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## RECENT DEVELOPMENTS IN THE LAW REGARDING AGRICULTURAL COOPERATIVES

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This article addresses recent administrative, legislative and judicial developments affecting agricultural cooperatives. Although little new ground appears to have been broken in the past year or two, a recent governmental study, pending federal legislation and new court decisions have further defined and clarified the existing law.

Agricultural cooperatives are unique entities, formed to provide producers with marketing services or to supply them with needed commodities at lower costs. Although generally incorporated, cooperatives are distinguished from other business enterprises by such characteristics as operation at cost, limited return on investment, democratic control by members, and participation in net margins on the basis of patronage.<sup>1</sup>

As economic associations formed for mutual benefit, agricultural cooperatives are intended to strengthen their members' economic position in the marketplace. The favorable governmental attitude towards this effort at both the state and federal level is reflected by specialized state incorporation statutes,<sup>2</sup> unique federal income tax deductions,<sup>3</sup> partial antitrust exemptions,<sup>4</sup> and judicial recognition of the unique nature of the cooperative enterprise.<sup>5</sup> Whether that favorable attitude should be maintained is

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1. See generally AGRIC. COOPERATIVE SERVICE, USDA, COOP. INFORMATION REPORT NO. 1, COOPERATIVE PRINCIPLES AND LEGAL FOUNDATIONS (1977); FARMER COOPERATIVE SERVICE, USDA, LEGAL PHASES OF FARMER COOPERATIVES (1976) [hereinafter LEGAL PHASES]; EWELL P. ROY, COOPERATIVES: DEVELOPMENT, PRINCIPLES AND MANAGEMENT (4th ed. 1981); ISRAEL PACKEL, THE ORGANIZATION AND OPERATION OF COOPERATIVES (4th ed. 1970).

2. For a review of the state statutes governing agricultural cooperatives, see JAMES R. BAARDA, AGRIC. COOPERATIVE SERVICE, USDA, COOPERATIVE INFORMATION REPORT NO. 30, STATE INCORPORATION STATUTES FOR FARMER COOPERATIVES (1982).

3. Specialized federal income tax deductions are available to entities operating on a cooperative basis pursuant to Subchapter T of the Internal Revenue Code, 26 U.S.C. §§ 1381-1388 (1988). Additional deductions are available to cooperatives qualifying under 26 U.S.C. § 521 (1988). See discussion *infra* notes 108-136 and accompanying text.

4. The Capper-Volstead Act, 7 U.S.C. §§ 291-292 (1988) (enacted in 1922 to create a partial exclusion from the federal antitrust laws for agricultural cooperatives). See LEGAL PHASES, *supra* note 1, at 293-317, and discussion *infra* notes 81-82 and accompanying text.

5. See, e.g., *Claasen v. Farmers Grain Coop.*, 490 P. 2d 376, 381 (1971) (recognizing that: "Permeating each of the conclusions herein is the general consideration that cooperative marketing associations are fostered and encouraged by legislative enactment and judicial construction . . ."). See also *Fairdale Farms v. Yankee Milk, Inc.*, 635 F.2d 1037, 1043 (2d Cir. 1980).

one of the recurring themes in the recent developments discussed in this article.

## I. RELATIONSHIP BETWEEN MEMBER AND COOPERATIVE

The relationship between member and cooperative differs in many respects from that between a shareholder and a typical non-cooperative, for-profit corporation. One of the key distinctions is the type of rights acquired by investment. The purchaser of corporate shares generally receives a proportional share of voting rights, proportional distributions of income (dividends), and proportional rights to assets at dissolution.<sup>6</sup> The investment is generally intended to remain in the corporation until dissolution. If the shareholder wants to recoup his investment prior to that event, he generally does so by sale of the shares in the relevant market. A purchaser of cooperative shares, in contrast, generally receives one vote regardless of the number of shares held,<sup>7</sup> and distributions of income are based on patronage rather than shareholdings.<sup>8</sup> The distribution of assets at dissolution may also be allocated in proportion to patronage rather than shares held.<sup>9</sup> Furthermore, most of the equity invested by cooperative members is generated not by outright purchase of shares, but by the retention by the cooperative of a portion of the purchase price for which products are sold through the cooperative (or a portion of the savings generated by purchases through the cooperative).<sup>10</sup> This investment, referred to as a patronage retain, is generally evidenced by common stock, preferred stock, or some type of equity certificate or book entry established for that member.<sup>11</sup> Unlike the permanent investment in a profit corporation, the equity invested in the coop-

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6. See generally HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS § 124 (3d ed. 1983), which recognizes that:

Except as otherwise provided in the articles of incorporation, all shares enjoy equal rights. Chief among these are: (a) the right to participate ratably in earnings by way of dividends when, as and if declared by the board of directors, usually in the exercise of discretion, out of legally available funds; (b) the right to participate ratably in net assets (after satisfying liabilities to creditors) upon liquidation; (c) the right to participate ratably (one vote per share) in control; and (d) the preemptive rights to preserve ratably the foregoing rights.

*Id.*

7. See BAARDA, *supra* note 2, § 11.01 and Table 11.01.

8. For a discussion, see LEGAL PHASES, *supra* note 1, at 2-7.

9. See BAARDA, *supra* note 2, § 17.03.02 and Table 17.03.02. Statutes addressing the distribution of assets by an agricultural cooperative at dissolution apportion them in three ways: 1) according to property interests; 2) according to stock ownership, or 3) according to past patronage. *Id.*

10. See generally LEGAL PHASES, *supra* note 1, at 471-80.

11. See generally MARY BETH MATTHEWS, AGRIC. COOPERATIVE SERVICE, USDA,

erative in this manner is intended to be redeemed by the cooperative at some point in the future.<sup>12</sup> The timing and amount of redemption is generally a financial decision made within the discretion of the board of directors, based on available assets. Cooperative members recoup the bulk of their investment not by sale in a market, therefore, but by redemption of the shares or equity certificates by the cooperative.<sup>13</sup> Many of the traditional attributes of profit corporations do carry over to cooperatives, however.<sup>14</sup> Corporate law generally supplements cooperative statutes either impliedly or expressly.<sup>15</sup> As in profit corporations, the relationship of the board to cooperative members is a fiduciary one. The board, therefore, owes to the members such typical obligations as the duty to obey the cooperative articles and bylaws, and the responsibility to treat members impartially.

The fiduciary duties owed to members in the cooperative setting were recently considered in two interesting cases. The first, *Mitchellville Cooperative v. Indian Creek Corp.*,<sup>16</sup> was decided by the Iowa Court of Appeals. The second, *Hajmm Co. v. House of Raeford Farms, Inc.*,<sup>17</sup> was decided by the North Carolina Supreme Court. In *Mitchellville*, a cooperative filed an action against a family farm corporation for amounts due on open account for the purchase of hog feed. As an affirmative defense and counterclaim, the member (Indian Creek Corporation) asserted that the cooperative had violated fiduciary duties owed to it in three respects. First, Indian Creek claimed that the priority given by the cooperative articles to the redemption of preferred stock owned by deceased natural persons and retirees was improper. Second, the member asserted that the cooperative had failed to fully inform it of the cooperative's complete redemption program. Third, the member argued that the cooperative had engaged in unfair competition and failed to disclose a material conflict of interest by selling hog feed to a rival agricultural cooperative.

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ACS RESEARCH REPORT 68, FINANCIAL INSTRUMENTS ISSUED BY AGRICULTURAL COOPERATIVES (1988).

12. See generally AGRIC. COOPERATIVE SERVICE, USDA, ACS RESEARCH REPORT 23, EQUITY REDEMPTION, ISSUES AND ALTERNATIVES FOR FARMER COOPERATIVES (1982) [hereinafter EQUITY REDEMPTION].

13. *Id.*

14. See generally ALLEN HOBERG & DOUGLAS FEE, AGRICULTURAL COOP. SERV., USDA, STAFF REPORT, DIRECTOR LIABILITY IN AGRICULTURAL COOPERATIVES (1984).

15. For express statutory supplementation, see BAARDA, *supra* note 2, § 1.04 and Table 1.04.01.

16. 469 N.W.2d 258 (Iowa Ct. App. 1991).

17. 403 S.E.2d 483 (N.C. 1991).

Perhaps the most interesting fiduciary issue raised by Indian Creek's claims was never addressed by the Iowa Court of Appeals. That issue is whether a cooperative, as a separate entity, owes a fiduciary duty to its members. Although traditional corporate law dictates that directors owe a fiduciary duty to their corporation, and perhaps to the shareholders as a body, corporate law has not generally recognized such a duty on the part of the entity itself.<sup>18</sup> The relationship between a shareholder and the corporation is basically founded upon contract. In the cooperative setting, the rights and obligations constituting the agreement between the parties should be found in the articles, the bylaws, the cooperative resolutions, the membership application, the marketing contract, etc. If those obligations are violated by the cooperative, the member's cause of action against the cooperative should be based on breach of contract, not breach of fiduciary obligation.

A cause of action against cooperative board members, on the other hand, may be based on breach of fiduciary obligation. Directors owe duties to the cooperative and to the membership as a whole to be loyal, to abide by the corporate documents, to act with a certain degree of care, to treat members impartially, and so on. Breach of those duties may render the director liable in tort. Perhaps the breaches of duty asserted by Indian Creek against the cooperative should, therefore, have been asserted against the cooperative board members. The court in *Mitchellville* fails at times to make the distinction between the two<sup>19</sup> and ultimately concludes that the evidence is insufficient to show a breach of duty on the part of the *cooperative*.<sup>20</sup> It would have been instructive for the court to have examined the sources and parameters of such a duty.

Without discussing the nature of such a cooperative duty, the Iowa Court of Appeals rejected all three of Indian Creek's claims

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18. See, e.g. HENN & ALEXANDER, *supra* note 6, § 235 (discussing fiduciary duties of directors, officers, and possibly shareholders in the corporate setting). See also 3 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 803-860 (perm. ed. 1975) (discussing fiduciary duties of directors and employees). 6 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 2600-09 (perm. ed. 1989) (discussing fiduciary duties of a corporation only in the context of the corporation's ability to become an agent or attorney in fact for another corporation or natural person).

19. *Mitchellville*, 469 N.W.2d at 263. For example, the court discusses the duty to disclose in terms of an obligation owed by the directors: "As fiduciaries, the directors owe a duty to disclose information to those who have a right to know the facts . . ." The court concluded that no duty was breached in terms of the *cooperative*: "[W]e conclude that there is insufficient evidence to show the Co-op breached a fiduciary duty or failed to disclose relevant information to Indian Creek." *Id.* at 264.

20. *Id.*

on the merits and affirmed judgment in favor of the cooperative.<sup>21</sup> The court first considered the member's objection to the priority given by the articles to the redemption of patronage stock held by certain noncorporate members.<sup>22</sup> The cooperative articles specifically provided that redemption would first be applied to the families of deceased members, then to retired members over the age of 65, and then to all other members.<sup>23</sup> Indian Creek claimed that the failure of the cooperative to provide a separate "death" redemption policy for corporations violated the cooperative's duty to provide an equitable program to redeem patronage equity. Since a corporation cannot die, Indian Creek argued that the cooperative was unfairly discriminating against it.

