description of the system and problems, in this case the accounting firm that approved the classification, is *Reves v. Ernst &*

Young, 494 U.S. 56 (1990).[172] A run on instruments that, while not demand notes as generally understood, contained call provisions that activated after a period of time were the final blow recently forcing the largest cooperative in the United States, Farmland Industries, into bankruptcy.

A. "New Generation" Cooperatives

In the last two decades, a number of cooperatives has been created that combine several principles and practices that respond to significant capital needs for organizations engaging in processing and value-added activities. The term "new generation cooperatives" has been applied to these organizations without assigning particular or uniform attributes to them. The following description is typical, but by not means exclusive, of new generation cooperatives. The innovations of new generation cooperatives on cooperative characteristics are not solely financial. New generation cooperatives are noted here because their financial aspects gain the most attention.

The cooperative creation process begins with a group of farmers who wish to capture the profits of value-added operation that converts their produced commodity into a higher-value product. The needed processing facility is expensive and requires substantial equity investment. It also requires an established and regular amount of commodity throughput to maintain efficiency. To meet both requirements, the incipient cooperative matches the amount of product needed and the amount of equity investment needed.

"Delivery rights" are assigned to equity so that a certain amount of delivery will accompany a certain amount of equity investment. Prospective cooperative members agree to purchase the proportion of equity matching the equity requirement. Not only do delivery rights permit the member to deliver the specified amount of product, the member is required to do so. When that total delivery rights are combined, the efficient product needs are met, and when the total equity investments are combined, the total equity needs are met.

New generation cooperatives also typically require up-front equity investment so that at the initiation of the cooperative it will have sufficient equity capital to build or purchase the plant. Membership is limited because it is directly tied to delivery.

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[172] This odd system and its implications have been discussed in several publications including: Duft, Ken D., "Prospects and Problems of General Ledger Financing by Agricultural Cooperatives," *American Cooperation* (1988) 217-226); Baarda, James R., "Bankruptcy Case Decision: Demand Notes Not Securities," 55 *Farmer Cooperatives* 25 (1989 No. 10); Baarda, James R., "Unusual Co-op Financing Method Causes Problems," 57 *Farmer Cooperatives* 23 (May 1990); Bartsch, Eric A., and Joel L. Dahlgren, "Interest Bearing Patron Credit Balances – A Liability Trap for Everyone," THE COOPERATIVE ACCOUNTANT 45 (Winter 1997); Duft, Ken D., Patron Demand Deposit Account Financing By Cooperatives: Prospects and Pitfalls," THE COOPERATIVE ACCOUNTANT 15 (Summer 1998); Hanson, M.J., R.D. McFall, K.R. Prohaska, and J.R. Thompson, "Cooperative Patron Note Programs," THE COOPERATIVE ACCOUNTANT 3 (Summer 1999); and Duft, Ken D., "Closing Comments on Patron Demand Deposit Financing Agribusiness Cooperatives," THE COOPERATIVE ACCOUNTANT 68 (Spring 2002).

Another typical characteristic of the new generation cooperative is that of tradeable equity. The equity associated with delivery rights may be sold from one producer to another, who purchase the equity and obtains the relevant delivery rights. The rather unique feature of this process is that the value of the equity/delivery rights transferred is a matter of agreement between seller and buyer. Some new generation cooperatives have actively accepted investment by those who are not patrons of the cooperative.

New generation cooperatives are said to be more market oriented than more traditional cooperatives because they establish a specific structure and strict rules based on what the cooperative can profitably market, what the cooperative can produce in response, and bases commodity acceptance on the cooperative's need rather than the general offering of members.

Several conditions exist that make new generation cooperatives attractive. These include:

1. The desire on the part of producers to capture value-added benefits;
2. High capital requirements;
3. Commitment to an efficient processing system;
4. Response to market signals;
5. Product differentiation – from a commodity to a unique product;
6. Failure of an efficient market chain system.

