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**Farmer Cooperative Equity Conflicts:
Judicial Decisions in the 1980s**

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FARMER COOPERATIVE EQUITY CONFLICTS: JUDICIAL DECISIONS IN THE 1980s

*James R. Baarda**

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. In-depth 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.¹ 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

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1. 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).

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 with 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.² 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 years to replace old equity with new,³ 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.⁴

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 in some cooperatives may be acquired by direct purchase either to

2. Referred to as "per unit capital retain."

3. Referred to as the "revolving period."

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

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 per 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*⁵ 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*.⁶ In both cases circumstances surrounding direct purchase determined the parties' redemption rights.⁷ No membership or 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*⁸ and *Williams*⁹ 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.¹⁰ *In re Stinson*¹¹ clearly defined the distinction. A bank-

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

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

7. See "Contract and Prior Conduct" *infra* text accompanying note 84 for discussion of the courts' decisions.

8. *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).

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

10. See *Southeastern Colo. Coop. v. Ebright*, 563 P.2d 30 (Colo. Ct. App. 1977).

11. *In re Stinson*, 59 Bankr. 914 (Bankr. W.D. N.Y. 1986).

rupt dairy farmer possessed "letters of advice"¹² issued by a cooperative. The letters of advice represented funds retained by the cooperative as patron equity. Applicable law¹³ 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."¹⁴ 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.

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.¹⁵ All three were the subject of litigation in the recent cases analyzed.

Membership certificates or stock were the relevant instruments in only one case.¹⁶ 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.¹⁷ The majority of recent cases dealt with patronage related equity interests. Twelve cases

12. "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 thereof, if any, which constitutes a patronage dividend.

I.R.C. § 1388(b) (1986).

13. N.Y. C.P.L.R. § 5205(f) (McKinney 1977).

14. 59 Bankr. 914, 916 (Bankr. W.D. N.Y. 1986).

15. 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).

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

17. *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).

involved equity formed in retained patronage refund systems.¹⁸ 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.¹⁹

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*²⁰ describes a situation in which a bankrupt dairy farmer's "letters of advice" in a 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.²¹

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.²²

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 implica-

18. *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).

19. *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).

20. *In re Stinson*, 59 Bankr. 914 (Bankr. W.D. N.Y. 1986).

21. See *supra* text accompanying note 12.

22. See "Setoff" *infra* text accompanying note 119.

tions 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.²³ 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 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.²⁴

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.²⁵ In four decisions the bankruptcy of a cooperative, itself a member of another cooperative, led to litigation.²⁶

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.²⁷ Courts assess-

23. *Milton v. Aransas Shrimp Coop.*, 668 S.W.2d 735 (Tex. Ct. App. 1983).

24. See "Role of Statutes" *infra* text accompanying note 31.

25. *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 Schauer*, 835 F.2d 1222 (8th Cir. 1987); *In re Schifflett*, 40 Bankr. 493 (Bankr. S.D. Va. 1984); *In re Stinson*, 59 Bankr. 914 (Bankr. W.D. N.Y. 1986); *In re Walker*, 48 Bankr. 668 (Bankr. D. S.D. 1985).

26. *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).

27. See "Role of Director Discretion" *infra* text accompanying note 64.

ing 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.²⁸ "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."²⁹ 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.³⁰ 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.³¹ In *Atchison*,³² 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."³³

Second, the nonprofit nature of a cooperative may be important to

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

29. *Id.* at 917.

30. *Id.*

31. 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).

32. *Atchison County*, 241 Kan. 357, 736 P.2d 917 (1987).

33. 736 P.2d at 922.

help determine the relative weight of an individual member's interest in withdrawing 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 . . . the paramount concern was not the advancement of the individual as such."³⁴ 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 financial needs.³⁵

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 in equity redemption.³⁶

Finally, certain statutory provisions may relate directly to the equitable redemption process.³⁷ The court in *Christian County*³⁸ applied the Illinois cooperative incorporation statute³⁹ requiring the board of directors, upon withdrawal or expulsion of a member,⁴⁰ 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.⁴¹ The court refused to apply the payment requirement to preferred stock, holding "membership stock" did not apply to "all stock."⁴² The court held that the problems which might be caused by board of director discretionary powers were quite

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

35. *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. INFO. REP. 30 (1984) [hereinafter Baarda, *State Incorporation Statutes*].

36. *Atchison 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).

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

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

39. ILL. REV. STAT. ch. 32, § 454.6 (1983).

40. 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.

41. *Christian County*, 476 N.E.2d at 453.

42. *Id.* at 454.

different for transferable preferred stock and nontransferable common stock, and the statute distinguished between the two.⁴³

State statutory provisions describing equity redemption for an expelled member were also at issue in *Sanchez*.⁴⁴ 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."⁴⁵

Second, bylaws describe the characteristics of financial instruments. Of special importance, as noted in recent cases, are provisions on redemption,⁴⁶ on transfer,⁴⁷ on the establishment of security interests in a patron's equity by the cooperative,⁴⁸ and on the deferral of re-

43. 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.

