REORGANIZING AND FINANCING AGRICULTURAL COOPERATIVES

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For a cooperative corporation to attain any degree of success in fulfilling its economic purposes, it must be more responsive to the will of the individuals who compose it than would necessarily be true of an ordinary commercial corporation.¹ The nature of the structure of a cooperative requires this. A cooperative is not only a legal personality, but also an association of its members.² The articles of incorporation, by-laws, and member-corporate contracts are the framework upon which a cooperative corporation is built. Those documents include not only matters which are necessary to comply with the law under which the corporation is chartered, but also an expression of the corporate purpose of the members who compose it.

The cooperative appears as an anomaly to those who examine it only cursorily. The fact that it is incorporated to operate on a non-profit basis leads some to believe that its members do not believe in the profit motive. Nothing could be farther from the truth. The persons who compose cooperatives are associated to make their own efforts more profitable. Farmer members of cooperatives are true entrepreneurs. The cooperative, which itself is non-profit, is an agent or instrumentality by which the farmer enhances his individual income. In certain phases of the business cycle, it might be more proper to say that it is the instrument by which he fights for existence. The fact that the cooperative makes a market for the farmer’s product, and the additional margin he can acquire through the use of his cooperative, can mean the difference between survival or failure.

Statutes which authorize the formation of cooperative corporations as distinguished from general commercial corporations are of comparatively recent origin. Usually such acts have not been in existence for more than forty years, and many of them were placed on the statute books in the Twenties.

Most of the acts relate to the formation of farmer cooperatives for the purpose of enabling farmers to associate together in the marketing of farm products, the purchasing of farm supplies, and the furnishing of farm business services. The legislatures recognized the plight of farmers and the economic need which drove them to organize cooperative associations and societies.³

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³“Co-operative marketing associations . . . are now to be found . . . in every section of the country. Their origin and growth are unquestionably founded upon a pressing economic necessity.” Warren v. Alabama Farm Bureau Cotton Ass’n, 213 Ala. 61, 65, 104 So. 264, 267 (1925).
In the main, an excellent job has been done in providing basic legislation for the formation and operation of cooperatives to serve the needs of their members. The same thing cannot be said regarding the drafting of corporate papers of many of the cooperatives formed under such laws. When cooperatives were first formed, much of formal organization was omitted, to be improvised as required. The members developed practices to fit the needs of the times.

Many of the early cooperative articles and by-laws contained some very uncooperative provisions regarding comparative treatment of members and non-members. Many early cooperatives were organized and operated in such a manner that the members made a profit on non-member business. The members were mixing their own capitalistic views into the non-profit cooperative, and confusing compulsion with education. Equitably, the non-member should be required to put up his share of the capital needed by the corporation, but it is inequitable to discriminate between member and non-member business in the refunding of net patronage margins in a true cooperative.

The Need for Reorganization

The need for reorganization of perhaps the majority of the agricultural cooperatives formed under the cooperative marketing acts, whether organized with capital stock or on a membership basis without capital stock, is perhaps something that is to be expected in the normal course of events. It has been asserted that reorganization is a normal phase in the life of ordinary corporations. Very few commercial corporations are operating with the same type of capital structure they had fifty or seventy-five years ago.

The reasons for reorganization of cooperatives are varied. A common reason is inadequate capitalization. Cooperatives performing a useful purpose and fulfilling an economic need are not likely to fail. They partake of the character and personality of their members, and are in effect the agents of their members. Only a portion of the farmer's capital is invested in this off-the-farm business service, and it is usually found that the service rendered in providing a market or purchasing supplies, even at an occasional loss, is worth more to the individual farmer over a period of a very few years than his investment in the enterprise. This does not minimize the necessity for reckoning with the capital investment, but it does provide a clue to the tenacity of a cooperative, even in times of adversity.

