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Eighth Circuit rules cooperative equities held by inactive members are not "securities"

In a long-awaited decision, the Eighth Circuit has ruled that certain equities known as "capital credits" held by inactive members of Farmland Industries, Inc., North America's largest farmer cooperative, as the result of the conversion of the members' common stock in Farmland, the exchange of equity from one entity to another, or as patronage refunds, are not "securities" within the meaning of the 1933 Securities Act and the 1934 Securities Exchange Act. *Great Rivers Coop. of Southeastern Iowa v. Farmland Industries, Inc.*, No. 98-2527, 98-2528, 1999 WL 1191459 (8th Cir. Dec. 16, 1999). The issue resolved by this ruling was the subject of a presentation by the plaintiffs' counsel at the AALA Twentieth Annual Meeting and Educational Symposium held in New Orleans last fall. *See* Frank A. Taylor & Patrick A. Reinken, *Are Financial Instruments Issued by Agricultural Cooperatives Securities?: A Framework of Analysis*, 1999 AALA Conference Materials at F-3-1. The action, which was brought as a class action by two cooperatives and an individual farmer, also has been the subject of two earlier Eighth Circuit decisions. *Great Rivers Coop. of Southeastern Iowa v. Farmland Industries, Inc.*, 59 F.3d 764 (8th Cir. 1995)(reversing a district court order that, among other requirements, barred Farmland from communicating to potential class members anything that could reasonably be taken as an invitation to opt out of the class); *Great Rivers Coop. of Southeastern Iowa v. Farmland Industries, Inc.*, 120 F.3d 893 (8th Cir. 1997)(holding that an article in Farmland's newsletter regarding a similar securities fraud claim put the sole named class representative on "inquiry notice" of misrepresentations for statute of limitations purposes). Farmland capital credits also were the subject of securities fraud litigation in Colorado, where they were held to be a "security." *Consumers Gas & Oil, Inc. v. Farmland Industries, Inc.*, 815 F. Supp. 1403, 1410 (D. Colo. 1992). *See also Consumers Gas & Oil, Inc. v. Farmland Industries, Inc.*, 840 F. Supp. 794 (D. Colo. 1993)(order approving settlement).

Farmland limits its membership to agricultural producers and associations of such producers who hold a minimum of $1,000 in par value of its common stock. For purposes of patronage refunds, it enters into patronage agreements with its members and with nonmember patrons (associate members) who qualify for membership in all respects except for holding the minimum equity investment.

Prior to 1980, Farmland had only two classes of member equity: common stock and associate member common stock. In distributing its net earnings, Farmland first allocated a portion of its earnings to the payment of dividends on outstanding preferred stock. Any amounts attributable to nonmember patronage or nonpatronage transactions were set aside in a surplus account. The remaining sums were distributed to its members and associate members in proportion to their respective patronage. At the discretion of the board of directors, patronage refunds were made partially in cash and partially in common stock or associate member common stock. Members received common stock; associate members received associate member common stock.

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San Joaquin Agricultural Law Review bibliography

The San Joaquin College of Law, Fresno, California, has published the San Joaquin Agricultural Law Review every year since 1991. The compiler of this Agricultural Bibliography indexed Volume 1 of the San Joaquin Agricultural Law Review into the bibliography in the regular course of compiling it. The compiler also added Volume 9 of the Review into the bibliography in the regular course. While adding Volume 9 to the bibliography, the compiler discovered that he had unintentionally failed to index Volumes 2 through 8 of the San Joaquin Agricultural Law Review into the bibliography.

Below please find the appropriate bibliographic information on Volumes 2 through 8 of the San Joaquin Agricultural Law Review. I apologize to the authors of the indexed scholarship and the readers of this bibliography for the oversight.

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IN FUTURE ISSUES

• Status of regional dairy compacts

In 1980, Farmland created a new type of non-voting, non-interest-bearing equity known as "capital credits." This class of equity was created to avoid having to redeem in cash the common stock held by entities that had ceased doing business on a cooperative basis or had misrepresented to Farmland that they were cooperatives. The common stock held by such entities could be converted to capital credits, with the decision whether to redeem these capital credits being vested in the discretion of the board of directors. Farmland also amended its articles of incorporation to give the board the option of either redeeming or converting into capital credits the common stock or associate member common stock of any person or entity that was no longer qualified to hold either category of stock.