44. *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).

45. *Atchison 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. Ct. App. 3d 665, 179 Cal. Rptr. 459 (1981); *In re Schauer*, 835 F.2d 1222 (8th Cir. 1987).

46. *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).

47. *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).

48. *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 *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).

demption decisions to the discretion of the board of directors.⁴⁹

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 member expulsion. Bylaws and statutes often play related roles. The bylaws of the cooperative described in *Sanchez*⁵⁰ 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.⁵¹ The California cooperative incorporation statute mandated certain repayments in the absence of bylaw provisions.⁵² 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.⁵³

Fourth, it is common practice for bylaws to assign redemption discretion to the board of directors.⁵⁴

49. *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).

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

51. "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.

52. In the case of expulsion of a member and where the bylaws do not provide any 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 shall 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 § 54122), *reh'g denied*, 126 Cal. App. 3d 665, 179 Cal. Rptr. 459 (1981).

53. *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).

54. See, e.g., *Atchison County*, 241 Kan. 357, 736 P.2d 917 (1987); *In re Axvig*, 68 Bankr.

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*⁵⁵ 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, among other documents, may state that the parties are bound by bylaws.⁵⁶ 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.⁵⁷ 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."⁵⁸

Certificates evidencing an equity interest may also describe holders' rights and limitations on those interests. Rights and obligations are often contained in certificates which include: a cooperative's right to redeem,⁵⁹ assignment of redemption discretion to the board of directors,⁶⁰ and restrictions on transfer.⁶¹ As with bylaws, a certificate evidencing investment may contain terms establishing contractual rela-

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.

55. *Milton v. Aransas Shrimp Coop.*, 668 S.W.2d 735 (Tex. Ct. App. 1983).

56. *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).

57. *Atchison County*, 241 Kan. 357, 736 P.2d 917 (1987).

58. *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).

59. *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 Bankr. 16 (Bankr. S.D. Fla. 1984).

60. *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).

61. *In re M.D.F.*, 39 Bankr. 16 (Bankr. S.D. Fla. 1984).

tions between cooperative and investor, and its interpretation will follow contract principles.⁶²

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 illusory. Two courts have specifically rejected the argument when raised by an equity holder,⁶³ and by a cooperative in an attempt to prevent transfer of revolving fund certificates to a trustee in bankruptcy.⁶⁴

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.⁶⁵

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*,⁶⁶ 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 the certificate. "The indebtedness of the garnishee to the debtor, was, therefor[e], contingent and nothing was payable to the garnishor."⁶⁷ In *Shiflett*,⁶⁸ a bank claimed to have a secured interest in

62. *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.

63. "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).

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

65. See "Setoff" *infra* text accompanying note 119.

66. *In re M.D.F.*, 39 Bankr. 16 (Bankr. W.D. Fla. 1984).

67. *Id.* at 18 (applying Florida law).

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 by-laws, 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."⁶⁸ 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*.⁷⁰ A related but more specific standard noted in recent cases was a "discriminatory treatment" measure. In this case an equity holder pleaded that a cooperative had redeemed equity of similarly situated holders. The court in *Schauer*⁷¹ declined to find "arbitrary and capricious" refusal to redeem absent a showing of "particularized discrimination" by the cooperative. The equity holder in *Lamar*⁷² 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*,⁷³ 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 boards' 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 redemp-

68. *In re Shiflett*, 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."

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

70. *In re Cosner*, 3 Bankr. 445 (Bankr. D. Or. 1980) (no such behavior was found).

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

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

73. *Claassen v. Farmers Grain Coop.*, 208 Kan. 129, 490 P.2d 376 (1971).

tion must be met before a board's discretion is bypassed.⁷⁴

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 supercede 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 Act⁷⁵ and the associated regulations⁷⁶ were discussed in *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.⁷⁷

The Bankruptcy Court in *Massengill*, cited *In re Walker*,⁷⁸ where the court held that to permit a debtor to retire or cancel Production Credit Association stock as part of a 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."⁷⁹ The court rejected that approach, relying instead on a Fourth Circuit Court of Appeals decision.⁸⁰ In that 1966 case the issue was of 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 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."⁸¹

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 land banks and production credit associations were designed to enhance their capital structure."⁸² The court relied on purposes of Chapter 12, and the "greater flexibility"

74. *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).

75. 12 U.S.C. § 2034(a) (1988).

76. 12 C.F.R. § 615.5260(b) (1988).

77. *In re Massengill*, 73 B.R. 1008 (Bankr. E.D. N.C. 1987).

78. *In re Walker*, 48 B.R. 668 (Bankr. D.S.D. 1985).