The inadequacy of legal structure is another important reason why cooperatives have needed reorganization. The law evolves from commercial practices which are proved sound by experience. It was not strange, therefore, that lawyers unfamiliar with this new type of business unit generally were unable to express in corporate papers a proper framework for the operation of the cooperative corporation. A few lawyers who made a study of the subject did an admirable job. But farm lead-

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ers in the cooperative system have overlooked the necessity of appealing to the legal profession to become better acquainted with this comparatively new type of corporation.

Many of the early cooperatives in the Midwest were formed on a stock basis. In the Intermountain and Pacific areas, non-stock membership cooperatives predominated. Ownership of capital stock accomplished two purposes. It separated the members from the non-members, and provided a means of furnishing capital with which the corporation could function. One common determinative of the cooperative character of a corporation is the necessity of doing more business with members than with non-members.7

The major difficulty experienced, with cooperatives organized with capital stock is to limit ownership of the stock to current patrons of the cooperative. Another difficulty arises regarding the retirement of the stock of persons who cease to be farmers, or who move away or otherwise become ineligible as stockholders and uninterested in the success or failure of the enterprise.

The failure to retire one $100 share of capital stock upon the removal of the owner from the community may seem unimportant. With the passage of time, several other owners move away, and this may occur when heavy inventories call for maximum use of cash funds, and the retirement of such stock might impair the operating functions of the organization.

Also, upon the retirement of the stock, the management should make sales of stock to new patrons who have moved into the community. Many reasons are found (the managing officers being human) for failure to solicit new patrons to purchase stock. A common excuse is that pushing the sale of stock after the cooperative is well established indicates that the cooperative is financially weak.

By the time it becomes important to do something about it, the amount of stock to be retired has reached sizable proportions. When this condition exists, the board of directors and the manager are fearful of starting a stock retirement plan, advancing as a reason that current patron members with more than one share will importune them to retire their so-called excess shares.

The life cycle of a patron member alone demonstrates the necessity of including in the corporate structure a method of retiring the capital interests of those persons who are no longer able to avail themselves of the services of the cooperative. Many cooperatives have recognized half of the problem, by including in the articles and by-laws provisions to the effect that no patronage refunds shall be paid to a new patron in cash until he has first applied for membership (or purchase of a share) and has either paid for it or agreed that patronage refunds shall be applied towards the purchase until a full membership or share of stock has been acquired. In going thus far, they leave unsolved the problem of retiring the membership shares or other capital equities of those leaving the membership. This frequent deficiency, exist-

7 See the various state statutes, and also: Capper-Volstead Act, 42 Stat. 388 (1922), 7 U.S.C. §§291, 292 (1940); L. S. Hulbert, Legal Phases of Cooperative Associations 171, 375 (Farm Credit Administration, United States Department of Agriculture, Bull. No. 50, 1942).
ing over a period of time, creates one important need for a general overhaul of the corporate structure.

There are a number of other implications of the failure to have the capital investment owned by current farmer patrons. The necessity of doing more than 50 percent of the business with members, the necessity of having the voting media in the hands of current patrons in order to borrow from a bank for cooperatives, and compliance with the Internal Revenue Code and Regulations are in themselves sufficient reasons. However, the all-important basic reason is that a cooperative exists only for the purpose of performing service for those who use it, and such persons are the ones who should finance its operations. It is highly important that an examination be made of the articles of incorporation and by-laws, in as much as many cooperatives have, by act of the directors, established revolving funds, without authority under the corporate papers. By withholding net margins without authority, they may change their position under the Internal Revenue Code and Regulations, thus subjecting themselves to additional tax liability, if they have not included in the corporate documents a mandatory obligation to allocate patronage refunds and to account therefor.

**Type of Capital**

Fluctuation of capital requirements—the need for additional and more efficient facilities as well as additional working capital—poses a problem for cooperatives as for other businesses. Capital stock with a par value does not permit much flexibility for a cooperative which desires to receive its capital from its members in the exact proportions in which the members do business through the organization. When the cooperative has been in existence a number of years, handling commodities for its patrons in the community overshadows the complicated calculations necessary to adjust stock ownership to volume of business. Such problems call for a structure in which the voting medium that determines the difference between members and non-members is at a small par value and the remainder of the capital is represented in some other form of a more flexible nature.