In 1982, Farmland issued the first capital credits, known as Type 5 capital credits, to several dissolved or liquidated cooperatives in exchange for their Farmland common stock. Holders of some of the Type 5 capital credits later brought a securities fraud class action against Farmland after Farmland failed to redeem them. *See Consumers Gas & Oil, Inc. v. Farmland Industries, Inc.*, 815 F. Supp. 1403 (D. Colo. 1992). In 1983, capital credits denominated as Type 4 capital credits were issued to other local cooperatives. By agreement, these credits were redeemable only upon the dissolution of Farmland.

In 1990, Farmland again amended its articles to permit the transfer of capital credits with the consent of the board. Farmland then issued a new series of capital credits known as Type 12 capital credits. The common stock of cooperatives or producers who had ceased doing business with Farmland but had not dissolved could be converted to Type 12 capital credits. Such a conversion was intended to foreclose the possibility that members would become inactive solely to have their common stock redeemed and then be free to resume doing business with Farmland.

Farmland also used Type 12 capital credits to purchase the outstanding equity of its wholly owned subsidiary, Foods. In 1991, the named individual plaintiff in the litigation received Type 12 capital credits in exchange for his equity in Foods. In making the exchange, he relied on certain representations made by Farmland, including that within one or two years he would be able to recoup the equity represented by the capital credits either through their redemption or their sale in a secondary market to be created by Farmland.

Also in 1991, the two named cooperative plaintiffs in the litigation, each of which had become inactive in Farmland, received Type 12 capital credits through the conversion of their common stock into capital credits. Each cooperative had received the common stock as patronage refunds in the years in which they had actively patronized Farmland. The capital credits received by one of these cooperatives also included capital credits that were exchanged for stock the cooperative held in a cooperative whose assets had been acquired by Farmland.

At the time that the named cooperative plaintiffs received the capital credits, Farmland had registered them with the SEC in connection with its plan to operate an information system that would assist holders of Farmland equities to transfer them to other eligible persons. In its submissions to the SEC, Farmland stated that the redemption of common stock and associate member common stock would receive priority over the redemption of capital credits.

During the years from 1991 through 1995, no secondary market in capital credits developed, and Farmland adopted various equity redemption plans. The redemption of capital credits, however, remained discretionary with the board, and their redemption had a lower priority than the redemption of common stock and associate member common stock. Nonetheless, some capital credits were redeemed.

In their multiple count action against Farmland, the plaintiffs contended that Farmland never intended to redeem their capital credits. They also maintained that Farmland had an obligation to redeem them when it was financially able to do so, and cooperative principles obligated Farmland to redeem the capital credits of inactive or dissolved members.

The plaintiffs' securities fraud claim was premised on the contentions that the capital credits were securities either under the "family resemblance" test set forth in *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990), or the investment contracts test established in *SEC v. W.J. Howey Co.*, 328 U.S. 293, 288-99 (1946). The Eighth Circuit disagreed.

The meaning of the term "security" is discussed in the In Depth article in this issue. Summarizing the court's reasoning, the court observed that the capital credits at issue were received by the members of the plaintiff class as a result of the conversion of their common stock in Farmland, the exchange of equity from one entity to another, or as patronage refunds. The capital credits, therefore, represented equity in Farmland that was initially obtained as an incident of membership in Farmland. They were not offered for sale by Farmland to its members or the general public. They were transferable only with Farmland's consent and had no secondary market. They neither bore interest nor appreciated, nor could they be readily converted to cash. Their only value resided in their future redemption by Farmland, at its board's discretion, at their face amount. They did not, therefore, represent an investment of money in the traditional sense; that is, the investment of capital with the reasonable expectation of a return on that investment. Instead, the capital credits represented the equity remaining in Farmland by persons who had earlier patronized Farmland to gain the benefits of that patronage. In economic substance the capital credits were not securities but were "patronage refunds or equity interests reflecting membership or former membership in [Farmland] and/or commercial transactions conducted with Farmland or an entity Farmland now owns." *Great River Coop. of Southeastern Iowa v. Farmland, Inc.*, 1999 WL 1191459 at *15.