In determining the validity of the article provision, the Iowa court considered the relevant statute. Unlike statutes in other states, which prohibit discrimination between members,<sup>24</sup> the Iowa statute specifically provided that priority as to the redemption of patronage stock was given to deceased natural persons.<sup>25</sup> Furthermore, the court cited with approval an opinion of the Kentucky Court of Appeals recognizing valid distinctions between corporations and natural persons in regard to redemption.<sup>26</sup> The Kentucky court had acknowledged that the needs of surviving family members are usually different from the needs of shareholders of a dissolved corporation, and that delay in redemption need not delay the liquidation of a dissolved corporation as it might the liquidation of an estate.<sup>27</sup> Based on the differential treatment permitted by the Iowa statute and the policy considerations noted by the Kentucky court, the Iowa Court of Appeals held that under Iowa law, a cooperative was not prohibited from prioritizing the payment of patronage equity among deceased natural persons, retirees, and corporations.<sup>28</sup>

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21. *Id.*

22. *Id.* at 261-62.

23. *Id.* at 261.

24. The North Dakota statute scrutinized in *In re Great Plains Royalty Corp.*, 471 F.2d 1261, 1264 (8th. Cir. 1973), prohibited discrimination in the distribution of net proceeds, except between members and nonmembers in specific situations. *Mitchellville*, 469 N.W.2d at 261 (citing N.D. CENT. CODE § 10-15-33(4)(b) (1985)). The court therefore held that the bylaw provisions requiring the early retirement of patronage equity upon the death of any patron must be applied to a bankrupt corporation. *Id.* at 1265. A similar holding was reached by the North Dakota Supreme Court in *Schill v. Langdon Farmers Union Oil Co.*, 442 N.W.2d 408 (N.D. 1989).

25. *Mitchellville*, 469 N.W.2d at 261 (citing IOWA CODE ANN. § 499.33 (1991)).

26. *Id.* at 261-62. See *Richardson v. South Ky. Rural Elec. Coop.*, 566 S.W.2d 779 (Ky. Ct. App. 1978).

27. *Mitchellville*, 469 N.W.2d at 262 (citing *Richardson*, 566 S.W.2d at 784).

28. *Mitchellville*, 469 N.W.2d at 262.

In addition, Indian Creek argued that the cooperative had breached a fiduciary duty by failing to inform Indian Creek of the cooperative's complete redemption policy. The alleged breach appeared to consist of two defects. The first was the failure of the cooperative to inform Indian Creek that it had no policy of redemption for corporate members prior to 1989. The second was that no setoff of patronage stock against amounts due to the cooperative would be available.

The Iowa court recognized that cooperative directors owe the corporation complete loyalty, honesty and good faith, and further owe a duty to the shareholders to disclose information affecting the general welfare of the corporation.<sup>29</sup> However, the record indicated that the president/principal shareholder of Indian Creek had been provided with and had read copies of the cooperative articles and redemption policy. As early as 1979, he was aware that the cooperative had no policy for corporate redemption, and he had urged the board on a number of occasions to adopt a policy that would be more fair to corporate members. The court further noted that Indian Creek's principal shareholder had both a law and veterinary degree and that in spite of the available information about cooperative redemption policies, Indian Creek had remained a member of the cooperative for over ten years.<sup>30</sup> Finally, the court pointed out that Indian Creek had received over \$49,000 through the cooperative's redemption plan when adopted.<sup>31</sup> Based on these factors, the court held that the evidence was insufficient to show that the cooperative had "breached a fiduciary duty or failed to disclose relevant information to Indian Creek."<sup>32</sup>

Finally, Indian Creek argued that the cooperative had breached a fiduciary duty to its members by selling hog feed to a rival agricultural cooperative. As discussed above, the court considered whether such duty had been breached without addressing the source of the duty.<sup>33</sup> Indian Creek contended that such conduct constituted either unfair competition or a failure to disclose material facts concerning a conflict of interest. The court pointed out, however, that the relevant Iowa statute<sup>34</sup> specifically authorized the board to deal with nonmembers so long as their share of

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29. *Id.* at 263.

30. *Id.* at 264.

31. *Id.*

32. *Id.*

33. See *supra* notes 18-19 and accompanying text.

34. IOWA CODE § 499.3 (1989), summarized in *Mitchellville*, 469 N.W.2d at 260.

the business did not exceed dealings with members.<sup>35</sup> The court indicated that some amount of competition should therefore be anticipated, stating: "In today's highly complex marketplace, it is wholly within the realm of expectation there will be some competition between members of a coop and nonmembers who do business with the coop."<sup>36</sup> Because the board had not engaged in oppressive tactics such as depleting assets, paying disproportionate salaries, or freezing out minority shareholders, the court found no breach of fiduciary duty on the part of the cooperative.<sup>37</sup>

In addition to providing some guidance as to fiduciary duties owed by a cooperative board, the *Mitchellville* opinion addressed another frequent equity redemption issue—the question of set-off.<sup>38</sup> A variety of cooperative members through the years have attempted to claim that patronage equities should be available to offset a cooperative claim for amounts due. The courts have generally rejected such an approach.<sup>39</sup> The Mississippi Supreme Court, in *Clarke County Cooperative v. Read*, explained:<sup>40</sup>

It is well settled that equity credits allocated to a patron on the books of a cooperative do not reflect an indebtedness which is presently due and payable by the cooperative to such patron. . . . The interest will be paid to the patron at some unspecified later date to be determined by the board of directors of the cooperative. . . . The patron has no right to offset such equity credits, not being an indebtedness which is presently due and payable, against an indebtedness which is presently due and payable by him to the cooperative.<sup>41</sup>

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35. *Mitchellville*, 469 N.W.2d at 264.

36. *Id.*

37. *Id.*

38. *Id.* at 262-63.

39. See *Howard v. Eatonton Coop. Feed Co.*, 177 S.E.2d 658 (Ga. 1970) (no setoff of equity credits against indebtedness due to cooperative at merger); *Forrest County Coop. Ass'n v. Manis*, 235 So. 2d 925 (Miss. 1970) (no setoff of equity credits against indebtedness due to cooperative); *Christian County Farmers Supply Co. v. Rivard*, 476 N.E.2d 452 (Ill. App. Ct. 1985) (no setoff of preferred stock against indebtedness due to cooperative); *Atchison County Farmers Union v. Turnbull*, 736 P.2d 917 (Kan. 1987) (no setoff of equity credits against indebtedness due to cooperative).

Setoff was permitted in *Southeastern Colo. Coop. v. Ebright*, 563 P.2d 30 (Colo. Ct. App. 1977), but only because the relevant cooperative had not taken steps to convert net margins into patronage equity. In that case, the bylaws provided that members were entitled to receive their proportional share of net margins. *Id.* at 32. Although the bylaws further provided that the board could require contributions of additional capital, no amounts had been debited from the member's share of net margins on the ledger account. *Id.* at 33. Therefore, the court held that the full amount of proportional net margins was available as a setoff in favor of the member in issue. *Id.*

40. 139 So. 2d 639 (Miss. 1962).

41. *Clark County Coop. v. Read*, 139 So. 2d 636, 641 (Miss. 1962).



The member in *Mitchellville* approached the setoff issue somewhat more creatively. Rather than argue that the preferred stock itself created a current obligation on the part of the cooperative, Indian Creek claimed that the cooperative's breaches of fiduciary duty created a mature tort claim.<sup>42</sup> Thus, Indian Creek argued that its current indebtedness to the cooperative for hog feed should be offset by the cooperative's current indebtedness to it for breach of fiduciary duty (apparently measured by the value of the preferred stock). Indian Creek's unique argument was no more successful than the traditional ones made by its predecessors. After a brief review of cooperative setoff cases, the Iowa Court of Appeals concluded that in the absence of fraud or oppressive conduct, Indian Creek had no right to setoff.<sup>43</sup> The court adopted the traditional rationale:

We do not believe the patronage funds sought to be setoff by Indian Creek are an indebtedness of the cooperative which is due and payable to members, but represent an interest which will be paid at some future date to be determined by the board of directors . . . .<sup>44</sup>

Fiduciary obligations on the part of the cooperative board were also recently considered by the North Carolina Supreme Court in *Hajmm Co. v. House of Raeford Farms, Inc.*<sup>45</sup> The court in that case affirmed an award of damages against a cooperative and its president/chairman of the board for failure to redeem patronage equities in the form of a revolving certificate. The opinion gives guidance to both the extent of fiduciary duties and to the method of establishing the breach of those duties at trial.

The plaintiff in *Hajmm* was one of three turkey producers who joined together to form a cooperative, House of Raeford Farms (Raeford). The turkey producers sold their stock in an existing corporation to Raeford and received revolving fund certificates as part of the consideration for the stock. The certificates recited that they bore no interest, were subordinate to other debt, were subject to the company's bylaws (which were incorporated by reference), and were retirable in the sole discretion of the

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42. *Mitchellville*, 469 N.W.2d at 260. As discussed, the breaches of fiduciary duty should perhaps have been asserted against the cooperative board rather than the cooperative itself. The claim against the cooperative would seem to have been based upon a breach of contract.

43. *Id.* at 263.

44. *Id.*

45. 403 S.E.2d 483 (N.C. 1991).

board "either fully or on a pro rata basis."<sup>46</sup> The bylaws stated that the certificates "shall be issued in annual series . . . and each series shall be retired fully or on a pro rata basis, only at the discretion of the board . . . in the order of issuance by years as funds are available for that purpose."<sup>47</sup> The certificates were reflected as stockholders' equity on Raeford's balance sheet.

During 1978, Raeford retired the revolving certificate issued to one of the three original turkey producers, Stone Brothers.<sup>48</sup> Stone Brothers had negotiated the relevant certificate to FCX, Inc., and the retirement was a component of Raeford's purchase of all interest FCX then held in Raeford.<sup>49</sup> No value was placed on the certificate when it was retired. The retirement was reflected on Raeford's books by discounting the certificate to zero value.

Some time later, Raeford retired the revolving certificate issued to the second of the three original producers. Retirement was also shown on Raeford's books by discounting the certificate to zero value. Furthermore, Raeford retired certificates of the same series (although of a different class) issued to other patrons of Raeford.<sup>50</sup> The third original revolving certificate held by the

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46. *Hajmm Co. v. House of Raeford Farms, Inc.*, 403 S.E.2d 483, 485-86 (N.C. 1991).

47. *Id.* at 486.

48. The relevant transactions are set out in greater detail by the North Carolina Court of Appeals in *Hajmm Co. v. House of Raeford Farms, Inc.*, 379 S.E.2d 868, 870-71 (N.C. Ct. App. 1989).