To those desiring to use capital stock throughout, where that is feasible under the state statutes, common voting stock may be issued in units of ten dollars or twenty-five dollars par and the remainder of capital may be represented by non-voting preferred stock. Subject to the requirements of state laws it is suggested that the preferred stock have a par value of one dollar, so that shares can be issued in any amount. If the non-stock membership type of corporation is desired, the price of the memberships can be small and comparable to common stock, and the remainder of the capital can be represented by certificates of equity or certificates of participation or some similar evidence of capital investment. A third method is the use of

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10. HULBERT, op. cit., supra note 7, at 265, 269 and cases cited.
capital stock for membership purposes, and certificates of equity or participation for the
bulk of the capital requirements.

The important feature of any of these capital structures is the allocation each year of the net margins, and the use of the cash funds for the purpose not of paying a cash patronage refund in the current year, but of building up an adequate amount of capital and thereafter retiring the allocations made in previous years, the oldest outstanding allocations to be retired first. By this plan, each patron provides capital funds in accordance with the use he makes of the cooperative.11

In certain cases, where fixed assets have been acquired at admittedly high prices or there has been an unusual business expansion, it may appear probable that net margins in the future will not be earned in the same proportion to investment in fixed assets as in the past. In these cases, there may be need for so-called fixed or permanent capital. This may be evidenced by preferred stock with a fixed interest rate (cumulative or non-cumulative), to be retired at the discretion of the board of directors. This feature can be included in the articles of incorporation along with a revolving fund, but the state statutes should be consulted to determine whether there is authority for such an arrangement.

Contrary to general belief, allocation of net margins of the patrons at the end of the year, notice to patrons of the amount determined, and the withholding of such patronage refunds in the capital structure of the organization are not actions taken to avoid income taxes. The real purpose is to capitalize the corporation in accordance with cooperative philosophy on the exact basis of use by the patron members. The fact that one farmer has a considerable volume to market in one year and less in a subsequent year makes it impractical to attempt to adjust the capital investment entirely by the use of capital stock.

This has brought about, by an evolutionary process, what is known as the revolving-fund type of cooperative. The explanation for this type of capital structure and forms for its organization may be found in a number of publications.12

Congress, in Section 101 of the Internal Revenue Code,13 has provided an exemption for farmer cooperatives meeting the requirements of the Code and Regulations. The Bureau of Internal Revenue has permitted bona fide farmer cooperatives to exclude from taxable income net refunds allocated or paid on a patronage basis in pursuance of a mandatory obligation to do so. The Bureau has permitted organizations other than farmer cooperatives to do the same thing where such organizations were likewise under a mandatory obligation to make such patronage refunds.14 This is a logical result of strict adherence to cooperative

11 Id. at 276.
12 See Frank Evans and E. A. Stokdyk, The Law of Agricultural Cooperative Marketing 174, 426, 489 (1937); Hulbert, op. cit. supra note 7, at 402; S. D. Sanders, Organizing a Farmers' Cooperative (Farm Credit Administration, United States Department of Agriculture, Circular No. C-105, 1938) (revised in 1945).
principles. The cooperative is the tool or the agent of the farmer.\textsuperscript{15} The additional income, if any, resulting from patronage refunds is his, and it is so treated for income-tax purposes. From the standpoint of reorganization, this is only an incident to the greater and more important principle of capitalization of the cooperative on the basis of use.

The laws of Iowa, prior to 1935, permitted the organization of stock and non-stock cooperatives. In that year the legislature adopted a new statute which expressly permits operation of cooperatives on a revolving-fund basis.\textsuperscript{16} The Bureau of Internal Revenue has specifically recognized this revolving-fund type of organization in authorizing the exclusion from taxable income of sums allocated to the member-patrons' accounts.\textsuperscript{17}

**Method of Reorganization**

Many directors and officers of cooperative associations have reached the conclusion that the revolving-fund type of capital is the most equitable method so far devised for handling the capital structure. To change a cooperative which has been operating on a capital-stock basis to the revolving-fund method in such a way as to keep the interested parties fully aware of what is taking place requires considerable time and a number of meetings.