The Eighth Circuit also rejected the plaintiffs' breach of fiduciary duty claims essentially on the grounds that the redemption of the capital credits was discretionary with Farmland's board of directors, and the plaintiffs had not presented sufficient evidence of director self-interest, fraud, or abuse of discretion to overcome the business judgment rule. Finally, it rejected plaintiffs' claims of unjust enrichment essentially because to do otherwise would amount to the court substituting its own equity redemption plan for the plan adopted by Farmland's board and thereby "eviscerating the discretion specifically placed with the board of directors." *Id.* at *20.

—Christopher R. Kelley, Assistant Professor of Law, University of Arkansas, Of Counsel, Vann Law Firm, Camilla, GA

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AALA Editor..........................Linda Grim McCormick
Rt. 2, Box 292A, 2816 C.R. 163
Alvin, TX 77511
Phone: (281) 388-0155
FAX: (281) 388-0155
E-mail: lgmccormick@teacher.esc4.com
American Agricultural Law Association website: http://www.aglaw-assn.org

Contributing Editors: Christopher R. Kelley, University of Arkansas; Drew Kershen, University of Oklahoma.
For AALA membership information, contact William P. Babione, Office of the Executive Director, Robert A. Leflar Law Center, University of Arkansas, Fayetteville, AR 72701.

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— *Drew L. Kershen, Professor of Law, The University of Oklahoma, Norman, OK*

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Cooperative stock and the federal securities acts: defining a "security"

By Christopher R. Kelley

The recent decision in *Great Rivers Coop. of Southeastern Iowa v. Farmland Industries*, Nos. 98-2527, 98-2528, 1999 WL 1191459 (8th Cir. Dec. 16, 1999), presented the issue of whether "capital credits" issued by Farmland were "securities" under the federal securities laws. The court's decision is discussed on page 1 of this issue of the *Agricultural Law Update*. This article discusses the federal securities law definition of a "security" in the context of farmer cooperatives.

The Securities Act of 1933[1] and the Securities Exchange Act of 1934[2] are the principal federal securities laws. Broadly distinguished, the 1933 Act regulates the initial sale of securities, and the 1934 Act regulates the public trading of securities on the national security exchanges and over-the-counter trading. Both statutes share the general purposes of requiring disclosure to investors of material information concerning public offerings of securities and preventing misrepresentation, deceit, and other fraud in securities sales.

As discussed below, farmer cooperatives have issued "securities," though not all of cooperative's equity instruments are likely to be "securities." The issuance of a security has at least two consequences. First, unless either the security or the transaction through which it is issued is exempted from registration, the security must be registered before it is sold.[3] Second, even if an exemption from registration applies, the offer and sale of the security is subject to the antifraud provisions of the Securities Act.[4]

Both Acts broadly define the term "security,"[5] and both definitions are nearly identical.[6] A "security" under these definitions includes, "unless the context otherwise requires,"[7] a variety of instruments or transactions. To name but a few, they include any note, stock, bond, debenture, investment contract, and "any interest or instrument commonly known as a 'security.'"[8] The terms used in the definition of a "security" are not defined, however, so this task has been assumed by the courts and the SEC.

In *United Housing Foundation, Inc. v. Forman*[9] the United States Supreme Court rejected the notion that any instrument called "stock" must be considered a security simply because the Security Act of 1933 defines "security" to include "any ... stock."[10] Instead, the Court adhered to what it characterized as "the basic principle that has guided all of the Court's decisions in this area."[11] Specifically, "'[i]n searching for the meaning and scope of the word 'security' in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality.'"[12]

At issue in *Forman* was whether stock issued by a nonprofit housing cooperative was a "security" within the meaning of the 1933 and 1934 Securities Acts. The cooperative, the Riverbay Corporation, operated a large housing project in New York City known as Co-op City that had been built with state subsidies under a program designed to promote the availability of housing for persons with low incomes.[13]

Christopher R. Kelley is Assistant Professor of Law, University of Arkansas and is Of Counsel to the Vann Law Firm, Camilla, GA.