49. Both the purpose and the detail of the retirement of the certificates held by the two other original holders are not clear from the opinions. The relevant opinions discuss these financial transactions in conclusory terms. The North Carolina Court of Appeals merely states:

The same year, Raeford retired the Class B-Series 1975 certificate originally issued to Stone Bros., who negotiated its certificate to FCX, Inc. In its 1984 financial statement Raeford discounted to zero value the Stone Bros./FCX certificate *and* the certificate to NJS. Raeford subtracted the value of the Stone Bros./FCX and NJS Class B-Series 1975 certificates from the total amount owed on other certificates, thereby reducing stockholder's equity. Plaintiff's Class B-Series 1975 certificate was not redeemed at that time and continues to be shown as part of stockholder's equity in Raeford's financial statements.

*Hajmm Co.*, 379 S.E.2d at 871. The North Carolina Supreme Court provides little further explanation:

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

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

*Hajmm Co.*, 403 S.E.2d at 486.

50. These facts are stated in more detail in the intermediate court opinion. See *Hajmm Co.*, 379 S.E.2d 868 at 870-72 (Class B—Series 1975 Revolving Fund Certificates were issued to the former owners, while Class A—Series 1975 certificates were issued to patron members).

plaintiff, Hajmm, was not retired. Hajmm thereafter made demand for the retirement of its revolving certificate (by payment in full rather than by any type of discounting as with the other two certificates) but Raeford refused. Hajmm, therefore, instituted suit against Raeford and its president/chairman of the board (Johnson) for compensatory, punitive and treble damages. The plaintiff claimed that the failure to retire its revolving certificate constituted a breach of fiduciary duty, breach of corporate bylaws, and unfair practices affecting commerce.

The unfair practices claim was dismissed by the trial court.<sup>51</sup> On the remaining claims, a jury awarded Hajmm compensatory damages of \$387,500 against both Raeford and Johnson (the president/chairman of the board), plus punitive damages of \$100,000 against Raeford. On appeal, the intermediate court reversed the dismissal of the unfair practices claim but found no error in the trial.<sup>52</sup> The North Carolina Supreme Court affirmed the award of both compensatory and punitive damages but agreed with the trial court that no unfair practices claim had been stated.

The issues raised in *Mitchellville* as to the nature of the duties owed by a cooperative and its board were again raised in the *Hajmm* case. Perhaps these issues can be more clearly analyzed by scrutinizing the basis of the actions against both Raeford and Johnson. When a cooperative fails to abide by its own structural documents, it should be liable to its member for breach of contract. Since both Raeford's bylaws and the instruments issued in *Hajmm* required that the revolving certificates be retired as a series, either fully or pro rata, Hajmm ought to have been able to insist that all certificates of that series be retired simultaneously. Failure to do so would give rise to a cause of action against the cooperative for breach of contract.<sup>53</sup> Such a cause of action appears to have been stated by the plaintiff ("breach of corporate bylaws") and should have supported an award of compensatory damages by the jury against Raeford.

Furthermore, cooperative directors have a fiduciary obligation to comply with and carry out the cooperative documents. The failure to do so should give rise to a cause of action against the

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51. *Hajmm Co.*, 403 S.E.2d at 483 n.1. The North Carolina Supreme Court noted that this claim was dismissed at the August 4, 1986 session of Superior Court, Scotland County. *Id.*

52. *Hajmm Co.*, 379 S.E.2d at 877.

53. The intermediate court opinion recognized this relationship, stating, "Plaintiff's certificate constituted a contract between plaintiff and Raeford . . . . Raeford's by-laws were incorporated into plaintiff's certificate. Those by-laws constituted additional terms of the parties's contract . . . ." *Id.* at 874.

directors for breach of the fiduciary obligation of obedience.<sup>54</sup> As to this issue, no question of discretion should be involved. If the bylaws require the board to retire only pro rata, it must do so. Failure of the board to abide by the bylaws should thus support an award of compensatory damages against the board for breach of fiduciary obligations.

The bylaws in *Hajmm* gave the directors certain discretion. The bylaws did not address whether some certificates could be retired and not others, but rather granted the directors discretion to determine whether the cooperative was in a financial position to retire any certificates at all. The issue of whether the directors abused their discretion in refusing to retire Hajmm's certificate was submitted to the jury, which found that the only director named as a defendant did breach a duty in failing to retire it.<sup>55</sup> Thus, the jury appeared to have found that the board breached its fiduciary duties both in failing to retire all certificates equally as required by the bylaws and in abusing its discretionary power to determine whether certificates should be retired at all.

The analysis thus far is consistent with a finding of breach of contract on the part of the cooperative, and breach of fiduciary duties on the part of the board. However, certain expert testimony and findings by the jury went even further. In response to interrogatories, the jury concluded that the *cooperative* owed a fiduciary duty to the member<sup>56</sup> and that the *cooperative* had breached that duty by failing to engage in an open, fair and honest transaction.<sup>57</sup> As was discussed in regard to *Mitchellville*, such a duty is not commonly recognized in corporate law.<sup>58</sup> Fiduciary duties are generally imposed upon the corporate board, not the corporate entity itself.

It is possible that the finding of a fiduciary duty on the part of the cooperative could be confined to the unique circumstances of

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54. See generally HENN & ALEXANDER, *supra* note 6, §§ 231, 233.

55. *Hajmm*, 403 S.E.2d at 486. The jury's response to interrogatories was as follows:

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

4. If so, was their refusal to retire HAJMM's revolving fund certificate an open, fair and honest transaction? No.

*Id.*

56. *Id.*

57. *Id.* at 491. The court concluded that there was substantial evidence that "both defendants breached their fiduciary duties by not retiring the certificate." *Id.* The court noted that the term "breach of fiduciary duties" was not specifically submitted to the jury, but found that the question submitted regarding "open, fair and honest" transactions was an equivalent submission. *Id.* at 491 n.4.

58. See *supra* notes 18-19 and accompanying text.

the case. *Hajmm* appeared to be arguing that a fiduciary relationship arose when it accepted the revolving certificate in return for its interest in the prior corporation. The evidence indicated that *Hajmm* placed special confidence and trust in both defendants when it did so and justifiably expected them to deal fairly.<sup>59</sup> In contrast, the defendants appeared to be arguing that only a debtor-creditor relationship existed. Therefore, the jury's finding that a fiduciary relationship existed<sup>60</sup> could be interpreted as being based on the unique relationships created by the parties at the initial formation of the cooperative, rather than upon the garden variety cooperative-member relationship. The opinion of the North Carolina Supreme Court suggests this possibility, noting that there is no rigid definition of a fiduciary relationship and that it may stem from varied and unpredictable factors.<sup>61</sup>

The impact of the *Hajmm* case is therefore unclear. If the opinion is interpreted as supporting a fiduciary obligation on the part of every cooperative to every member, then it may alter the way the relationship between the two is analyzed. The source, scope, and effect of the cooperative's fiduciary duties will have to be carefully considered. If, on the other hand, the court is merely saying that a fiduciary relationship was created between the plaintiff and the cooperative in *Hajmm* because of their unique circumstances, the impact would be much less significant.

The court's failure to more clearly explore the source of the fiduciary duties is especially troublesome in *Hajmm* because of the award of punitive damages. Since punitive damages do not normally lie for breach of contract, it would seem inappropriate for the jury to award them against the cooperative for breach of its bylaws. On the other hand, the jury might appropriately award punitive damages against the board for a tortious breach of fiduciary obligation. The jury in *Hajmm* chose to award \$100,000 in punitive damages against the cooperative, but none against Johnson. It therefore appears that the jury was punishing the cooperative for breach of *its* fiduciary obligations. The existence and extent of duties owed by a cooperative entity, therefore seem to be of fundamental importance in determining the validity of the punitive damage award against the cooperative.

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59. *Hajmm*, 403 S.E.2d at 490.

60. The jury's finding was based upon the opinion of an expert witness. *Id.* at 487-89. For a discussion of the expert witness, see *infra* note 64 and accompanying text (recognizing that this expert testimony was held to have been improperly admitted).

61. *Hajmm*, 403 S.E.2d at 488.

The *Hajmm* case provides some guidance as to how a breach of fiduciary duties should be proven at trial. On the issue of the board's abuse of discretion in retiring equity, the court indicated that the availability of funds for retirement was one factor that could be taken into account by the jury.<sup>62</sup> Thus, the jury could consider that Raeford had loaned over \$1 million to Johnson and his family's other businesses, had made large purchases such as a corporate jet, had shown an increase of over \$11 million in net worth, had invested \$3.4 million in outside securities and had \$922,000 cash on hand.<sup>63</sup>

However, the court indicated that whether a fiduciary relationship existed between the Hajmm Company and the defendants, and whether duties arising from such relationship had been breached, were not matters for expert testimony. The admission of the testimony of an expert witness that such relationship existed and that such duties had been breached was held to be improper.<sup>64</sup> The court indicated that the expert could testify as to the existence of the underlying factual components, but that the existence of the relationships were matters for the jury.<sup>65</sup> However, the court concluded that the error in *Hajmm* was a harmless one, because the expert's testimony was merely cumulative or corroborative of other evidence.

The *Hajmm* case further illustrates the type of conduct which may support an award of punitive damages against the cooperative. When Hajmm made demand on Raeford for redemption of its certificate, the directors stated that they "had us a little meeting and decided that we didn't need to bother with it; it shouldn't be paid, it wasn't good business and we didn't do it."<sup>66</sup> Johnson also told other persons that he might never pay the certificate. The court held that the state of the evidence was such that the

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62. *Id.* at 491.

63. *Id.*

64. *Id.* at 487-89. The expert was Dr. James Baarda. See BAARDA, *supra* note 2. Such expert testimony might still be valuable in future cases, but would be subjected to a narrower scope under the North Carolina court's interpretation. The court gave some guidance as to the reach of such testimony:

A qualified expert such as Dr. Baarda should be permitted under Evidence Rule 704 to give an expert opinion regarding the existence of these factors. For example, the expert witness may give an opinion that under the circumstances one party has reposed special confidence in another party, or that one party should act in good faith toward another party, or that one party must act with due regard to the interests of another party. However, the witness may not opine that a fiduciary relationship exists or has been breached.

*Hajmm*, 403 S.E.2d at 490.

65. *Id.*

66. *Id.* at 492.

jury could find the conduct reached the level of "outrageousness" required by the jury instructions to support punitive damages, even apart from the erroneously admitted expert testimony.<sup>67</sup>

The *Hajmm* court also rejected the plaintiff's effort to characterize the failure to redeem cooperative equity as a treble damage claim for unfair trade practices under North Carolina statute.<sup>68</sup> The trial court dismissed the claim because Hajmm failed to establish that the defendants' conduct was "in or affecting commerce" within the meaning of the statute, and the North Carolina Supreme Court agreed.

As these two cases indicate, the relationship between a cooperative and its member is a complex one. The cooperative board clearly owes fiduciary duties to its members. Whether the cooperative itself similarly owes fiduciary duties is a more controversial question. Although neither case comprehensively addresses the source or scope of such a duty, the implied recognition of its existence should make both cases important in the future evolution of the cooperative-member relationship.