The board of directors and the manager should have a special meeting, free from the routine business of the corporation, to discuss fully the effect of such a change. There should be available at such a meeting a set of articles of incorporation and by-laws in general form outlining the method of operation on a revolving-fund basis.\textsuperscript{18} The cooperative's attorney should be fully acquainted with its proposed plan. The directors should likewise consult with the cooperative's auditor.

If the directors vote to proceed, the value of the assets of the cooperative should be considered. If a review of the situation indicates that members' equities should be revised or revalued at the time of reorganization to preserve their relative position, a committee should be appointed to value the assets. On such a committee there ought to be a representative of the board of directors and a representative of members or stockholders who is not on the board of directors. It is helpful if an outside appraiser or accountant is available to serve on the committee. A careful valuation of all the fixed assets, inventories, accounts receivable, and any other assets should be made.

On the basis of this appraisal, the value of the present capital equities can be determined. If the corporation has a deficit, it can be determined whether this should be recognized in the reorganization and the par value of the stock lowered. If the corporation has only normal and reasonable reserves, it is undoubtedly

\textsuperscript{15} Burley Tobacco Society v. Gillaspy, 51 Ind. App. 583, 100 N. E. 89 (1912); Bowles v. Inland Empire Dairy Ass'n, 53 F. Supp. 210 (N. D. Wash. 1943).

\textsuperscript{16} IOWA CODE, c. 499 (1946).

\textsuperscript{17} Bureau of Internal Revenue, Cum. Bull. 1938-2, p. 127.

\textsuperscript{18} Some years ago the Cooperative Research and Service Division of the Farm Credit Administration, Washington, D. C., had available certain charts showing graphically how a revolving fund operates.
advisable to permit them to remain and the stock or membership to be exchanged at par. If, as sometimes occurs, there is an unusually large surplus or reserve which really belongs to the members or stockholders and is not allocated, it is necessary to recognize this and to provide that a portion of it be allocated in the reorganized corporation as a capital equity to be paid out prior to the retirement in cash of any subsequent net margins on a revolving-fund basis. Such a fund can be pooled with the excess shares, to which reference is later made.

The valuations which have been arrived at can then be submitted to the stockholders or members at the meetings hereinafter mentioned. The directors and managing officers have a fiduciary relationship to the stockholders, and it is their duty to disclose all facts known to them bearing on the value of the stock or other capital equities. A failure to do this may subject the corporation to liability for damages.\(^9\)

When it has been determined to go forward with the plan, arrangements should be tentatively made for two meetings of the stockholders or members. Any attempt to make such a change at one stockholders' meeting is likely to create distrust or ill-feeling because of lack of understanding. It is almost too much to expect that a group will hear an explanation of such changes, listen to a reading of articles and by-laws, engage in a period of discussion, and be ready to vote at one meeting.

The first meeting, formal notice of which should be given to all members and stockholders, should be held for the purpose of informally presenting the problems of reorganization. This permits adequate presentation and discussion. No tension is created, as any vote taken is entirely informal. After the matter has been fully discussed, an informal vote can be taken to determine whether the voting members desire to proceed. If the vote is in the negative, no harm has been done and the matter can be dropped.

If the vote is in the affirmative, plans can then be made for a second and formal meeting thirty or sixty days later. The interim period permits the drafting of amended and substitute articles of incorporation and by-laws in final form. It allows a full discussion by stockholders or members of points concerning the reorganization which may not have occurred to them at the first meeting, or which may not have been discussed.