Examples of some new generation cooperatives include:

Ethanol/biomass
Aquaculture
Speciality cheeses
Swine processing
Bison processing
Cattle feedlots
Soybean processing
Corn processing
Goat/sheep processing
Pasta production
Beer manufacture
Cattle processing
Sugar beet processing
Wine production

Several recurring issues are present in a new generation cooperative. Included are:

1. The "selecting-out" problem where all producers except those with investable funds are excluded from participation and benefits;

2. Limits on governance, particularly where the cooperative engages in processing and marketing far beyond the personal capabilities of the members and the board of directors;

3. A producer portfolio problem because the investing producers are investing in the same industry upon which their farming operation depends, eliminating counter cyclical investment portfolios;

4. The various members may have significantly different motivations for participation, especially where the desire for equity appreciation conflicts with a desire for returns from product delivery;

5. Promoter-driven establishment were those wishing to sell the plant, and perhaps operate it for the cooperative, and the driving force and the cooperative is only a tool to reach promoters' goals;

6. Outside equity is sometimes obtained introducing obligations to the equity-holders and a mix of entity objectives; and

7. The "growth-at-any-cost" syndrome has caused problems for some new generation cooperatives as they grew beyond the bounds of the original purposes for which they were formed and became more oriented toward the growth objectives of management rather than the income-producing objectives of producers.

B. Non-member Equity

When a cooperative accepts "outside" equity – equity from someone other than a patron that uses the cooperative – several issues are raised. This phenomenon is currently being addressed in various forums and for a variety of reasons. Three general broad issues are raised.

1. Obligations Imposed

When a cooperative obtains capital, whether debt or equity, it becomes obligated to the contributor of that capital. The obligations are a mix of legal obligations and those based on the nature of business and the capital associated with the business. These obligations are the underlying reason – the primary driving force – for reactions to outside equity based on legal principles and cooperatives.

2. Changing Objectives

The term "objective" encompasses the internal objective functions of the various participants in the cooperative enterprise, including the cooperative entity itself, producer members, producer patrons, former members or patrons, groups of member-patrons, the board of directors, and management. Cooperatives and other entities or groups will modify their actions and policies to reflect responses to each capital type. As examples, if capital is obtained from non-member, non-producers, the cooperative will need to operate in such a way as to generate funds to compensate entities other than cooperative member patrons; cooperatives may adjust costs and returns to increase the value of tradeable equity thus reducing payout to producers; cooperatives may increase risks because losses can be allocated at least in part to non-member investors; cooperatives may change their planning horizons based on the demands of equity holders; or cooperative leadership may begin to focus on returns to equity-holders, whether members or not, rather than on returns to producer users. In general, every organization is driven by its objectives, and a change in objectives at any level is a fundamental change in the organization itself.

3. Governance

Governance issues are of three general types.

The first and overall issue is *who* controls the cooperative. One rather obvious example of this issue is a cooperative's obligation to the entities that provide capital and the decisions that those entities may impose on the cooperative. The legal rights of equity-holders of various kinds to take a direct part in cooperative governance, either on specific issues or on more general issues, is a key consideration in assessing the impact of financing methods on cooperative principles related to ownership and control.

The second issue is *what* controls the cooperative. The "traditional" cooperative has only one central objective – to provide the greatest returns to its patrons. This is often achieved by focusing primarily on favorable pricing or generating patronage refunds while the member-patrons' investment in the cooperative is regarded only as a means to an end without an independent return-to-equity objective. Other forces may begin to control the cooperative with new types of capital, obligations, and objectives, forces related to returns to capital, capital value and marketability, and the interests of outside investors with no connection to the returns generated from use of the cooperative. These forces, too, may be considered contrary to the fundamental principle of returns of margins to users in proportion to use.

The third cooperative governance issue is that of the internal *balance of authority and control*. Examples include: Does management have more independent power and an independent objective if capital is "permanent" or if capital is obtained from non-member, non-patrons? Are members' interests set in opposition to the interest of the cooperative and how are those interests represented in the cooperative's governance system? What is the position of members or former members who have equity in the cooperative but no effective way to counter forces that focus on current returns? Are some groups of members advantaged or disadvantaged, or do groups of members have divergent interests in the cooperative as a result of changing financial systems? In general, an already complicated internal dynamic may be further destabilized by the addition of new objectives and new participants in the cooperative enterprise.