## II. RELATIONSHIPS WITH THIRD PARTIES

Recent cooperative cases have dealt not only with the internal relationship between the cooperative and its members, but also with their relationships to third parties. One facet of such external relationships is the interference by third parties with the marketing contract between the cooperative and its member. The favorable governmental attitude toward cooperatives in the past has been reflected by the provision of liberal rights and remedies against parties interfering with a cooperative marketing contract. State cooperative statutes variously prohibit interference, establish civil fines, criminal penalties and treble damages,<sup>69</sup> authorize injunctions,<sup>70</sup> and provide that the filing of the marketing contract gives constructive notice of the cooperative's rights.<sup>71</sup> Further remedies may be provided by state common law or by federal statute. A court may, therefore, be required to determine the availability and applicability of varying remedies.

The relationship among some of these sources of remedies was recently considered by the Sixth Circuit in *Southern Milk Sales*,

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67. *Id.*

68. *Id.* at 492-94.

69. See BAARDA, *supra* note 2, § 14.04.17 and Table 14.04.17.

70. See *id.* § 14.04.14 and Table 14.04.14.

71. See *id.* § 14.04.11 and Table 14.04.11.

*Inc. v. Martin*.<sup>72</sup> In that case, a dairy marketing cooperative contracted with a certain hauler to deliver its members' milk to a processing plant. At the instigation of a milk broker, however, the hauler began diverting his milk pickup to another purchaser for the benefit of a competitor of the cooperative. The cooperative sought a preliminary injunction against the hauler, the broker, and the competitor to restrain them from wrongfully interfering with its contracts with its members.

The cooperative sought the preliminary injunction pursuant to a Michigan cooperative statute,<sup>73</sup> Federal Rule of Civil Procedure 65, and the federal Agricultural Fair Practices Act.<sup>74</sup> Between the state statute and the federal rule, the court was faced with two issues. The first issue was whether the remedy of a preliminary injunction was created by the Michigan statute at all. The second issue was whether the state statute or the federal rule set the standard for its issuance.

Although inclined to conclude that the Michigan statute contemplated only a permanent injunction, the court ultimately did not decide the first issue.<sup>75</sup> Rather, the Sixth Circuit held that whether a preliminary injunction should issue was a question of procedure and that federal law should, therefore, have been applied by the district court.<sup>76</sup> Therefore, the court held that the standards for issuance of the preliminary injunction were those set by the federal rule.<sup>77</sup> Rule 65 of the Federal Rules of Civil Procedure requires a showing of irreparable injury in order for a preliminary injunction to issue.<sup>78</sup> Since the cooperative had made no such showing, the Sixth Circuit affirmed the denial of the injunction.<sup>79</sup>

The same analysis appeared to render moot the issue of whether a preliminary injunction should be issued pursuant to the Agricultural Fair Practices Act (AFPA). Although acknowledging that the cooperative might have standing for relief under that statute, the Sixth Circuit stated that the issuance of a preliminary injunction would still be governed by federal procedural law

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72. 924 F.2d 98 (6th Cir. 1991).

73. MICH. COMP. LAWS ANN. § 450.109 (West 1990).

74. 7 U.S.C. §§ 2301-06 (1988).

75. *Southern Milk Sales, Inc. v. Martin*, 924 F.2d 98, 102 (6th Cir. 1991).

76. *Id.*

77. *Id.* at 102-03.

78. *Id.* The court relied on the four-part test for Rule 65 set forth in *In re DeLorean Motor Co.*, 755 F.2d 1223, 1228 (6th Cir. 1985). *Id.* at 103 n.3.

79. *Southern Milk Sales*, 924 F.2d at 103.



rather than the substantive provisions of the AFPA.<sup>80</sup>

The *Southern Milk* case illustrates the difficulty courts may have in choosing between conflicting sources of cooperative remedies. The court may first have to determine if the remedy is created by the relevant provision, and then resolve conflicts and supersession issues created by other law.

### III. ANTITRUST

Another field in which agricultural cooperatives have enjoyed some measure of governmental favor is antitrust enforcement. The Capper-Volstead Act<sup>81</sup> was enacted in 1922 to permit producers who meet certain conditions to act together in associations to collectively process and market agricultural products.<sup>82</sup> However, the courts made clear that the protection from antitrust enforcement created by Capper-Volstead was only partial. Cooperative antitrust protection did not extend to conspiracies or combinations with noncooperatives,<sup>83</sup> to predatory tactics,<sup>84</sup> or to entities not composed of producers.<sup>85</sup>

Although mergers between cooperatives have not generally been subjected to antitrust challenges,<sup>86</sup> acquisitions by coopera-

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80. *Id.*

81. 7 U.S.C. §§ 291-292 (1988).

82. See generally LEGAL PHASES, *supra* note 1, at 265-321; Eugene M. Warlich & Robert S. Brill, *Cooperatives Vis-a-vis Corporations: Size, Antitrust and Immunity*, 23 S.D. L. REV. 561 (1978) (examines the application of antitrust law to cooperatives and the relation to non-cooperative business corporations); David T. Baumer, Robert T. Masson & Robin Abrahamson Masson, *Curdling the Competition: An Economic and Legal Analysis of the Antitrust Exemption for Agriculture*, 31 VILL. L. REV. 183 (1986) (uses the dairy industry as an economic model for legal analysis demonstrating how antitrust laws may be used to combat cooperative monopolization, anticompetitive mergers, and undue price enhancement); Thomas W. Paterson & Willard F. Mueller, *Sherman Section 2 Monopolization for Agricultural Marketing Cooperatives*, 60 TUL. L. REV. 955 (1986) (evaluates application of § 2 of Sherman Act to agricultural marketing cooperatives); A.S. Klein, Annotation, *Monopolies: Construction of § 1 of the Capper-Volstead Act (7 USCS § 291) Authorizing Persons Engaged in the Production of Agricultural Products to Act Together in Association*, 20 A.L.R. FED. 924 (1974) (collects federal cases dealing with the construction and application of § 1 of the Capper-Volstead Act).

83. *United States v. Borden Co.*, 308 U.S. 188 (1939).

84. *Maryland & Virginia Milk Producers Ass'n, Inc. v. United States*, 362 U.S. 458 (1960); *Otto Milk Co. v. United Dairy Farmers Coop. Ass'n*, 388 F.2d 789 (3d Cir. 1967); *Fairdale Farms v. Yankee Milk, Inc.*, 635 F.2d 1037 (2d Cir. 1980).

85. *Case-Swayne Co., Inc. v. Sunkist Growers, Inc.*, 389 U.S. 384 (1967); *National Broiler Marketing Ass'n v. United States*, 436 U.S. 816 (1978). See also Worth Rowley & Marvin Beshore, *Chicken Integrators' Price-Fixing: A Fox in the Capper-Volstead Coop*, 24 S.D. L. REV. 564 (1979).

86. Baumer, Masson & Masson, *supra* note 82, at 239 n.210. Between 1968 and 1972, mergers by 217 milk cooperatives went unchallenged. *Id.* Commentators suggest that this is a matter of federal enforcement policy and that such attack would be "ludicrous since Capper-Volstead specifically allows cooperatives to engage in collective action tantamount to a de facto merger." Note, *Trust Busting Down on the Farm: Narrowing the Scope of Antitrust Exemptions for Agricultural Cooperatives*, 61 VA. L. REV. 341, 374-75 (1975).

tives of noncooperatives have been successfully attacked.<sup>87</sup> The most recent challenge considered by the federal district court, at the preliminary injunction stage, was *United States v. Country Lake Foods, Inc.*<sup>88</sup> In that case, Country Lake Foods entered into a contract to purchase all of the outstanding stock of a non-cooperative fluid milk processor.<sup>89</sup> The government then sought to preliminarily and permanently enjoin the proposed acquisition, asserting that it would substantially lessen competition in the relevant product and geographic markets in violation of section 7 of the Clayton Act.<sup>90</sup>

The federal district court denied the government's motion for preliminary injunction, concluding that the government had failed to show a probability of success on the merits either in establishing the relevant geographic market or in proving that the proposed acquisition was likely to substantially lessen competition in that market.<sup>91</sup> The government had asserted that the relevant market was the area approximately within fifty miles of Minneapolis, and the court acknowledged that if it were to accept such as the relevant market, it would be "highly concentrated" under the HHI index.<sup>92</sup> Such a high concentration would warrant a presumption of a prima facie violation of section 7, unless the defendants presented clear evidence that the proposed acquisition was not likely to have such anticompetitive effects.

The court found that the government had failed to define the area of effective competition in terms that reflected the actual dynamics of the fluid milk market.<sup>93</sup> Persuasive evidence indicated that distant dairies might enter the market area if prices

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87. See, e.g. *Maryland & Virginia Milk Producers Ass'n*, 362 U.S. at 472-73 (the relevant cooperative was forced to divest itself of a competitor noncooperative dairy). See also *United States v. Rice Growers Ass'n*, 1986-2 Trade Cas. (CCH) ¶ 67,288 (Rice Growers Association of California was required to divest itself of Pacific International Rice Mills).

88. 754 F. Supp. 669 (D. Minn. 1990).

89. *United States v. Country Lake Foods, Inc.*, 754 F. Supp. 669, 670 (D. Minn. 1990). Country Lake Foods, Inc. is a majority-owned subsidiary of Land O'Lakes, Inc. See James R. Baarda, *Court Okays Dairy Acquisition*, FARMER COOPERATIVES, Oct. 1990, at 27.

90. *Country Lake Foods*, 754 F. Supp. at 670. Section 7 of the Clayton Act, codified at 15 U.S.C. § 18 (1988), provides that:

No person engaged in commerce or in any activity affecting commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital . . . of another person engaged also in commerce or in any activity affecting commerce, where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.

91. *Country Lake Foods*, 754 F. Supp. at 681.

92. *Id.* at 673. The Herfindahl-Hirschman Index is a measure of market concentration calculated by squaring the market share of each firm competing in the market and then summing the resulting numbers. *Id.* at 673 n.4.

93. *Id.* at 675.

increased and could profitably compete even without a price increase. The court therefore concluded that the government's proposed relevant geographic market was too small.<sup>94</sup> Because prior case law held that a preliminary injunction could still be appropriate in certain circumstances, however, the court went on to consider the government's likelihood of success on the merits should that geographic market be accepted.<sup>95</sup>

In regard to whether the proposed acquisition would substantially lessen competition, the defendant cooperative introduced evidence indicating that the proposed acquisition was likely to enhance, rather than diminish, competition. The cooperative established that low entry barriers existed, making it unlikely that a price increase could be sustained. The cooperative further showed that milk purchasers had significant market power, that buyers might vertically integrate in response to increased prices, and that the acquisition might enable the cooperative to compete directly with the market leader. The court found, therefore, that the government had failed to show a probability of success in proving that the acquisition would substantially lessen competition.<sup>96</sup>

The dairy industry was also the focus of a recent governmental study on the current role and effect of the Capper-Volstead Act.<sup>97</sup> In response to a request by Senators Metzenbaum and Bradley, the General Accounting Office (GAO) undertook a study to determine dairy farmers' continued need for the exemption, the effect of the exemption on dairy prices, and the adequacy of oversight of cooperative pricing activities provided by the United States Department of Agriculture (USDA). Despite the fact that the study focuses only on the dairy industry and in some respects fails to reach definitive conclusions, it provides valuable guidance as to continued governmental support for the Capper-Volstead exemption. The study also revives a continuing controversy about the role of the USDA in cooperative antitrust enforcement.