To lease an apartment in Co-op City, a prospective tenant had to buy eighteen shares in Riverbay for each room desired. The purpose of this requirement and the attributes of the stock were summarized by the Court as follows:

> The sole purpose of acquiring these shares is to enable the purchaser to occupy an apartment in Co-op City; in effect, their purchase is a recoverable deposit on an apartment. The shares are explicitly tied to the apartment: they cannot be transferred to a nontenant; nor can they be pledged or encumbered; and they descend, along with the apartment, only to a surviving spouse. No voting rights attach to the shares as such: participation in the affairs of the cooperative appertains to the apartment, with the residents of each apartment being entitled to one vote irrespective of the number of shares owned.
>
> Any tenant who wants to terminate his occupancy, or who is forced to move out, must offer his stock to Riverbay at its initial selling price of $25 per share. In the extremely unlikely event that Riverbay declines to repurchase the stock, the tenant cannot sell it for more than the initial purchase price plus a fraction of the portion of the mortgage that he has paid off, and then only to a prospective tenant satisfying the statutory income eligibility requirements.[14]

As to the cooperative, Riverbay, the Court noted its "nonprofit" nature, a point also made in information distributed to prospective purchasers of the stock. If the rental payments exceeded expenses, the difference would be returned to the tenants as a rebate. It would not be invested by the cooperative for profit.[15]

The Court held that the stock was not a "security" under the 1933 and 1934 Acts, even though both statutes define a "security" to include "stock." It reached this conclusion by first noting the absence of any contention that the tenants had been, or could be, misled into believing that federal securities law governed the sale of the stock simply because the stock was called "stock." "Common sense," the Court observed, "suggests that people who intend only a residential apartment in a state-subsidized cooperative, for their personal use, are not likely to believe that in reality they are purchasing investment securities simply because the transaction is evidenced by something called a share of stock."[16]

The Court then proceeded to distinguish the stock at issue from the ordinary concept of a security. It noted that the stock lacked "the most common feature of stock: the right to receive 'dividends contingent on an apportionment of profits.'"[17] To that distinction, the Court added that the shares of stock did not possess the other characteristics traditionally associated with stock: they are not negotiable; they cannot be pledged or hypothecated; they confer no voting rights in proportion to the number of shares owned; and they cannot appreciate in value. In short, the inducement to purchase was solely to acquire subsidized low-cost living space; it was not to invest for profit.[18]

Having reached the conclusion that the stock, as such, was not a security within the ordinary concept of that term, the Court addressed the question of whether the stock was an "investment contract" within the meaning of the 1933 and 1934 Acts. It prefaced its analysis by observing that, in its view, there was "no distinction, for present purposes, between an 'investment contract' and an 'instrument commonly known as a 'security'"[19] Drawing upon its decision in *SEC v. W.J. Howey Co.,*[20] the Court stated that both are distinguished from other commercial transactions by the basic test of "'whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.'"[21] This test, according to the Court, "embodies the essential attributes that run through all of the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."[22]

The Court then observed that in the cases where it had concluded that the instrument at issue was a security, the investor "was 'attracted solely by the prospects of a return' on his investment."[23] It contrasted this motivation for acquiring an instrument with one where the motivation and the instrument are linked to the right to use or consume something: "[W]hen a purchaser is motivated by a desire to use or consume the item purchased – 'to occupy the land or to develop it themselves,' as the *Howey* Court put it, ... – the securities laws do not apply."[24]

The Court concluded that the stock issued by Riverbay was not an investment contract because its acquisition was motivated by a desire for housing, not for a return on an investment.[25] It also noted that Riverbay operated on a nonprofit basis by returning any rental payments in excess of its costs to the tenants as rebates. It did not invest that excess for profit. Moreover, tenants could not sell their stock at a profit because it had to be first offered back to Riverbay at its purchase price.[26]

The Court bolstered its conclusion that the stock was not an investment contract by "summarily" disposing of "supposed sources of income or profits" that had been relied on by the court below.[27] It disposed of the gain represented by income tax deduction that stockholder-tenants received for the portion of the monthly rental charge applied to interest on the mortgage by stating that "[w]e know of no basis in law for the view that the payment of interest, with its consequent deductibility for tax purposes, constitutes income or profits."[28] The Court added that even if they were profits, "they would not be the type associated with a security investment since they do not result from the managerial efforts of others."[29] The Court also found that the subsidized rent that was an incident of tenancy in Co-op City was not profits. The subsidies provided by the state, the Court noted, neither could be liquidated into cash nor did they result from the managerial efforts of others.[30] In addition, the Court disagreed with the lower court that the possibility of profits from cooperative's leasing of commercial facilities, offices, and parking areas and its operation of washing machines was enough to make the stock an investment contract. In the Court's view, these "stores and services ... were established not as a means of returning profits to tenants, but for the purpose of making essential services available for the residents of this enormous complex."[31]

