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Cooperatives: Identifying and Clarifying the Responsibilities

by

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COOPERATIVES: IDENTIFYING AND CLARIFYING THE RESPONSIBILITIES

by
DAVID W. DEWEY*

Many different people assume divergent roles in the modern cooperative. Each of these roles carries with it certain rights and responsibilities. The author discusses the various responsibilities of patrons, members, directors, managers, and officers of a cooperative. In addition, the author discusses the relationship between a cooperative and its banker.

INTRODUCTION

Different farmers stand in different legal relationships to the same farmer cooperative, and any one farmer frequently stands in more than one legal relationship to the cooperative. One farmer may be a member, but not a patron of the given cooperative. The second farmer may be a patron, but not a member of the same cooperative. The third farmer may be both a member and a patron of that cooperative. In such a situation, the first and third farmers, as members, have certain rights, such as the right to vote. But the second farmer, as a nonmember patron, has none of these rights. The second and third farmers, as patrons, have certain rights, such as the right to share in net margins, but the first farmer, as a nonpatron member, has no such right. Of course, with these rights come responsibilities, and it is these responsibilities that will be considered in this article.

RESPONSIBILITIES OF PATRONS

The responsibilities of patrons are dependent upon the "patronage contracts."¹ Early patronage contracts were generally called marketing agreements. Because these were individual contracts there were many problems with them.

The mechanical difficulties and expense of periodically "signing up" all patrons, mostly the same ones, all over again and of keeping track of many separate, eg. almost identical, documents, problems of enforcement of marketing

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1. Nieman, *Multiple Contractual Aspects of Cooperative's By-Laws*, 39 MINN. L. REV. 135 (1955).

contracts, the decline of the concept of "tying up" patrons' production so as to enable the cooperative to influence prices, and the rise of the concept of maintaining an adequate volume of patronage by furnishing satisfactory services and prices led to the decline of the separate "Marketing Contracts" to the substitution of additional new provisions in the by-laws—the insertion of the "patronage contract" in the bylaws.²

These provisions should set forth the cooperative's obligation to pay, and the patron's right to receive the net margins, as well as the provisions for computation of the net margins. Such provisions in the bylaws spell out the terms under which the cooperative transacts business with its patrons, defines the rights and obligations of the cooperative and its patrons as such, and sets out the primary tax responsibility for the written notices of allocation and cash refunds given to the patron by the cooperative.

The patron has other everyday responsibilities. The patron is certainly responsible for complying with the credit policy of the cooperative, and handling his account on a businesslike basis. The patron, under the bylaws or marketing contracts of the cooperative, also has a responsibility to invest in the cooperative. He is the one who is receiving the benefit of the cooperative, and he should be the one to invest or risk capital in it. It is not the member, as such, but the patron who should have this responsibility. This responsibility has traditionally been covered through the retention of deferred patronage refunds, or through per unit retention procedures.

The responsibility to invest in the capital of the cooperative is a continuing responsibility. The capital of an association should be owned by the current patrons. This is not only required for section 521³ associations by tax law, but is good business for all associations. There are numerous plans by which cooperatives retire capital. Most plans involve the traditional revolving out of old patrons—persons who have moved or ceased farming and estates. Capital can be retired only by introducing new capital. Certainly private corporations do not require constant recapitalization. This is one of the many ways that cooperatives are different from private corporations. There have been several recent cases litigating the responsibility of a patron to maintain his investment in a cooperative. One such case was *Claassen v. Farmers Grain Cooperative*.⁴ During his lifetime, Mr. Claassen had acquired \$6,000 in par value stock in the cooperative at Walton, Kansas. He also had acquired another \$10,000 in an equity called merely "deferred patronage refunds." The association had a policy of redeeming such equities when the holder died, if the heirs were not going to continue the farming operation. Otherwise, the equities of

2. *Id.* at 141 (footnote omitted).