In drafting new articles and by-laws, no insurmountable problems should arise as to the rights of minority stockholders or members of a cooperative corporation, so long as the general scope and purposes of the corporation are not changed and stockholders or members are dealt with equitably.\(^20\) The cooperative's methods of operation should, if possible, be stated with greater precision than in the original documents. The state statutes should, of course, be consulted as to the procedure

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\(^9\) Snyder v. Colwell Cooperative Grain Exchange, 231 Iowa 1210, 3 N.W. 2d 507 (1942).

for amending the articles of incorporation and by-laws.\textsuperscript{21}

Upon the holding of the second and final meeting, at which a formal vote is to be taken, it is possible in some instances under state statutes and articles of incorporation and by-laws relating to amendments to obtain votes by mail or by ballot from those who are unable to attend the meeting. The board of directors, the manager, and, in many instances, a special reorganization committee should attempt to acquaint all members with the plans prior to the holding of the final meeting. The vote at that meeting will thus be the expression of the entire membership.

Upon adoption of the amended articles of incorporation and by-laws, and after filing in accordance with the appropriate state laws, there should be a sustained program to exchange the shares or memberships held under the prior corporate documents for the new instruments to be issued under the reorganization, until the complete change-over has been made.

The investor who puts money into an ordinary commercial corporation usually has only one motive: that is, as high a return as possible on his investment, tempered by the service the corporation renders to the public, fair treatment of employees, and similar matters. It is entirely in keeping with American ideals to strive for this high return. This is not inconsistent with the motive of a farmer in capitalizing his own cooperative corporation. However, his yield is received in a different manner. He invests his capital to perform a service. The investment furnishes plant, equipment, and working capital. He limits his return on capital and specifies that the remainder shall be paid to him on the basis of his use of the cooperative.

In many reorganizations, the patrons are limited to ownership of one share. In order to prevent dissipation of the capital in the reorganization, the equity represented by the excess shares of patron-members and shares owned by ineligible persons is evidenced by certificates of participation or certificates of equity. It is then provided under the new corporate papers that net savings each year will be allocated on the books to the patrons and that they will be notified of the allocation. The funds are withheld and used to retire the certificates issued for the excess shares of stock. Ultimately the certificates of equity or participation are retired in full, and the capital of the corporation is represented by shares or memberships held by the patron-members and revolving-fund certificates or credits issued for patronage earnings, plus such reserves or surpluses as have been established.

It will be readily seen that this is a fair method of capitalizing a cooperative corporation. Very few such corporations are large enough for their stock to have a

\textsuperscript{21}This article is confined to the reorganization of a cooperative type of corporation, which is already organized under some state statute which permits the formation of a cooperative corporation. It is not intended to include the subject of converting a private profit corporation into a cooperative corporation. In such a conversion more difficulties may be encountered concerning the rights of minority stockholders. This is not to say, however, that such a change cannot be accomplished. Cf. Huefle v. The Farmers Elevator, 145 Neb. 424, 16 N.W. 2d 855 (1944); 7 William Meade Fletcher, Cyclopaedia of the Law of Private Corporations §3684 (Perm. ed. 1938).
market value. The persons who cease to be eligible, or who for other reasons no longer have use for a share in the ordinary stock cooperative, have no practical method of disposing of their stock, and, of course, properly are unable to withdraw their capital stock from the corporation at their demand. Under the revolving-fund plan, the current patrons capitalize the corporation, and the persons who cease to use it are gradually paid out. This is accomplished in a manner which will not deprive the corporation of needed capital nor impair its operations.

FINANCING Cooperatives

In many respects, cooperative organizations are in the same position as ordinary corporations with regard to financing their operations. The financing of plant and equipment and the attraction of long-term operating capital create problems for any organization. Commercial banks are naturally restricted in these fields because the funds which they lend are usually demand deposits.

Large corporations, whether of the ordinary commercial or cooperative type, can use bond issues and debentures. This is usually not feasible for relatively small organizations. Congress recognized this deficiency and in 1932 established the Reconstruction Finance Corporation, by which medium-sized and smaller corporations may finance their operations through commercial banks.

The special needs of cooperative corporations were recognized, also, by the establishment in 1933 of one central and twelve regional Banks for Cooperatives, expressly to finance farmer cooperative associations engaged in marketing farm products, purchasing farm supplies, or providing farm business services. To be eligible for financing by the Banks for Cooperatives, the associations must meet certain requirements.