Conceding that the "purchasers in this housing

cooperative sought to obtain a decent home at an attractive price," the Court found that this "type of economic interest characterizes every form of commercial dealing."[32] It added, in summation, "[w]hat distinguishes a security transaction – and what is absent here – is an investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a commodity for personal consumption or living quarters for personal use."[33]

The *Forman* Court's reliance on its decision in *Howey* reflects that fact that much of the litigation over the scope of the definition of a "security" has involved the meaning of the term "investment contract." As a result, this term has become "a paradigm of the Securities Act's inclusiveness."[34]

In *Howey* the respondents were two Florida corporations under common control and management. One corporation owned large tracts of citrus trees. It produced fruit on about one-half of its land and offered the remaining land to the public through land sales contracts. The sales were made by warranty deed. The tracts sold were usually narrow strips of land so that an acre consisted of a row of forty-eight trees.[35]

Purchasers of these tracts were told that their investment in their grove was not feasible without a service contract. Most of the purchasers of these holdings chose to have their citrus groves serviced by the other corporate respondent, though they were free to use other providers.[36]

The respondent's service contracts were for ten-year terms and granted the respondent a leasehold interest conveying full possession of the tract. For the service fee, plus the costs of labor and materials, the respondent exercised complete control over the production, harvesting, and marketing of the citrus. The net sales receipts were returned to the respective tract owners after all of the fruit from the various tracts had been pooled and sold in the respondents' names.[37]

Most of those who purchased the tracts and a service contract were neither Florida residents nor knowledgeable about citrus production and marketing. Based at least in part on respondents' representations, they were attracted by the expectation of substantial profits.[38]

The issue before the Court was whether the sales contract, the warranty deed, and the service contract together constituted an "investment contract" as that term is used in the definition of "security" in the Securities Act of 1933. [39] Holding that they did, the Court disregarded the form of the transactions in favor of their economic realities. It ruled that "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise."[40] This definition, according to the Court, "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[41]

In concluding that the series of transactions before it collectively constituted an investment contract, the Court noted that the investors were not knowledgeable about citrus production; they did not intend to occupy the land or develop it themselves; the size of the tracts sold was too small to be economically cultivated and developed independent of each other; and, therefore, a common enterprise managed by the respondents or other third parties was essential if the investors were to realize their goal of a return on their investment.[42] As to the instruments used, the Court found that the land sales contracts and warranty deeds evidenced the investors' respective shares in the enterprise and "served as convenient method of determining the investors' allocable shares of the profits."[43] The resulting transfer of the land, according to the Court, was "purely incidental."[44]

Notwithstanding the *Howey* Court's definition of an investment contract as a scheme involving the investment of money in a common enterprise with profits coming *solely* from the efforts of others, lower courts have found transactions to be investment contracts where the profit was not derived solely from the efforts of others. For example, in *SEC v. Glenn W. Turner Enterprises, Co.*[45] the Ninth Circuit held that certain arrangements sold under a pyramid scheme were investment contracts even though some of the profits came from the efforts of purchasers of these plans to find additional purchasers. It ruled that the term "solely" should not serve to limit the definition of an investment contract; otherwise, the federal securities laws could be evaded by a scheme that required "the buyer [to] contribute a modicum of effort" to the success of the enterprise.[46] The Ninth Circuit, therefore, reframed the test for an investment contract in this regard to require an inquiry into "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[47] This test was subsequently followed by the Fifth Circuit.[48]

Other than *Forman*, the only Court decision to address an instrument issued by a cooperative is *Reves v. Ernst & Young*.[49] In *Reves,* a farmers' cooperative with 23,000 members sold promissory notes payable on demand by the holder. The notes were sold to raise money to support the cooperative's general business operations. The notes were uncollateralized and uninsured, but they paid a variable rate of interest that was adjusted monthly to keep its rate higher than the rate paid by local financial institutions. The notes were offered to members and nonmembers. The cooperative advertised that the notes were safe and secure and that the cooperative "stood behind" them with its $11 million in assets.[50]

After the cooperative filed for bankruptcy with over 1,600 people holding notes with a total of $10 million, a class of holder of the notes filed suit against the accounting firm that had audited the cooperative's financial statements alleging that it had violated the antifraud provisions of the 1934 Act. The Court, therefore, was presented with the issue of whether the notes were securities.[51]