3. I.R.C. § 521.

4. 208 Kan. 129, 490 P.2d 376 (1971).

the decedent would not be retired out of order, but would remain as part of the association's capital. All capital was revolved on a rather short revolving cycle. The opinion does not so indicate, but a sizeable portion of the equities involved in the litigation were actually retired by revolving out while the litigation was pending. The Kansas Supreme Court quite correctly held that all of the patronage credits were capital in nature, and that it was not mandatory that they be paid on the death of the holder.

Another case in this area was *Southeastern Colorado Cooperative v. Ebright*.⁵ This case started as a simple suit by a cooperative to collect an open account of \$1,712.80. Defendants made a counterclaim to recover \$4,486.06 in deferred patronage refunds. The lower court decision in favor of the cooperative was reversed by the court of appeals. The court held that the association's deferred patronage refunds were not capital and were in effect payable on demand. The court said that the association's board, under their bylaws, could declare deferred patronage refunds to be capital, but they had not done so. Certainly the cooperative's position in this litigation indicated that the board thought that the deferred patronage allocation had been designated as capital. The opinion of the court made it clear, however, that capital designation was a two step procedure under this association's bylaws. In this case, to create additional capital for the cooperative, the first step would be the retention of deferred patronage allocations. The second step would be declaring and informing the member how much of his deferred patronage allocations is to be considered invested in the capital of the cooperative.

The bylaws involved in *Ebright* imposed a limitation on the amount of capital that any member would be required to invest in the cooperative. The bylaws provided, "*the member may not be required to furnish capital by reinvesting his net margins in capital credits when he has bought or acquired through reinvestment at least \$100 in capital credits.*"⁶ The court's opinion was apparently based on this single bylaw provision because the court appeared to have ignored the following sentence of the cooperative's bylaws: "It shall be mandatory that the individuals reinvest at least fifty percent (50%) of the previous year's patronage in capital credits."⁷ These provisions are obviously in conflict when the individual member has more than one hundred dollars invested in capital. The average member of the cooperative involved in this litigation had over four thousand dollars invested in capital in the cooperative.

This opinion attempted to enforce the provisions of the cooperative's bylaws. Because of this fact, this decision can be a comfort to cooperatives in general. Even though the decision required the

5. — Colo. App. —, 563 P.2d 30 (1977).

6. *Id.* at 32 (italics original).

7. *Id.*

cooperative to redeem a member's deferred patronage refund, it is felt that *Ebright* could not be used as authority to require such redemption under different bylaws.

RESPONSIBILITY OF A MEMBER

The principle difference between a member and a patron is the member's right to vote at the business meetings of the association. This right to vote places additional responsibilities on the member: he should attend membership meetings so that he can exercise his right to vote; he should inform himself concerning the issues being considered in the membership meeting; and he should take knowledgeable action on these matters. An often overlooked difference in this right to vote is that a director, as will be considered later,⁸ acts in a representative capacity and must vote in board meetings in the best interests of the association as a whole. A member, on the other hand, voting in a membership meeting, may quite properly vote solely in his own individual interest.

One of the most important cooperative principles is that a cooperative business must be owned and controlled by the patrons it serves, rather than by nonpatron investors. Experience has demonstrated that to be successful, cooperative practice must conform to that cooperative principle; otherwise a conflict of interest develops between the patrons and the investors. The patrons will be interested primarily in obtaining satisfactory service and maximum return on the products marketed, or maximum savings on their supplies purchased through the cooperative. Investors on the other hand, naturally and legitimately, look for maximum profits directly from their investment in the cooperative. In associations where shares of capital stock originally were issued to the farmer patrons, but without adequate provisions for revolving or retiring such shares, the shares will gradually pass into the hands of nonpatron shareholders by reason of retirement or death of the original patron shareholders. In such a case, a sharp conflict of interest can rise concerning the rate of dividend to be paid on the capital stock. A loss of tax exemption or a loss of eligibility to borrow from banks for cooperatives can result from too large a proportion of shares being in the hands of nonfarmers or nonpatrons. A classic example of the trouble a cooperative can experience with nonpatron members is *Lambert v. Fisherman's Dock Cooperative, Inc.*⁹

Democracy is a wonderful form of government. The New England cities at one time practiced this form of government in almost an absolute, pure form with their town meeting organizations. Throughout the intervening years, absolute democracy has been replaced by representative democracy. The same thing is true for cooperatives as

8. See text accompanying note 16, *infra*.

9. 61 N.J. 596, 297 A.2d 566 (1972).

they become larger. One of the responsibilities that members of a cooperative have is to allow their representatives to make management decisions. It is clearly wrong for the members to try to take management away from the board of directors and hold it in their own hands. In the usual course of events, members have little or nothing to do with the actual management of the cooperative.¹⁰ The same thing is true in private business corporations.