79. *Id.* at 670.

80. *Columbia Bank for Coop. v. Lee*, 368 F.2d 934 (4th Cir. 1966), *cert. denied*, 386 U.S. 992 (1967).

81. *Id.* at 938 n.10.

82. *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.*

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."⁸³ 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."⁸⁴ 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*⁸⁵ described an investment security not related to membership or patronage. The certificate was sold 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."⁸⁶ 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 director approval. The case was remanded for a determination of the tortious misrepresentation claim against the cooperative.⁸⁷

83. 11 U.S.C. § 1222(b)(8) (1988) (emphasis in original).

84. *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*.

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

86. *Id.* at 41.

87. The trial court found such misrepresentation on the part of the cooperative's selling

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*⁸⁸ 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 manager, 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 cooperative'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 Banks⁸⁹ and Production Credit Associations⁹⁰ 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 invest-

agent, but the agent did not appeal.

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

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

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

ment requirement may decrease. The excess may then be available for redemption.⁹¹

One bankruptcy court has recently held that the right to cancel PCA stock upon the borrower's default is discretionary with the PCA.⁹² 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*⁹³ 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."⁹⁴ 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."⁹⁵

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.⁹⁶ 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 discre-

91. "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.

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

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

94. *Id.* at 943.

95. *Id.*

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

tionary 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.⁹⁷ 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.

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.⁹⁸ The cooperative in *Cosner*⁹⁹ 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 do not divest the asset of its nature as property though value and marketability may be affected.¹⁰⁰

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 case¹⁰¹ hold-

97. 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).

98. *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).

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

100. *Id.* at 447.

101. *In re Schauer*, 835 F. 2d 1222, 1225 (8th Cir. 1987), *aff'g*, *In re Schauer*, 62 Bankr.

ing 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,"¹⁰² 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.¹⁰³

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.¹⁰⁴ The trustee obtains no greater rights in property than the debtor had at the date of filing.¹⁰⁵

Several arguments have been advanced for giving a trustee in bankruptcy rights not possessed by the bankrupt. However, the "happstance 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."¹⁰⁶

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

526 (Bankr. D. Minn. 1986).

102. *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).

103. 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.

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

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

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

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.¹⁰⁷ A lien for the benefit of a cooperative organization may also be established by statute as in the cases of Federal Land Banks¹⁰⁸ and Production Credit Associations.¹⁰⁹

Two courts have found the bylaw provision method, standing alone, inadequate to establish a perfected secured interest.¹¹⁰ *Axvig*¹¹¹ 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."¹¹²

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.¹¹³ 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

107. 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).

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

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

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

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

112. *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.

In re Cosner, 3 Bankr. at 448.

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

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.¹¹⁴ 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."¹¹⁵ 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 and redeemable at the board of directors' discretion, and the existence 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 not all that surprising given the fact that the Bankruptcy Court was the same court that decided *Massengill*.¹¹⁶

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

114. 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.

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

116. *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).

patron to set his or her equity interest in the cooperative off against the debt.¹¹⁷ This circumstance was common to ten of the recent cases.¹¹⁸

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.¹¹⁹

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 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*¹²⁰ and *Lamar*.¹²¹ 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 issue¹²² the court in *Atchison* held

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

118. *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).

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

120. *Atchison County*, 241 Kan. 357, 736 P.2d 917 (1987).

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

122. *Claassen v. Farmers Grain Coop.*, 208 Kan. 129, 490 P.2d 376 (1971); *Clarke County*

that equity credits are contingent on board decisions and are not "vested" until the board mandates redemption. The court held a member or stockholder 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.¹²³

Setoff was tied even more directly to the rights of redemption by the court in *Lamar*.¹²⁴ 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."¹²⁵

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*¹²⁶ 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.¹²⁷

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*.¹²⁸ A bank for cooperatives agreed to redeem equity of a bankrupt cooperative mem-

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).

123. *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).

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

125. *Id.* at 716.

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

127. *Id.*

128. *In re Cooperativa Cafeteros de Puerto Rico*, 19 Bankr. 732 (Bankr. D. P.R. 1982).

ber. By statute the bank could redeem stock at "fair market value."¹²⁹ 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."¹³⁰

The court in *Massengill*¹³¹ addressed the valuation issue and an argument by cooperatives that a "discount factor should be applied to the value 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."¹³² 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."¹³³

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

129. "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).

130. *In re Cooperativa Cafeteros de Puerto Rico*, 19 Bankr. 732, 734 (Bankr. D. P.R. 1982).

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

132. *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(a) (1988); 12 U.S.C. § 2094(k) (1988).

133. *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. ACCT. 19 (1981); Royer, *Financial Impact of Mandatory Equity Programs of Farmer Cooperatives*, 43 AG. FINANCE REV. 30 (1983).

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 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.