While the definition of the term "security" in the 1934 Act includes "any note," as does the same definition in the 1933 Act, it excludes "any note... which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."[52] The same exclusion is found in the 1933 Act, though it is not in the definition of the term "security" but in separate exemptive section.[53]

The Court began its analysis by opining that "any note," as such, was not "obviously within the class [of instruments] Congress intended to regulate because they are by their nature investments."[54] It distinguished a "note" from "stock" that bears the traditional characteristics of stock in the sense that the latter is the "quintessence of a security" while "the same cannot be said of notes, which are used in a variety of settings, not all of which involve investments."[55] "Thus, the phrase 'any note' should not be interpreted to mean literally 'any note,' but must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts."[56]

Having rejected a literal approach for determining whether a note is a security, the Court also declined to follow lower court decisions that had used either the "investment versus commercial" or an "investment contract" analysis to make that determination.[57] Instead, the Court settled on the "family resemblance" test.

The "family resemblance" test originated with the Second Circuit's decision in *Exchange Nat. Bank of Chicago v. Touche Ross & Co.*[58] In that decision, the court crafted a list of notes that were obviously not securities. Starting from the rebuttable presumption that "any note" was a security, an issuer could rebut that presumption by showing that the note in question bore a "'strong family resemblance'" to an item on the list or convincing the court that a new item should be added to the list.[59]

For its part, the Court agreed with the items on the Second Circuit's list,[60] but it perceived the need for standards for determining when an item should be added. Therefore, under the Court's reformulation of the test, the "family resemblance" test begins with rebuttable presumption that every note is a security. From there it precedes to a consideration of four factors:

> First we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." ... Second, we examine the "plan of distribution" of the instrument ... to determine whether it is an instrument in which there is "common trading for speculation or investment".... Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction.... Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.[61]

The Court concluded its listing of these factors with the following instruction:

> A note is presumed to be a "security," and that presumption may be rebutted only by a showing that the note bears a strong resemblance (in terms of the four factors we have identified) to one of

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the enumerated categories of instrument. If an instrument is not sufficiently similar to an item on the list, the decision whether another category should be added is to be made by examining the same factors.[62]

Applying the "family resemblance" test to the notes at issue, the Court held that the notes were "securities." It concluded that they neither bore a strong resemblance to any of the notes that were not securities listed by the Second Circuit nor did an examination of the four factors lead to the conclusion they were not securities.

As to the first factor, the motivations of the buyers and the seller, the notes were sold to raise capital for the cooperative's general business operations. They were purchased by persons seeking a profit from their interest rate, which was higher than the rate offered by other local financial institutions. "From both sides, then, the transaction is most naturally conceived as an investment in a business enterprise rather than as a purely commercial or consumer transaction."[63]

The Court also found that "plan of distribution" for the notes satisfied the "requisite 'common trading' in the instrument."[64] Over an extended period, the cooperative had offered the notes to its 23,000 members and to nonmembers, and more than1,600 persons held the notes when the cooperative filed for bankruptcy.[65]

As to the "public's reasonable perceptions," which constitutes the third factor, the Court noted that it had "consistently identified the fundamental essence of a 'security' to be its character as an 'investment.'"[66] Here, the advertisements for the notes called them "'investments,'" and, according to the Court, "there were no countervailing factors that would have led a reasonable person to question this characterization."[67]

Finally, the Court found "no risk-reducing factor to suggest that these instruments are not in fact securities."[68] The notes were uncollateralized and uninsured and, the Court observed, they "would escape regulation entirely if the [Securities] Acts were held not to apply."[69]

With respect to farmer cooperatives, *Forman* is generally regarded as supporting the proposition that a farmer cooperative's membership stock is not a "security," at least if the stock has the attributes possessed by the housing cooperative stock at issue in that decision. For example, in *B. Rosenberg & Sons, Inc. v. St. James Sugar Cooperative, Inc.*[70] the issue was whether a share of common stock in a sugar cooperative was a security. Each member of the cooperative was required to purchase one share of common stock. The stock was not negotiable, bore no dividends, and entitled its holder to one vote in the affairs of the cooperative.[71]

The court held that the stock was not a security, relying in part on *Forman*:

> The stock certificate here denotes nothing more than membership in the cooperative. It has none of the characteristics associated with the concept of a security. It is nonnegotiable, bears no dividends, can only be owned by a member and can only be transferred with approval of the board of directors.[72]

The court also found that the stock was not an "investment contract." In that context, it ruled that "[e]quity credits or patronage dividends are not profits similar to income from ordinary stock investments but are rebates or refunds to members based solely on patronage and not on the amount of money invested in the stock."[73] Moreover, according to the court,

> [i]t is readily apparent that local sugar cane farmers purchasing shares of stock in the defendant cooperative did not believe that they were purchasing investment securities. The inducement to purchase was membership in an association that would provide the sugar cane farmer with services he might not otherwise obtain[;] that is, the assurance of a place to process and market the fruits of his labor. The cooperative member did not participate for the purpose of obtaining profits from investment securities.[74]

The SEC has also followed *Forman* in its no-action letters with respect to cooperatives generally. The no-action letter process allows counsel for a company that is contemplating taking some security-related action to request that no SEC enforcement proceeding be brought against the company if it proceeds with its contemplated action. No-action letters are conditional, affirmative responses by the SEC staff to such requests. While a no-action letter does not bind the Commission with respect to future enforcement proceedings, it essentially represents the SEC staff's approval of the company's contemplated action.[75]

SEC no-action letters have indicated that a cooperative's membership stock is not a security if the stock is not freely transferable; no capital appreciation can be realized on the stock's redemption or sale; and the stock does not bear interest or dividends.[76] In addition to issuing no-action letters with respect to membership stock with these attributes, the SEC has issued no-action letters with respect to other methods of raising capital from members, including "annual dues payments, no-interest debentures, refundable and non-refundable initiation fees, reserve contributions, and various revolving fund equities."[77]

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[1] 15 U.S.C. §§ 77a-77aa.

[2] *Id.* §§ 78a-78jj.

[3] *Id.* § 77f.

[4] *See generally* John E. Noakes, *Agricultural Cooperative Securities in* 14 Neil E. Harl, Agricultural Law § 136.02[4] (1996) [hereinafter Noakes]; Kathleen M. Graber et al., *Securities Fraud*, 30 Am. Crim. L. Rev. 909 (1993).

[5] 15 U.S.C. §§ 77h(1) (Securities Act of 1933), 78(a)(10) (Securities Exchange Act of 1934).

[6] *See Reves v. Ernst & Young*, 494 U.S. 56, 61 n.1 (1990).

[7] 15 U.S.C. §§ 77h, 78(a). For an extended discussion of the meaning of this phrase, which precedes all of the definitions in both Acts, see Lewis D. Lowenfels & Alan R. Bromberg, *What Is a Security Under the Federal Securities Laws?* 56 Alb. L. Rev. 473, 483-89 (1993).

[8] 15 U.S.C. §§ 77h(1), 78(a)(10).

[9] 421 U.S. 837 (1975).

[10] *Id.* at 848.

[11] *Id.*

[12] *Id.* (quoting *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)). Although the Court ruled that the name given to an instrument is not dispositive of whether the instrument is a "security," it also indicated that the name is not wholly irrelevant. In this regard, the Court observed that "[t]here may be occasions when the use of a traditional name such as 'stocks' or 'bonds' will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument." *Id.* at 850-51.

[13] *Id.* at 840-41.

[14] *Id.* at 842-43.

[15] *Id.* at 854.

[16] *Id.* at 851. In *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 (1985), the Court described the characteristics traditionally associated with common stock as follows: "(i) the right to received dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value." *Accord Gould v. Ruefenacht*, 471 U.S. 701, 704-06 (1985)

[17] 421 U.S. at 851 (quoting *Tcherepnin v. Knight*, 389 U.S. 332, 339 (1967)).

[18] *Id.*

[19] *Id.* at 852.

[20] 328 U.S. 293 (1946).

[21] *Forman*, 421 U.S. at 852 (quoting *Howey*, 328 U.S. at 301).

[22] *Id.*

[23] *Id.* (quoting *Howey*, 328 U.S. at 300).

[24] *Id.* (citations and footnote omitted).

[25] *Id.* at 853, 859.

[26] *Id.* at 854.

[27] *Id.* at 855.