The GAO first concluded that valid justifications for the Capper-Volstead exemption continue to exist. Although acknowledging that the dairy industry has changed significantly since the statute was adopted in 1922, the study indicated that dairy farmers continue to be of relatively small size compared to the increasingly

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94. *Id.* at 680.

95. *Id.* at 678.

96. *Id.* at 680.

97. 7 U.S.C. §§ 291, 292 (1988). See also U.S. GEN. ACCOUNTING OFFICE, GAO/RCED 90-186, DAIRY COOPERATIVES: ROLE AND EFFECTS OF THE CAPPER-VOLSTEAD ANTITRUST EXEMPTION (Sept. 1990) [hereinafter DAIRY COOPERATIVES].

concentrated processing and distribution firms that purchase their products. The study inferred that dairy farmers would continue to be in a relatively weak bargaining position if required to act without cooperatives. To the extent of this offset, therefore, the GAO concluded that “the premise of the Capper-Volstead antitrust exemption for cooperatives—that farmers cannot effectively bargain independently because their operations are too small—remains.”<sup>98</sup>

The study was much less conclusive as to the price-enhancing effects of Capper-Volstead. A review of the research by the GAO indicated that the relationship between cooperative market power and over-order payments in the dairy industry remained unclear. The GAO therefore stated that “we see no basis for reaching a definitive conclusion concerning the effect of Capper-Volstead on either consumer prices or government costs.”<sup>99</sup>

The GAO was more outspoken in its suggestions for changes in cooperative antitrust enforcement. Section 2 of the Capper-Volstead Act imposes the responsibility for ensuring that cooperatives do not abuse their antitrust exemption upon the Secretary of Agriculture.<sup>100</sup> More specifically, the USDA is responsible for restraining cooperatives when it believes they are “unduly enhancing” prices.<sup>101</sup> A 1979 GAO study had criticized the USDA’s performance of this enforcement role, expressing concern that the USDA was not actively monitoring cooperative pricing and questioning whether the USDA could effectively both encourage and regulate cooperatives.<sup>102</sup>

The 1991 GAO study reiterated these concerns and concluded that the USDA had done little since 1979 to improve its oversight activities.<sup>103</sup> The report stated that the USDA continued

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98. DAIRY COOPERATIVES, *supra* note 97, at 3.

99. *Id.* at 28.

100. 7 U.S.C. § 292 (1988). Section 2 of the Capper-Volstead Act provides:

If the Secretary of Agriculture shall have reason to believe that any such association monopolizes or restrains trade in interstate or foreign commerce to such an extent that the price of any agricultural product is unduly enhanced by reason thereof, he shall serve upon such association a complaint stating his charge in that respect, to which complaint shall be attached, or contained therein, a notice of hearing . . . .

*Id.*

101. *Id.*

102. U.S. GEN. ACCOUNTING OFFICE, GAO/CED 79-109, FAMILY FARMERS NEED COOPERATIVES: BUT SOME ISSUES NEED TO BE RESOLVED 42-44 (July 26, 1979) [hereinafter FAMILY FARMERS]. See also James F. Baarda, *Current Cooperative Topics: Cooperative Antitrust Inquiries*, 12 J. AG. TAX & LAW 78 (1990) (provides further background on the dispute).

103. DAIRY COOPERATIVES, *supra* note 97, at 4-5.

to investigate complaints as received rather than actively monitor prices, and it had investigated only eight complaints in 68 years—all of which had been dismissed.<sup>104</sup> Furthermore, the role of the FTC in monitoring cooperatives had been reduced since 1979. Federal statutes had barred the FTC from examining cooperative conduct exempted under Capper-Volstead in an effort to eliminate perceived operational conflicts between the USDA and the FTC.<sup>105</sup>

Based on its continuing concerns, the GAO recommended that Congress closely monitor the USDA, and if the USDA failed to initiate active monitoring of cooperative activities, Congress should consider assigning regulatory responsibility for cooperative pricing activities to the FTC.<sup>106</sup> The report noted, however, that USDA officials disagreed with the need for such oversight.<sup>107</sup> The controversy regarding the role of the USDA in cooperative anti-trust enforcement therefore continues.

As indicated by this review, agricultural cooperatives remain subject to antitrust challenge when engaging in activities outside the protection of the Capper-Volstead Act—such as acquiring non-cooperative entities. Although cooperatives may take comfort in the continued support for favorable antitrust treatment evidenced by the recent GAO report, they should heed the note of warning sounded by its criticism of the USDA's enforcement role.

#### IV. COOPERATIVE TAXATION

Efforts have recently been made to resolve two tax issues which have been the source of dispute between the IRS and cooperatives through the years. The first issue concerns the characterization of cooperative income as patronage or nonpatronage sourced. The second issue pertains to the requirements for qualifying as an "exempt" cooperative under section 521 of the Internal Revenue Code.

In recognition of their conduit nature, cooperatives are granted certain deductions under Subchapter T of the Internal Revenue Code not available to profit corporations.<sup>108</sup> These deductions consist of amounts returned to cooperative patrons as a portion of the earnings or savings generated by their patronage.<sup>109</sup>

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104. *Id.* at 30-31.

105. *Id.* at 32.

106. *Id.*

107. *Id.* at 33.

108. 26 U.S.C. §§ 1381-88 (1988).

109. *See id.* § 1388(a). The definition of "Patronage dividend" contained in the

The effect of Subchapter T is that such "patronage dividends" are taxed once—at the patron level—rather than taxed twice like corporate dividends.<sup>110</sup>

In order to qualify as "patronage dividends" eligible for the Subchapter T deduction, cooperative earnings must be generated by business with or for patrons.<sup>111</sup> The cooperative acts as a channeling agent for those funds only. Nonpatronage income, in contrast, is taxed at both the cooperative and patron levels like the earnings of any profit corporation. Furthermore, in order to prevent distortions of cooperative income, gains or losses generated by nonpatronage business may not be used to offset gains or losses generated by patronage business.<sup>112</sup> The characterization of income can thus be crucial in determining the tax liability of a cooperative.

Whether income generated by the sale of a cooperative asset is patronage or nonpatronage sourced has been the basis of dispute in the cooperative area for many years. The Treasury Regulations adopted pursuant to Subchapter T, by way of example, categorize income derived from the sale or exchange of capital assets as nonpatronage income.<sup>113</sup> However, the courts on occasion have found that the sale of assets used in the cooperative's business can be patronage sourced.<sup>114</sup> The test adopted by the courts and by the revenue rulings for categorizing cooperative income as patronage sourced has generally been whether the transaction facilitated the basic purchasing, marketing, or service activities of the cooperative rather than merely enhancing its overall profitability.<sup>115</sup>

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Internal Revenue Code includes the requirement that such amount be paid to a patron "on the basis of quantity or value of business done with or for such patron." *Id.*

110. The Tax Court in *Kingfisher Coop. Elevator Ass'n v. Commissioner*, 84 T.C. 600, 613 (1985), recognized "[T]he foundation of subchapter T is a single level of tax." *Id.*

111. 26 U.S.C. § 1388(a) (1988) (providing that the term "Patronage dividend" "does not include any amount paid to a patron to the extent that such amount is out of earnings other than from business done with or for patrons").

112. *Id.* § 1388(j)(1) (specifying that the net earnings of the cooperative may be determined "by offsetting patronage losses . . . against patronage earnings . . ."). The terms "patronage earnings" and "patronage losses" mean "earnings and losses, respectively, which are derived from business done with or for patrons of the organization." *Id.* § 1388(j)(4).

113. 26 C.F.R. § 1.1382-3(c)(2) (1991) describes nonpatronage income. It states that "income derived from sources other than patronage" means incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets, constitutes income derived from sources other than patronage." *Id.*

114. See, e.g., *St. Louis Bank for Coops. v. United States*, 624 F.2d 1041, 1053 (Ct. Cl. 1980) (holding that the profit from the sale of an automobile used in the business of the cooperative, together with other items of income, were patronage-based).

115. See Rev. Rul. 69-576, 1969-2 C.B. 166 (patronage allocations paid by bank for cooperatives qualified as patronage dividends when distributed by recipient cooperative);

Legislation is currently pending before Congress to clarify whether income generated from the sale of a cooperative asset is patronage or nonpatronage sourced. The current bill provides that a cooperative may elect to treat gain or loss from the sale of an asset as ordinary income or loss from business with or for patrons if it was used by the organization "to facilitate the conduct of business done with or for patrons."<sup>116</sup> The statute would, therefore, codify the test developed administratively and judicially. The pending bills are currently under consideration by the appropriate Congressional committees.<sup>117</sup>

The second cooperative tax issue recently clarified concerns section 521 "exempt" cooperatives.<sup>118</sup> Such cooperatives are entitled to deductions in addition to those provided nonexempt cooperatives under Subchapter T.<sup>119</sup> In order to qualify for section 521 status, a cooperative must comply with a variety of restrictions set out in the Internal Revenue Code. One of the designated requirements for a cooperative which has capital stock is that "substantially all such stock" must be "owned by producers who market their products or purchase their supplies and equipment through the association."<sup>120</sup>

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Rev. Rul. 74-160, 1974-1 C.B. 246 (interest earned on loans to keep principal supplier in business qualified as patronage dividends); Rev. Rul. 75-228, 1975-1 C.B. 278 (dividend received by cooperative from its Domestic International Sales Corporation qualified as patronage dividend); *St. Louis Bank for Coops.*, 624 F.2d at 1053 (interest on surplus funds earned by banking cooperative qualified as patronage dividends); *Cotter & Co. v. United States*, 765 F.2d 1102 (1985) (interest earned on commercial paper and certificates of deposit, and rental income, qualified as patronage dividends).

116. H.R. 2361, 102d Cong., 1st Sess. (1991). The bill provides that:

An organization may elect to treat gain or loss from the sale of other disposition of any asset (including stock or any other ownership or financial interest in another entity) as ordinary income or loss and to include such gain or loss in net earnings of the organization from business done with or for patrons, if such asset was used by the organization to facilitate the conduct of business done with or for patrons.

*Id.* For the Senate Bill, see S. 1522, 102d Cong. 1st Sess. (1991).

117. H.R. 2361 was referred to the House Ways and Means Committee on May 15, 1991. S. 1522 was referred to the Senate Finance Committee on July 22, 1991.