Generally speaking, these loans are made on a regular banking basis, the cooperative association, from a credit standpoint, faring no better and no worse than would another corporation. It is one of the established rules of the Farm Credit Administration, under which these banks operate, that the loan must be made directly to the cooperative. The policy is not to require directors or other individuals to endorse or guarantee the indebtedness of the cooperative association.

Loans for plant and other physical facilities are limited by law to an amount not exceeding 60 per cent of the fair value of the security. Thus the members or stockholders must have at least 40 per cent of the funds invested in plant and equipment. Operating capital loans are made on a basis which depends upon the operations of the organization. If the cooperative has inventories which it can legally pledge, it may be entitled to a larger loan than a cooperative which operates on a commission basis and has only a stated amount per unit to cover operating expenses and retirement of indebtedness.

The collective action of the members of a cooperative association, in forming and operating the organization, has some credit value if a sufficient number of mem-

\[22 \text{ 48 Stat. } 257 (1933), 12 \text{ U.S.C. } \S 1734 (1940).\]
\[23 \text{ 46 Stat. } 14, 18 (1929), 12 \text{ U.S.C. } \S 1141g, 1141j (1940).\]
bers belong and there is assurance of a sufficient volume to indicate successful operations. Some cooperative organizations obtain marketing agreements from their members, and the statutes of many states authorize such agreements. The use of such marketing agreements creates greater certainty of volume.\(^{24}\)

There is additional assurance of membership support, volume, and financial stability when the members have subscribed a large portion of the original capital. The revolving-fund type of corporate structure lends further stability in as much as it provides a steady source of capital funds for the organization.

Many cooperative organizations which have reached financial independence for ordinary operations continue to borrow during peak periods. It is uneconomic to build up and retain in the cooperative association a pool of funds to finance all needs, including peak operations, since this requires a sizable portion of the funds to remain idle the greater part of the year. The rotation or revolving of capital equities, considered in connection with an adequate borrowing program, permits adequate flexibility to meet the corporate needs throughout the fiscal year.

**Flexibility of Operation**

Considerable flexibility is permitted by use of the revolving capital plan. During periods of high inventories or high-priced inventories, it is possible to slow down the retirement of the oldest outstanding revolving-fund certificates and thus retain additional capital. When inventories are lower and cash capital needs are less, funds may be used by the board of directors to retire additional such certificates.

The legal effect of such a plan is that the patron, having been notified of his equity in the revolving fund, has, under the contractual obligations of the articles of incorporation and by-laws, acquiesced in his constructive receipt of the funds and has in turn authorized the board of directors to invest such sums in the capital of the corporation. The cooperative allocates such sums to the patrons by years, and when funds are not needed for the functioning of the cooperative they are used by the board of directors to retire the oldest outstanding revolving-fund certificates or credits by years. The corporate papers should authorize the payment of patrons' allocations in full or on a pro rata basis, by years, thus allowing the corporation to retire the certificates for a portion of a year. This is advisable because of the fluctuating net margins which a cooperative may retain due to price cycles and variations in volume.

Observation of several hundred cooperatives which have been reorganized shows an additional benefit which had not been expected. A great many new members were obtained and the volume of business increased materially. This may have been because the community was not fully aware of the benefits of the cooperative, and the reorganization acquainted more prospective patrons in the community.

\(^{24}\) A discussion of this subject will be found in Evans and Storkdyk, op. cit. supra note 12, c. IV; Israel Packel, The Law of the Organization and Operation of Cooperatives 130, 153 (2d ed. 1947); and Hulbert, op. cit. supra note 7, at 115.
with the benefits secured by patronizing the cooperative. In effect, the reorganization has been an educational campaign.

One farm editor, in making general observations with respect to cooperatives that had been in existence for a great many years, stated that they were suffering from "dry rot." A reorganization retiring the capital of non-patrons in an equitable manner, and again placing the cooperative in the hands of active patrons, is akin to trimming the dead limbs of a tree and permitting the healthy growth and expansion which should normally follow.