[28] *Id.* (footnote omitted)

[29] *Id.* n. 20

[30] *Id.* at 855.

[31] *Id.* at 857 (footnote omitted).

[32] *Id.* at 858.

[33] *Id.* (footnote omitted).

[34] Larry D. Soderquist & Theresa A. Gabaldon, Securities Regulation 128 (4th ed. 1999).

[35] 328 U.S. at 294-95

[36] *Id.* at 295.

[37] *Id.* at 296.

[38] *Id.*

[39] *Id.* at 297.

[40] *Id.* at 288-99.

[41] *Id.* at 299.

[42] *Id.*

[43] *Id.*

[44] *Id.*

[45] 474 F.2d 476 (9th Cir. 1973).

[46] *Id.* at 482.

[47] *Id.*

[48] *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 479-81 (5th Cir. 1974). *See generally* Kyle M. Globerman, *The Elusive and Changing Definition of a Security: One Test Fits All*, 51 Fla. L. Rev. 271, 286-88 (1999) (discussing the "common enterprise" test of *Howey*).

[49] 494 U.S. 56 (1990).

[50] *Id.* at 58-59.

[51] *Id.* at 59.

[52] 15 U.S.C. § 78c(a)(10).

[53] *Id.* § 77c(a)(3).

[54] 494 U.S. at 62 (citation omitted).

[55] *Id.* (citation omitted).

[56] *Id.* at 62-63.

[57] *Id.* at 63-64.

[58] 544 F.2d 1126 (2d Cir. 1976).

[59] 494 U.S. at 64 (quoting *Exchange Nat. Bank*, 544 F.2d at 1137-38).

[60] As listed by the Court, the types of notes that are not "securities" include, among others, "'the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer. . . .'" *Id.* at 65 (quoting *Exchange Nat. Bank*, 544 F.2d at 1138).

[61] *Id.* at 66-67 (citations omitted).

[62] *Id.* at 67.

[63] *Id.* at 67-68.

[64] *Id.* at 68 (citation omitted).

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[65] *Id.*

[66] *Id.* at 68-69 (citation omitted).

[67] *Id.* at 69.

[68] *Id.*

[69] *Id.* The Court also rejected the contention that the notes were excluded from the definition of a "security" because they had a maturity of nine months or less at the time they were issued. *Id.* at 70-73. Among other reasons for rejecting this contention, the Court found that "demand notes do not necessarily have short terms," and it observed that "[i]f it is plausible to regard a demand not as having an immediate maturity because demand could be made immediately, it is also plausible to regard the maturity of a demand note as being in excess of nine months because demand could be made many years or decades into the future." *Id.* at 72-73.

[70] 147 F. Supp. 1 (E.D. La. 1976), *aff'd*, 565 F.2d 1213 (5th Cir. 1977).

[71] *Id.* at 3.

[72] *Id.*

[73] *Id.* at 4.

[74] *Id.*

[75] *See* Noakes, *supra* note 4, at § 136.01[3][a].

[76] *See* Steve F. Brault, *Equity Financing of Cooperatives: Advantageous Federal Securities Law and Tax Treatment*, 21 Willamette L. Rev. 225, 243-44 (1985) [hereinafter Brault] (citations omitted) (also noting that the SEC may require that only members can own shares); *see also* Kathryn J. Sedo, *The Application of Securities Laws To Cooperatives: A Call for Equal Treatment of Nonagricultural Cooperatives*, 46 Drake L. Rev. 259, 278 (1997)(noting that "SEC has consistently issued no-action letters when the stock of a cooperative evidences membership, is not transferable, pays no dividends, and cannot appreciate in value" (footnote omitted)); Lewis D. Solomon & Melissa B. Kirgis, *Business Cooperatives: A Primer*, 6 DePaul Bus. L. J. 233, 253 (1994) (noting that "[w]hen cooperatives offer their members the possibility of capital appreciation and dividends, the Commission has viewed them as securities" (footnote omitted).

[77] Brault, *supra* note 76, at 244 (footnotes omitted). For a discussion of the issue of whether retained equities are securities, see Terence J. Centner, *Retained Equities of Agricultural Cooperatives and the Federal Securities Acts*, 31 U. Kan. L. Rev. 245 (1982).

[78] Brault, *supra* note 76, at 245.

[79] *Id.* at 245, 248-49.

[80] *Id.* at 249.

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