In *Curll v. Dairymen's Cooperative Sales Association*,¹¹ the court rejected the argument of appellant that the "cooperative association is an unusual and distinctive legal entity which gives the producer-stockholder a voice in the cooperative's management not possessed by stockholders of an ordinary business corporation."¹² Many cooperatives' bylaws or statutes, however, do provide for referendums to the membership. This type of provision is novel so far as nonpublic bodies are concerned. Typical of this type of statute is part of the Kansas Cooperative Marketing Act.¹³ It provides:

Upon demand of one third of the entire board of directors, any matter that has been approved or passed by the board must be referred to the entire membership or the stockholders for decision at the next special or regular meeting: *Provided, however*, That a special meeting may be called for the purpose.¹⁴

After the original incorporation, members of cooperatives usually are responsible for approving any amendments to the articles of incorporation or bylaws of the association. The directors then are responsible for managing the association within the limits set by the members in the articles and bylaws. Some jurisdictions require membership approval if a cooperative mortgages all its assets. Persons working with cooperatives must be aware of special statutory requirements of this type that may not apply to other types of corporations.

Finally, the most important membership responsibility is that members must choose and elect directors. Too often this is a last minute drafting detail. Much time, study, and consideration should go into this action. Too often that is not done. Many states require cooperative directors to be chosen from the membership. This means that members are responsible to serve on a board of directors, if elected.

OTHER RESPONSIBILITIES

Responsibilities of the Board of Directors

The general management of the cooperative is essentially the

10. *Noble v. Farmers Union Trading Co.*, 123 Mont. 518, 216 P.2d 925 (1950).

11. 389 Pa. 216, 132 A.2d 271 (1957).

12. *Id.* at —, 132 A.2d at 274.

13. KAN. STAT. § 17-1615 (1974).

14. *Id.* (italics original).

responsibility of the board of directors. Certainly this management responsibility can be shared by other persons, such as officers, committees, managers, or other agents. No well-defined line can be drawn to show the part that is played by these constituent elements in the management of a cooperative. It is an oversimplification to say that the management functions are performed by the board making decisions and by administrative personnel carrying out the decisions. The basic responsibility of the board of directors is to make all of the decisions on matters of policy, and on any substantial matter that is not in the regular course of the routine affairs of the cooperative.

The directors perform important functions in selecting officers and certain key employees. Directors also perform important financial functions. They should attempt to exercise budgetary control. They should study all financial reports and make sure that there are regular, adequate audits of the cooperative. Directors further have the duty to keep members informed of the general activities of the cooperative. This is usually handled by formal reports during the association's annual meeting.

A board usually adopts policies by resolution. The question is what type of policies should the board of a cooperative adopt. The following are a few examples of policies that could be adopted:

- A. Personnel Policies
 - 1. Employment practices policy
 - 2. Salary schedules
 - 3. Sick leave policy
 - 4. Leave policy
 - 5. Retirement policy
 - 6. Other benefit policies
- B. Business Policies
 - 1. Credit policy
 - 2. Policy on discounts
 - 3. Advertising policy
 - 4. Contributions, donations and memberships
- C. Member Relation Policies
 - 1. Handling allocations
 - 2. Membership publication

Obviously this list is not complete. In discussing this issue, it is important to emphasize that professional help is needed to formulate many policies. Fairly recent state and federal legislation makes the penalties for technical errors in such policies quite severe. An example of the severity is the pending Colorado case of *Montgomery Ward & Co. v. Berhenke*.¹⁵ Mr. Berhenke is the Colorado Consumer Credit enforcement officer in the Colorado Attorney General's office. He is seeking to recover twenty-five million dollars in overcharges alleged to have been made because of the method of computation of a monthly finance charge on open accounts.