118. See 26 U.S.C. § 521 (1988). The term "exempt," although widely used, is technically a misnomer. To the extent that § 521 cooperatives fail to qualify for deductions provided by Subchapter T, they are taxable like any other corporation. *Id.*

119. *Id.* § 1382. The additional deductions are set out in Subchapter T. *Id.* § 1382(c). The additional deductions consist of dividends paid on capital stock, as well as amounts paid to patrons on a patronage basis with respect to earnings derived from business done for the United States or from sources other than patronage. *Id.*

120. *Id.* § 521(b)(2). Section 521(b)(2) provides in full that:

Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned

In Revenue Procedure 73-39,<sup>121</sup> the Internal Revenue Service made clear that only producers marketing or purchasing more than fifty percent of their products or supplies through the cooperative would be counted for purposes of the "substantially all" test. This position was rejected by the tax court in the 1987 case of *Farmers Cooperative Co. v. Commissioner*.<sup>122</sup> The court stated that it was at a loss to understand the Service's concern about the percentage of business activity. Since it could conceive of no evil arising from patrons belonging to many cooperatives or only conducting a small portion of their total business activity with a particular cooperative, the court concluded that the statute would be satisfied by producers marketing *any* of their products or purchasing *any* supplies and equipment through the association.<sup>123</sup>

In Revenue Procedure 90-29, the IRS conceded.<sup>124</sup> Recognizing that the relevant section 521 requirement is qualitative, not quantitative, the Revenue Procedure provides that the stock owned by "persons who transact any amount of current and active patronage with an exempt cooperative during the cooperative's taxable year." will be counted towards the "substantially all" requirement.<sup>125</sup> The former revenue procedure was therefore specifically revoked.

Further clarification and guidance in regard to cooperative tax provisions in the past few years may be gleaned from Private Letter Rulings, despite the fact that such rulings may not be relied upon as precedent.<sup>126</sup> In regard to Subchapter T cooperatives, the Rulings reiterate that whether the cooperative is "operating on a cooperative basis" as required by subsection (a)(1) of section 1381 of the Internal Revenue Code<sup>127</sup> continues to be governed by the following factors: 1) democratic control, 2) subordination of capital, and 3) proportionate allocation of excess operating revenues.<sup>128</sup> Additional factors to be considered include 1) joint effort actively with, for, or on behalf of members, 2) minimum number

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by producers who market their products or purchase their supplies and equipment through the association.

*Id.*

121. Rev. Proc. 73-39, 1973-2 C.B. 502.

122. 89 T.C. 682 (1987).

123. *Farmers Coop. Co. v. Comm'r*, 89 T.C. 682, 687 (1987).

124. Rev. Proc. 90-29, 1990-1 C.B. 533.

125. *Id.*

126. 26 U.S.C. § 6110(j)(3) (1988) (although revenue rulings are binding on the taxpayers in issue, they are not accorded precedential weight, because they are subject to only limited internal review).

127. 26 U.S.C. § 1381(a)(1) (1988).

128. Priv. Ltr. Rul. 91-17-037 (Jan. 28, 1991). See also Priv. Ltr. Rul. 91-08-042 (Nov. 27, 1990).



of patrons, 3) limited business with nonmembers, and 4) proportionate participation in liquidation distributions.<sup>129</sup> Recent rulings also indicate some flexibility within Subchapter T for business arrangements with other entities<sup>130</sup> or for de minimus variations.<sup>131</sup>

As for section 521 cooperatives, recent rulings indicate that the requirements continue to be strictly applied. Such cooperatives can retain section 521 status during liquidation only if liquidating distributions are made in the same manner as earnings.<sup>132</sup> Further, section 521 cooperatives must treat members and nonmembers alike in regard to distributions<sup>133</sup> and may market for nonproducers only in emergency situations.<sup>134</sup> Recent Technical Advice Memorandums further indicate that cooperatives need not file informational returns for hauling services rendered by truckers<sup>135</sup> and that assessments against cooperative members to cover losses may be deducted on the member's tax return as ordinary business expenses.<sup>136</sup>

Although no major changes have been made recently in the area of cooperative taxation, both legislative and administrative action continue to clarify cooperative tax issues. The result is greater certainty for cooperative operations.

## V. SECURITIES

Cooperative authorities have expressed varying degrees of concern through the years as to whether financial instruments issued by cooperatives constitute securities within the meaning of

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129. Priv. Ltr. Rul. 91-17-037 (Jan. 28, 1991).

130. Priv. Ltr. Rul. 90-33-006 (May 14, 1990) (holding that portions of income resulting from sales to cooperative patrons but earned by partnership formed between cooperative and corporation was eligible for patronage dividend deduction).

131. Priv. Ltr. Rul. 90-49-026 (September 10, 1990) (permitting cooperative to reduce recordkeeping costs by retaining very small patronage dividends and by paying small patronage dividends in cash or by application to stock subscriptions).

132. Priv. Ltr. Rul. 90-21-013 (Feb. 21, 1990). Such distributions must be paid on a patronage basis in proportion "insofar as is practicable" to business done. *Id.* For a discussion of that requirement in regard to a cooperative attempting to liquidate on the basis of inadequate records, see Priv. Ltr. Rul. 91-38-014 (June 18, 1991).

133. Priv. Ltr. Rul. 91-14-002 (Nov. 27, 1990) (Section 521 cooperative lost its exempt status by dealing with nonmembers on a commercial basis in purchasing their products at current market price and returning to them no patronage dividends).

134. For two rulings in which section 521 cooperatives were permitted to market for nonproducers under the emergency exception, see Priv. Ltr. Rul. 90-34-043 (May 29, 1990) (nature of production was inelastic, sales commitments were made months in advance, production fell below projections due to heavy rainfall, pest infestation and unexpected production bottlenecks); Priv. Ltr. Rul. 91-32-038 (May 13, 1991) (record bad weather conditions, decline in production, pre-existing contractual commitments).

135. Tech. Adv. Mem. 91-27-002 (Mar. 13, 1991).

136. Tech. Adv. Mem. 91-28-007 (Mar. 28, 1991).

federal and state securities law.<sup>137</sup> If such instruments are so characterized, they become potentially subject to comprehensive and technical registration and disclosure requirements at both the federal and state levels. The question may arise as to a variety of cooperative financial instruments, including membership stock, instruments reflecting retained equity, and debt instruments as discussed in this section.

In regard to the issuance of membership stock, cooperatives have taken solace from the 1975 case of *United Housing Foundation, Inc. v. Forman*.<sup>138</sup> In *Forman*, the Supreme Court held that membership stock in a housing cooperative was not a security within the meaning of the Securities Act of 1933, because it lacked certain characteristics—characteristics typically lacking in several of the financial instruments issued by agricultural cooperatives.<sup>139</sup> These characteristics included that the stock was not transferrable, could not be pledged or bequeathed, carried only one vote despite the number of shares held, and was issued for a particular purpose other than investment. Because the stock was not a security within the meaning of the federal act, the Supreme Court held that it could not serve as the basis for fraud claims under the federal securities laws.<sup>140</sup>

In regard to retained equity, cooperatives have been comforted by certain no-action letters issued by the Securities and Exchange Commission. However, the Commission makes clear that in issuing such letters it reaches no legal conclusion that securities are not being issued.<sup>141</sup> Even if a cooperative instrument is classified as a security, however, an agricultural cooperative might

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137. See, e.g., Steve F. Brault, *Equity Financing of Cooperatives: Advantageous Federal Securities Laws and Tax Treatment*, 21 WILLAMETTE L. REV. 225 (1985) (examines equity capital formation of cooperative in light of federal securities law and tax provisions); Jerome P. Weiss & Edward B. Crosland, *Fact v. Fiction in Regulation of Agricultural Cooperative Securities*, 31 COOP. ACC'T. 12 (1978) (reviews issues and regulatory activities in the area of securities regulation of agricultural cooperatives); Terence J. Centner, *Retained Equities of Agricultural Cooperatives and the Federal Securities Acts*, 31 KAN. L. REV. 245 (1983) (analyzes patronage dividends and per-unit retain allocations to determine likelihood of judicial classification as securities); Jerome P. Weiss, *Reasons for and Costs of Registration of Agricultural Cooperative Securities*, AGRIC. L. J. 201 (1982) (discusses methods to be considered and used by agricultural cooperatives to satisfy applicable federal securities law requirements).

138. 421 U.S. 837 (1975). See Brault, *supra* note 137, at 242-49 (regarding the issuance of no-action letters by the SEC in regard to membership interests).

139. *Forman*, 421 U.S. at 858-60. For a discussion of the instruments issued by agricultural cooperatives, see MATTHEWS, *supra* note 11.

140. *Forman*, 421 U.S. at 859-60.

141. Mid-American Dairymen, Inc., [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) 81,110 (Feb. 2, 1977); United Suppliers, Inc., [1977-78 Transfer binder] Fed. Sec. L. Rep. (CCH) ¶ 81,147 (Mar. 14, 1977). See Weiss, *supra* note 137, at 202-03. In regard to more recent no-action letters, see Brault, *supra* note 137, at 244 n.93.

be able to claim an exemption. Exemptions from registration are created by a variety of specific provisions of federal and state securities statutes.<sup>142</sup>

In regard to debt instruments, the Supreme Court has recently made clear, in *Reves v. Ernst & Young*,<sup>143</sup> that promissory notes issued by agricultural cooperatives with certain characteristics will constitute securities within the meaning of the federal securities law.<sup>144</sup> The case was remanded to the Eighth Circuit Court of Appeals, which has recently held that the debt instruments under consideration also constituted securities within the meaning of the Arkansas blue sky law.<sup>145</sup>

The *Reves* case is instructive as to the circumstances and the instrument characteristics which should cause an agricultural cooperative to consider securities registration under federal or state law.<sup>146</sup> In that case, the relevant cooperative raised money to support its general business operations by the issuance of uncollateralized and uninsured promissory notes payable on demand by the holder.<sup>147</sup> The notes were sold to both members and non-members of the cooperative, were marketed as an "Investment Program," and were paid a variable rate of interest exceeding that of local financial institutions.<sup>148</sup> When the cooperative filed for bankruptcy, holders of the notes sued a variety of defendants, including the cooperative's directors, manager, attorneys, and accountants.<sup>149</sup> Among other claims, the note holders asserted that the defendant accounting firm had intentionally failed to follow generally accepted accounting principles in valuing one of the

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142. See, e.g., 15 U.S.C. §§ 77c(a)(2)-(11), 77d(1)-(6) (1988). In addition to these exemptions, the Securities Act of 1933 sets out a specific exemption for any security issued by "a farmer's cooperative organization exempt from tax under section 521 of Title 26." *Id.* § 77c(a)(5)(B). The Securities Exchange Act of 1934 also recognizes an exemption for cooperative associations as defined in the Agricultural Marketing Act of 1929. Such securities are exempt from registration, periodic reporting, proxy regulation, and insider trading provisions. 15 U.S.C. §§ 78l(g)(2)(E), 78m, 78n, 78p (1988). The Agricultural Marketing Act is set out at 12 U.S.C. § 1141j (1988).

In regard to blue sky laws, forty-two states grant complete or partial exemption to agricultural cooperatives. See JAMES R. BAARDA, USDA, AGRIC. COOPERATIVE SERVICE, STATE SECURITY LAW EXEMPTIONS FOR FARMER COOPERATIVES (1984).

143. 494 U.S. 56 (1990). See generally HARRY BLOOMENTHAL, SECURITIES LAW HANDBOOK § 4.04 (1990-91); Lucy Wiggins, *Cooperatives, Securities Violations, and Advisor Liabilities: A Case Study*, 2 J. OF AGRIC. COOP. 97 (1987).

144. *Reves v. Ernst & Young*, 494 U.S. 56, 67 (1990).

145. *Arthur Young & Co. v. Reves*, 937 F.2d 1310 (8th Cir. 1991). On remand, the Eighth Circuit further found that Arkansas law provides for secondary liability for aiding and abetting securities violations, and that the district court had therefore properly denied the accounting firm's motion for judgment notwithstanding the verdict. *Id.* at 1324.

146. *Reves*, 494 U.S. at 56.

147. *Id.* at 58.

148. *Id.* at 58-59.

149. *Id.* at 59.

cooperative's major assets for purposes of an audit. The holders brought an antifraud action, alleging that if the accountants had properly valued the asset, they would not have purchased the demand notes because the cooperative's insolvency would have been apparent.<sup>150</sup>

Judgment was entered by the district court on a substantial jury award to the note holders based on violations of the antifraud provisions of both federal and state securities law.<sup>151</sup> On appeal by the cooperative's accounting firm, the defendant claimed that the demand notes in issue did not comprise securities within the meaning of either federal or state securities law. The Eighth Circuit, applying the test for securities developed by the Supreme Court in *SEC v. W.J. Howey, Co.*,<sup>152</sup> agreed and therefore reversed the judgment of the district court.<sup>153</sup> On appeal, the Supreme Court, in a split decision, rejected the *Howey* test as the appropriate measure for determining whether a promissory note constituted a security within the meaning of the federal statute and reversed the judgment of the Eighth Circuit.<sup>154</sup>

In place of the *Howey* test, the Supreme Court adopted the "family resemblance" test developed by the Second Circuit as the appropriate standard.<sup>155</sup> The "family resemblance" approach begins with a presumption that any note with a term of more than nine months is a "security."<sup>156</sup> In recognition of the fact that not all notes are securities, however, the approach then identifies a list of notes that are obviously not securities.<sup>157</sup> The "family resemblance" test permits an issuer to rebut the presumption that a note is a security if it can show that the note in question bears a strong family resemblance to an item on the list, or convinces the court to add a new instrument to the list.<sup>158</sup>

The Supreme Court identified four factors that were consid-

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150. *Id.* The asset was a gasohol plant. *Id.*

151. *Id.*

152. 328 U.S. 293 (1946). The *Howey* test defines a security as (1) an investment; (2) in a common enterprise; (3) with a reasonable expectation of profits; (4) to be derived from the entrepreneurial or managerial efforts of others. *Id.* at 301.

153. *Arthur Young & Co. v. Reves*, 856 F.2d 52, 55 (8th Cir. 1988).

154. *Reves*, 494 U.S. at 64.

155. *Id.* at 65.

156. *Id.* at 63.

157. *Id.* The list devised by the Second Circuit and cited with approval by the Supreme Court includes the following types of notes: "[a] note delivered in consumer financing, [a] note secured by a mortgage on a home, a short-term note secured by a lien on a small business or some of its assets, [a] note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business." *Id.* at 65.

158. *Id.*

ered in labeling listed items as nonsecurities. The first factor was the motivation for the sale.<sup>159</sup> "If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the [note] is likely to be a 'security.'"<sup>160</sup> If, on the other hand, the note is utilized to facilitate the purchase of a minor asset or consumer good, to correct the seller's cash-flow difficulties, or to fulfill some other commercial or consumer purpose, the note is less likely to be a security.<sup>161</sup>

The second consideration was the plan of distribution.<sup>162</sup> The Court stated that it would examine the instrument to determine whether it was one in which there was "common trading for speculation or investment."<sup>163</sup> The third factor was the reasonable expectation of the investing public.<sup>164</sup> The Court indicated that a note may be held to be a security because of public expectations, even though an economic analysis of the transaction might suggest otherwise.<sup>165</sup> The final factor identified by the Court was whether another regulatory scheme existed which "significantly reduce[d] the risk of the instrument, thereby rendering [the] application of the Securities Acts unnecessary."<sup>166</sup>

Applying the family resemblance approach to the facts in *Reves*, the Court had little difficulty in concluding that the notes in issue were securities.<sup>167</sup> Regarding the motivation factor, the Court stated that the cooperative had "sold the notes in an effort to raise capital for its general business operations, and purchasers [had] bought them in order to earn a profit in the form of interest."<sup>168</sup> Regarding the distribution factor, the Court acknowledged that the Coop had offered the notes over an extended period to its 23,000 members, as well as to nonmembers, and that more than 1600 people held notes at the time the cooperative filed

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159. *Reves*, 494 U.S. at 66.

160. *Id.*

161. *Id.*

162. *Id.*

163. *Id.* (quoting *SEC v. Joiner Leasing Corp.*, 320 U.S. 344, 355 (1943)).

164. *Reves*, 494 U.S. at 66.

165. *Id.*

166. *Id.* at 67.

167. *Id.*

168. *Id.* at 67-68. The Supreme Court rejected the position of the Eighth Circuit that the interest on the notes in issue could not be construed as "profit." *Id.* at 67-68 n.4. In a footnote, the Court emphasized that "by 'profit' in the context of notes, we mean 'a valuable return on an investment,' which undoubtedly includes interest." *Id.* The Court recognized that 'profit' had been defined more restrictively in applying the *Howey* test to investment contracts, but refused to apply that restrictive definition to the determination of whether an instrument was a "note" within the definition of the federal securities acts. *Id.*

for bankruptcy.<sup>169</sup> Although the notes were not traded on an exchange, the Court found that the offer and sale to that broad segment of the public sufficiently established the requisite "common trading."<sup>170</sup>

As for the public expectation factor, the Court noted that advertisements for the notes characterized them as "investments," and that there were no countervailing factors leading reasonable persons to question that characterization.<sup>171</sup> Finally, in considering alternative protection, the Court found no risk-reducing factor to suggest that the instruments were not securities.<sup>172</sup> Pointing out that the notes were uncollateralized and uninsured, the Court expressed its concern that the notes in issue would escape federal regulation entirely if the securities acts did not apply.<sup>173</sup>

In light of *Reves*, it would behoove agricultural cooperatives to undertake a thoughtful review of all financial instruments they issue. Although membership stock and equity certificates may still fall outside the securities classification as discussed above, debt instruments issued for revenue-raising purposes should be carefully evaluated under the *Reves* guidelines.

## VI. BANKRUPTCY

Cooperative issues have also recently been addressed in the

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169. *Reves*, 494 U.S. at 68.

170. *Id.*

171. *Id.* at 69.

172. *Id.*

173. *Id.* A final issue addressed by the Court caused four Justices to dissent. The issue was whether the notes in *Reves* fell within an exemption in the 1934 Act for "any note . . . which has a maturity at the time of issuance of not exceeding nine months . . ." *Id.* at 70 (citing 15 U.S.C. § 78c(a)(10) (1988)). Although the notes in issue were demand notes and thus immediately mature for state purposes, four Justices concluded that the maturity of the notes was a question of federal law. *Id.* at 71-72. Since demand could be made for payment either before or after the nine-months limit, the plurality opinion stated that it was plausible that the maturity of a demand note could be regarded as being in excess of nine months. *Id.* at 72-73. The plurality stated, "Given this ambiguity, the exclusion must be interpreted in accordance with its purpose." *Id.* at 73. In light of Congress' broader purpose of ensuring that investments be regulated to prevent fraud and abuse, the four Justices interpreted the exception not to cover the demand notes in issue. *Id.*

Justice Stevens, in a concurring opinion, agreed that the notes in issue were securities but disagreed as to why they fell outside the nine-months exemption. *Id.* at 73-76 (Stevens, J., concurring). Justice Stevens concluded that the exemption should not be read literally, but should apply only to the types of commercial paper indicated by the legislative history of the 1933 Act—that is, to short-term, high quality instruments issued to fund current operations and sold only to highly sophisticated investors. *Id.* at 75-76.

Justices Rehnquist, White, O'Connor and Scalia dissented. Although agreeing that the notes in issue were "securities," the dissenters concluded that the instruments issued by the Co-op were exempted by the nine-months exclusion. *Id.* at 76-82 (Rehnquist, J., dissenting). Asserting that the notes were immediately due because payable on demand, the dissenters concluded that the notes therefore fell within the nine-months exemption. *Id.* at 82.

bankruptcy field.<sup>174</sup> The United States Bankruptcy Court for the District of Minnesota considered jurisdictional issues in *In re Fulda Independent Cooperative*.<sup>175</sup> In that case, a Minnesota agricultural cooperative had filed a voluntary Chapter 7 bankruptcy petition, designating the St. Paul Bank for Cooperatives as its principal secured creditor. The Bank agreed to settle its claims against the bankruptcy estate in return for certain property and the proceeds of the sale of other property. Subsequent to the sale, certain cooperative patrons brought suit against the Bank in state court. The patrons alleged that the Bank had converted agricultural supplies, that vehicles had been fraudulently transferred to the Bank, and that the Bank had committed fraud or negligent misrepresentation in holding out that it had the right to seize supplies and take certain other action. The Bank removed the case to bankruptcy court, and the patrons thereafter sought to remove it from bankruptcy jurisdiction.

The bankruptcy court found that an action based on the fraudulent transfer of vehicles was a "core proceeding" over which it had jurisdiction.<sup>176</sup> The court noted that only the bankruptcy trustee has standing to prosecute an action for avoidance of the fraudulent conveyance of the debtor's property.<sup>177</sup> The court therefore dismissed with prejudice the patrons' cause of action based on the transfer of vehicles, but specified that such dismissal was without prejudice to the bankruptcy trustee.<sup>178</sup> The court also found that the remaining claims were "related proceedings" over which it had jurisdiction.<sup>179</sup> Because the claims were based on common law injuries to property and were likely to be determined prior to the termination of the bankruptcy proceeding, the court exercised its discretion to abstain from hearing and deciding them.<sup>180</sup> It therefore remanded those issues to the state court.<sup>181</sup>

The case illustrates the difficulty patrons may have in characterizing injuries as individual claims separate from the cooperative bankruptcy proceeding. Although the fraudulent transfer counts of the patrons' complaint were "cleverly worded" as a claim for

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174. For bankruptcy issues in regard to cooperatives generally, see John D. Copeland, *The Status of an Agricultural Cooperative When a Farmer Member Experiences Financial Distress*, 23 U.C. DAVIS L. REV. 551 (1990).

175. 130 B.R. 967 (Bankr. D. Minn. 1991).

176. *In re Fulda Independent Coop.*, 130 B.R. 967, 973-74 (Bankr. D. Minn. 1991).

177. *Id.* at 978.

178. *Id.* at 979.

179. *Id.* at 975.