15. Civ. No. C-65097 (Colo.).

Responsibilities of Individual Directors

As previously mentioned, a director must not use his position to gain advantages not enjoyed by other members. For example, too often we see directors that do not pay their accounts within the terms of the association's credit policy. Many state cooperative acts provide that:

No director during the term of his office shall be a party to a contract for profit with the association differing in any way from the business relations accorded regular members or holders of common stock of the association, or to any other kind of contract differing from terms generally current in that district.¹⁶

It is disappointing to hear directors speculate on the meaning of such ambiguous terms as "contract for profit" or "current in that district." An individual director must realize that even if he is elected by a particular district, or has a particular group of supporters, his responsibility is to the cooperative and the membership as a whole. He should act in the best interests of the whole association and not just the persons who elected him to office.

The authority and responsibility of the board is exercised in formal meetings. Outside the meetings the individual director has no authority because of his position on the board. He is just another member, albeit an important one! He should remember that he is an important member. Undoubtedly, he is a community leader. As a leader, he will surely have followers. Therefore, a director of a cooperative has a responsibility to be a loyal member. He should speak well of the cooperative, emphasizing its strong points as he works in board meetings to correct its weak points.

An individual director has a responsibility to educate himself and to be informed. If he does not understand financial statements, he must immediately learn to do so. Instructional material and schools are available from a number of sources. An individual director must stay out of everyday operations of the cooperative. Nothing will discourage and drive away good management level employees like a director who sees himself as "a working director." An individual director must realize that he has access to confidential information. The open meeting government required by sunshine laws that we hear so much about does not apply to private business corporations, including those that operate on a cooperative basis.

Responsibility of the Manager

Whatever no one else is responsible for, is probably the responsibility of the cooperative's manager. The four words that best express

16. KAN. STAT. § 17-1611 (1974).

this responsibility would be “minimize risk” and “maximize savings.” It is the manager’s responsibility to administer the policies of the board. Certainly, part of any good administration is suggesting changes, additions, and improvements in existing policies, as well as recommending new policies as needed. It has been said that the board and officers of a cooperative administer the internal affairs, while the manager and employees administer the external affairs of the cooperative—*i.e.*, the dealings with third parties in the regular course of business. The board, of course, sets the limits within which these external affairs will be conducted.

The manager should be responsible to hire, supervise, and discharge all but certain key personnel. Such key personnel would vary from association to association, but might include the association’s attorney and auditor or comptroller, who might in turn be responsible directly to the board.

Responsibilities of Officers

The officers are the formal representatives of the cooperative. The president is the formal head of the cooperative. He has the power to call meetings of the members of the board of directors. He conducts all the meetings. He acts as the impartial leader of discussions. Normally, he refrains from voting, but as a member of the body, he has the same right to vote as any other member. He signs, on behalf of the cooperative, all formal documents that the directors have authorized him to execute.

The vice-president acts in the absence of the president and performs other duties assigned to him by the board of directors. The secretary keeps the formal minutes of the board meeting, has custody of corporate records, and signs and sees documents approved for execution by the board. The treasurer is the chief financial officer. He is especially concerned with the preparation of the association’s budget and audit.

The officers of a local cooperative are usually just board members that have accepted some additional responsibility. Their authority comes from the board and they are responsible to the board. Very little authority rests with an officer merely by virtue of his office. His authority comes from specific directions issued to him by the board of directors.

Responsibility of the Cooperative’s Banker

The responsibility of the cooperative’s banker is one area of responsibility that may have been omitted from this article. Nonetheless, the banker plays an important role in the life of a cooperative.

17. FARM CREDIT ADMINISTRATION, Annual Report to Congress (1977).

While there is, of course, still plenty of room for growth and improvement, I believe that banks have served cooperatives well. According to United States Department of Agriculture statistics, banks today provide about seventy percent of the borrowed money used by farmer cooperatives. No other privately owned financial institution, to my knowledge, has such a high level of market penetration.