180. *Id.*

181. *Id.* at 978.

money damages rather than the physical return of the property, the court in *In re Fulda* looked to the gist of the complaint.<sup>182</sup> The court held that the substance of the action was the satisfaction of patron claims against the cooperative by the recovery of value lost by the debtor in a fraudulent transfer, which issue should be determined by the bankruptcy court.<sup>183</sup>

Cooperative bankruptcy may also trigger the resolution of certain side issues. In *Quattrone Accountants, Inc. v. IRS*,<sup>184</sup> the cooperative's accounting firm was held liable for federal employee withholding taxes not paid by a bankrupt cooperative.<sup>185</sup> The court noted that the accounting firm had been authorized to pay bills, distribute payroll, and prepare and file tax returns for the cooperative without prior board approval.<sup>186</sup> The court found that the firm knew taxes were not being paid and that the firm had such influence with the board that it could have caused the taxes to be paid rather than debts to other creditors.<sup>187</sup> Under such circumstances, the court concluded that the accounting firm was a responsible person wilfully failing to account for and pay federal employment taxes within the meaning of Section 6672 of the Internal Revenue Code.<sup>188</sup> Accountants granted comparable powers by agricultural cooperatives would, therefore, be well advised to use their influence to assure that taxes are paid as due.

Bankruptcy issues also arise when the bankrupt party is a cooperative patron rather than the cooperative itself. In the recent case of *In re Bennett*,<sup>189</sup> a husband and wife filed a voluntary Chapter 7 bankruptcy petition and were discharged in 1985.<sup>190</sup> Over three years later, the Bennetts filed an amendment to their schedules to add property not originally listed. The additional property included bonds and "shares of equity patronage" in a cotton cooperative. Furthermore, the Bennetts amended

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182. *Id.*

183. *Id.*

184. 895 F.2d 921 (3d Cir. 1990).

185. *Quattrone Accts., Inc. v. IRS*, 895 F.2d 921, 928 (3d Cir. 1990).

186. *Id.* at 927.

187. *Id.* at 928.

188. *Quattrone*, 895 F.2d at 927. Section 6672 provides that:

Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

26 U.S.C. § 6672(a) (1988).

189. 126 B.R. 869 (Bankr. N.D. Tex. 1991).

190. *In re Bennett*, 126 B.R. 869, 871 (Bankr. N.D. Tex. 1991).



their exemptions to claim the bonds (valued at \$1) and shares (valued at \$8297) as exempt property. Debtors refused to divulge the total amount of money they had received from these sources. The Trustee's exhibits revealed, however, that the Debtors had received substantial payments on the bonds and over \$92,500 in redemption of equity patronage since the filing of their petition. Based on the failure of the debtors to report and deliver that property, the Trustee requested the revocation of their discharge.

Since all the payments in issue arose out of Debtors' prepetition farming operations, the court concluded that all such payments constituted property of the estate.<sup>191</sup> Holding that the Bennetts had knowingly and fraudulently failed to surrender all property and records concerning property of the estate to the Trustee, the court revoked the discharge in bankruptcy and entered judgment against the Bennetts for the property received by them post petition, less amounts the court allowed as exempt.<sup>192</sup>

As the above cases indicate, parties involved in transactions with agricultural cooperatives are subject to the same bankruptcy risks and obligations as those dealing with other types of entities. Such parties must, therefore, exercise care to avoid liability for unpaid obligations of the bankrupt entity, such as that imposed upon the accountants in *In re Fulda*. They should also list honestly and completely any assets held by them in an agricultural cooperative to protect their bankruptcy discharge from the type of revocation granted in *In re Bennett*.

## VII. MERGER

One problem which frequently arises when cooperatives merge is the extent of protection afforded to dissenting members.<sup>193</sup> Traditional corporate law permits shareholders dissenting from a merger to exercise appraisal rights to receive the value of their shares.<sup>194</sup> Whether such rights are afforded to cooperative members depends upon state law. Many state cooperative statutes contain specific references to merger,<sup>195</sup> although only a few detail

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191. *Id.* at 873.

192. *Id.* at 876.

193. See generally Kathryn J. Sedo, *Cooperative Mergers and Consolidations: A Consideration of the Legal and Tax Issues*, 63 N.D. L. REV. 377 (1987).

194. See, e.g., REVISED MODEL BUSINESS CORPORATION ACT §§ 13.01-13.31 (1984) (which was promulgated by the Committee on Corporate Laws (Section of Corporation, Banking & Business Law) of the American Bar Association. This statute has served as the model for many state corporate codes).

195. See BAARDA, *supra* note 2, § 16.01 and Table 16.01.

the rights of members who dissent.<sup>196</sup> In the absence of a cooperative provision, the general corporate law will usually be relied upon.<sup>197</sup> Since corporate law only applies if its provisions are not inconsistent with the cooperative statute, however, the applicability of corporate appraisal rights to cooperatives may still be subject to dispute.<sup>198</sup>

The issue of dissenters' rights at cooperative merger recently arose in the case of *Van Der Maaten v. Farmers Cooperative Co.*<sup>199</sup> In that case, a member of both of two merging cooperatives dissented from the merger and sought a lump sum payment of his interest.<sup>200</sup> The relevant Iowa cooperative statute provided as follows:

The new association shall pay to each dissenting member in cash within sixty days after the merger or consolidation the amount paid in cash by the dissenting member for that member's interest in the old association. The new association shall pay the remainder of each dissenting member's fair value at the same time other payments of deferred patronage dividends or redemption of preferred stock are made, but in any event within fifteen years after the merger or consolidation.<sup>201</sup>

Pursuant to the statute, Van Der Maaten received the \$20 he had paid for his interest in the old associations.<sup>202</sup> The parties further agreed that the "fair value" of his interest in the merged cooperatives was \$11,193.29.<sup>203</sup> The only issue in dispute, therefore, was when that amount was required to be paid by the cooperative. Van Der Maaten asserted that the amount must be paid *in full* at the time the cooperative made patronage dividend payments or redeemed preferred stock. The cooperative, on the other hand, asserted that Van Der Maaten was entitled to receive only a pro rata share of the total when such payments were made.

In terms of policy, the cooperative argued that the statute was designed to relieve financially troubled cooperatives of the obligation to pay a dissenting member in full. The member responded that financially troubled cooperatives were adequately protected

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196. See *id.* § 16.09 and Table 16.09.

197. See *supra* note 15.

198. See Sedo, *supra* note 193, at 398-99.

199. 472 N.W.2d 283 (Iowa 1991).

200. *Van Der Maaten v. Farmers Coop. Co.*, 472 N.W.2d 283, 283-84 (Iowa 1991).

201. IOWA CODE § 499.66(3) (1991).

202. *Van Der Maaten*, 472 N.W.2d at 284.

203. *Id.*

because they need not pay at all for fifteen years, unless financially able to pay dividends to all members.

The Iowa Supreme Court found Van Der Maaten's interpretation persuasive.<sup>204</sup> Because the statute was susceptible to two constructions, the court referred to prior legislation.<sup>205</sup> The prior statute had specifically required that payments to dissenting members at merger be paid at the same time and in the same proportion as those to nondissenting members.<sup>206</sup> Furthermore, a companion statute prohibited dissenting members from thereafter doing business with the cooperative. Because the statute had been amended to delete the proportionality requirement and because it appeared to sever the relationship between former members and the new association, the court interpreted it to require a lump sum payment to the dissenting member at the time the cooperative paid patronage dividends or redeemed preferred stock.<sup>207</sup> The court stated that it did not attribute to the legislature an intention to deny the former member the privilege of doing business with the cooperative, yet require him to continue to support it financially.<sup>208</sup> The rights of dissenters at the merger of agricultural cooperatives remains a controversial area. As the *Van Der Maaten* case illustrates, even cooperative statutes specifically addressing the issue of merger may require judicial clarification.

### VIII. MISCELLANEOUS ISSUES

A variety of issues have been addressed in recent cooperative cases which are not unique to cooperatives. Cooperatives are often parties to product liability suits, either as plaintiff<sup>209</sup> or defendant.<sup>210</sup> Cooperatives may be held liable for sexual discrimination<sup>211</sup> or for retaliatory discharge,<sup>212</sup> and the entity and its

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204. *Id.*

205. *Id.*

206. *Id.* at 285.

207. *Id.*

208. *Id.*

209. *See, e.g.,* Ag-Chem Equip. v. Limestone Farmers Coop., 567 So. 2d 250 (Ala. 1990) (cooperative as plaintiff in suit for breach of warranty as to fertilizer applicator); Midwhew Powder Co. v. Clayton Indus., 460 N.W.2d 426 (Wis. App. 1990) (corporation and two cheese cooperatives bring suit against manufacturer and seller of steam generators used to generate electric power).

210. *See, e.g.,* Evangeline Farmers Coop. v. Fontenot, 565 So. 2d 1040 (La. Ct. App. 1990) (cooperative liable for damages for negligently supplying wrong chemical); Baggett v. Bradley County Farmers Coop., 789 S.W.2d 733 (Ark. 1990) (suit against cooperative for negligently mixing cattle feed into hog feed survives summary judgment motion); Shuman v. Laverne Farmers Coop., 809 P.2d 76 (Okla. Ct. App. 1991) (cooperative liable for compensatory and punitive damages for failure to pass on manufacturer's warning regarding use of tire).

211. *See* Sandoval v. Saticoy Lemon Ass'n, 747 F. Supp. 1373 (C.D. Cal. 1990) (entity

officers may be barred from government contracts as a result of violations of ASCS requirements.<sup>213</sup> It may also be necessary to determine the issue of cooperative citizenship for purposes of federal diversity jurisdiction.<sup>214</sup> Although these cases raise interesting issues, they contribute little to the understanding of the agricultural cooperative as a unique entity.

## IX. CONCLUSION

This review of current developments in the cooperative field reveals that even in a short time span a variety of cooperative issues have been addressed. Interesting questions have been confronted in the courts concerning fiduciary duties owed by cooperatives, the classification of cooperative instruments as securities, and the rights of dissenters at cooperative merger. Federal administrative agencies continue to attack cooperative acquisitions of noncooperatives, to evaluate the Capper-Volstead exemption, and to enforce the federal tax code in light of cooperative functions. In addition, Congress has taken steps to clarify certain cooperative tax provisions. As in any field of legal study, the law applicable to agricultural cooperatives reveals a continuing evolution based on the interplay of the various branches of government.

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resulting from merger of two agricultural cooperatives held liable under Title VII for sexual discrimination in hiring practices).

212. See *Spiker v. Farmers Coop. Exchange*, 802 P.2d 650 (Okla. 1990) (retaliatory discharge suit against cooperative held to survive death of plaintiff.)

213. See *Girard v. Klopfenstein*, 930 F.2d 738 (9th Cir. 1991). In that case, the CCC discovered that some of the barrel cheese sold by a cooperative to the ASCS was ineligible. After a preliminary investigation, the cooperative was suspended from selling cheese to the government for 18 months. *Id.* at 739. Furthermore, the President and Sales Manager were notified of a hearing to debar them from participation in government contracts for one year. *Id.* at 739. The President and Sales Manager, therefore, brought a declaratory judgment suit to determine if they were entitled to have the hearing a) conducted by an administrative law judge, and b) conducted pursuant to the Administrative Procedure Act. *Id.* at 740. The Ninth Circuit concluded that neither were required. *Id.* at 743.

214. See *Luke v. Western Dairy Coop., Inc.* 734 F. Supp. 963, 967 (D. Utah 1990) (for purposes of federal diversity jurisdiction, dairyman's cooperative is citizen of both state of incorporation and state of principal place of business).