A banker has a responsibility to understand his borrowers and to understand their business. A banker has a responsibility to analyze and counsel with his borrowers, but he also has a responsibility to let the borrower control its own policies and operations. A banker must not substitute his own judgment for the judgment of his borrowers' board of directors. He must also allow administration of the business to be conducted by the borrower's manager and employees. Management decisions must be made on the spot—in the cooperative's office. Management decisions cannot be made in Wichita, St. Louis, or St. Paul for cooperatives that are located in our agricultural communities.

A banker should also know his borrower. He should be familiar with his operations specifically, and with the entire industry generally. In this way the banker can advise the borrower on areas of his business where he is below the industry average and should concentrate his managerial attention. A banker should provide a borrower with adequate lines of credit to support his business, or advise him in detail why such credit cannot be extended. The only direct control that a banker can regularly exercise is the distribution of loan funds. A more direct approach can only be justified when the banker determines that his loan funds are in jeopardy of not being repaid. The author recalls the final board meeting of a borrower that had been forced into liquidation. The cooperative's bank was charged with two mistakes: *First* it had loaned them too much money; and *second*, it had not loaned them enough money.

Responsibilities of the Cooperative

Finally, let us not fail to recognize that the cooperative itself, has responsibilities. It may be a person only through the use of legal fiction; nevertheless, it has certain rather clearly defined responsibilities. A cooperative is responsible to serve its patrons at cost. After deducting expenses and reserves, it is responsible to allocate its profits or net savings back to its patrons, either in cash or in equity credits. A cooperative does not exist to make profits for itself, but to improve the farming operations and net return of its patrons.

In this same regard a cooperative has the responsibility to treat all patrons within the same classifications in an equal manner. This does not mean that a cooperative must extend credit to a patron that is not credit worthy. It does mean that credit should be extended on

the same terms to all patrons that are equally credit worthy. Equality of treatment would also not prohibit quantity discounts, quality premiums and the like.

A cooperative is responsible to adequately compensate its employees. For many years cooperatives have had the reputation of being conservative in this area. While some of this feeling exists today, cooperatives generally have come to realize that the caliber of employee they need must be adequately compensated or he will not be available for very long. In the same manner, directors should be remunerated for time that they give their association. Generally, this honorarium is approved by the membership, or set by them in the bylaws. Today's cooperatives have recognized that service on the board is time consuming and need not be rendered gratuitously.

A cooperative has responsibilities to third parties to comply with all terms and conditions of the various contracts that it has executed. The loan agreements of the Wichita Bank of Cooperatives make the following requirements, which its borrowers are required to meet:

While this loan agreement is in effect, the Borrower will:

- (a) Maintain its status as an eligible cooperative association, as defined by the Farm Credit Act of 1971.¹⁸
- (b) Furnish such information as the Bank may request relative to its affairs and permit such examination of its books and records as the Bank may specify.
- (c) Maintain insurance, covering such risks, in such companies, form and amounts, and fidelity bond coverage in such companies, form and amounts, on such officers and employees as the Bank may request; provided, however, that facilities mortgaged to the Bank shall be covered by fire and extended coverage insurance equal to at least 80 percent of the value of such facilities.
- (d) Maintain management and business personnel and policies satisfactory to the Bank and promptly make such changes therein as the Bank may from time to time request in writing.
- (e) Obtain loans from other sources only upon written approval of the Bank.
- (f) Maintain a credit policy satisfactory to the Bank and promptly make such changes therein as the Bank may from time to time request in writing.
- (g) Pay no patronage dividends or capital stock dividends in cash or property other than written notices of allocation without written approval of the Bank.
- (h) Retire no certificates of indebtedness or other loans prior to maturity without written approval of the Bank.
- (i) Repurchase or redeem no capital stock, membership fees, per unit retain certificates, or written notices of allocation without written approval of the Bank.

The Wichita Bank's borrowers record of compliance with these requirements has generally been excellent.

18. 12 U.S.C.A. § 2129 (West Supp. 1977).

CONCLUSION

Discussing responsibility in today's complex society is a wide topic. This brief discussion indicates that responsibility in a cooperative flows in both directions and from many different sources.