
Revolving Patron-Member Equity in Cooperatives

Obligations and Expectations

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August 2015

“Although not legally obligated to repay member equity within a specified period, cooperatives often establish a target period or revolving cycle for returning capital...”¹

Cooperatives are organized to provide goods or services to their patron member owners, not financial returns to investors. The cooperative’s primary value to its patron members is transactional. While the cooperative operates “at cost” to deliver this value, as a business it also requires ongoing sources of capital for financial stability, and for reinvestment that allow it to continue to meet patron member needs.

Unique cooperative financial practices have evolved to manage capital requirements while maintaining patron member control. Reflecting its “at cost” service orientation, a cooperative may annually allocate any remaining net margin or profit to patron members in proportion to their use of cooperative services as “patronage.” However, so that patron members can contribute to meeting the capital needs of the cooperative, a portion of each individual’s allocated patronage may be retained. These retained patronage allocations are treated as patron equity investments on the cooperative’s balance sheet.

The strategic management of retained patron equity, including the possibility of eventual redemption, is a

perennial issue for cooperatives. Practices for revolving, or paying out, these patron equity accounts vary widely, and have been influenced by legal and tax requirements, capital needs, history, and expert opinion. Over time, these practices have been adopted and modified by members, board or directors, and management at the cooperative level. Individual cooperative traditions may develop that are closely associated with how the cooperative conducts business and manages its retained patron equity program, influencing expectations.

Statutory obligations to return retained equity

Most cooperatives, similar to other business entities, are incorporated under individual state cooperative statutes that enable them to conduct business.² State statutes are diverse, with widely varying requirements.

Every state has at least one cooperative incorporation statute for entities organized for agricultural purposes. Approximately half of the state cooperative statutes are based on the “Standard Act”,³ which was drafted by Aaron Sapiro and adopted by many states in the 1920s.⁴

At least half of the cooperative state statutes also allow cooperative incorporation for other, non-agricultural purposes. If the state statute is limited to agricultural purposes, there may – or may not – be additional state cooperative statutes to address this limitation.

State statutes typically generally address cooperative financial practices, but the level of specificity can differ significantly.⁵ A majority of state statutes permit the cooperative to create and maintain a general non-allocated reserve fund from a percentage of net margins, with varying requirements and limits⁶. In addition, a majority of statutes permit the cooperative to require periodic financial contributions by patron members to the cooperative, but only 16 statutes specifically refer to obtaining patron equity contributions through retained patronage allocations.

Most state statutes also make general provisions for assessing and returning patron “member interests” when membership is ended, either voluntarily or through expulsion. Member interest can be very broadly defined, and might include member stock, preferred stock, and other financial instruments, including retained patron equity.

The Standard Act and over one half of the statutes that use similar language specifies that the assessment of member interests is determined by the board of directors, which “... shall equitably and conclusively appraise his property interests in the association and shall fix the amount thereof in money...”

While the Standard Act specifies repayment within one year after a member withdraws or is expelled, many state statutes modify this time requirement, or leave it to the discretion of the board.⁷

Only a few statutes specifically address obligations for “redeeming”, or returning retained patron equity, and how this might be managed.⁸

While many state statutes may not specifically address certain cooperative financial practices, most state statutes give the cooperative bylaws wide leeway to describe or require a variety of governance and financial practices, including the distribution of net margins or profits⁹, periodic patronage-based equity contributions by members,¹⁰ and returning retained patron equity. Forty-five statutes mention a bylaw provision to determine the member’s interests in the association at the time of membership termination; thirty-one of these use language similar to the Standard Act.¹¹

Other legal considerations

The Standard Act described associations incorporated under it as non-profit, “inasmuch as they are not organized to make profit for themselves, as such, or for their members, as such, but only for their members as producers.” Since cooperatives are established to provide services, not reward investment, the individual’s claim on an equity interest is conditioned by the operation of the enterprise overall.¹²

The cooperative has an interest in maintaining a stable financial structure that benefits all members, and the board of directors carries out this fiduciary responsibility. Individual redemption of retained patron equity can sometimes come into conflict with these interests of the cooperative.

In lawsuits brought by cooperative members, the courts have considered both bylaw provisions and documentation that reflects member equity interests.¹³ Bylaw descriptions of financial structure, redemption rights, and decision-making powers of the board of directors are critical. Court findings about patron member equity redemption also may be affected by the type of equity, such as membership stock, preferred stock, or retained equity, that is in question.

Though the cases can be complex, several examples highlight how bylaws, the nature of equity documentation, and director discretion can influence rulings on the obligation of a cooperative to redeem retained patron equity. In the 1981 Sanchez case¹⁴, the court supported the cooperative’s bylaws, which stated that there was no intrinsic value to membership. As a result, the cooperative was not obligated to pay anything to members when membership ended. This allowed the board of directors to exercise discretion in how and when any redemption of patron member equity interests might occur. The bylaw redemption procedures were sufficient to override the California statute’s mandate to redeem the equity within one year of expulsion.¹⁵

In the 1984 Shiflett¹⁶ case, the Virginia court determined that the patron member’s retained equity account was not a true “account”, which by definition included the right to demand payment. A claim had been placed on a bankrupt member’s retained patron equity in an “account” on the cooperative’s books. However, because the cooperative’s bylaws made the payment of any redeemed patronage conditional on the discretion of the board, it was determined that the patron member’s retained equity remained outside bankruptcy trustee rights.¹⁷

The 1987 Atchison case¹⁸ found that the allocation of equity on the balance sheet does not represent an indebtedness to the patron member, because the equity credits are contingent on board decisions. Patron members wishing to offset individual debts to the cooperative with that individual's patron equity interests could not do so.

Observations and Conclusion

Financial participation in the cooperative is a patron member responsibility, and is consistent with cooperative practice.¹⁹ Cooperatives have a long history of retaining a portion of net margins allocated to members based on patronage, so that active patron members could provide ongoing equity financing to their cooperative in proportion to their patronage.²⁰

However, early cooperative leaders often did not recognize the extent to which the cooperative membership might change, and the implications that this changing base of patron members had on retained patron equity. Newer patron members with smaller equity contributions benefited from the equity contributions that had been made over time by inactive or retiring patron members. Democratic control of the cooperative, which resided in the voting rights of active members, might not align with the levels of retained patron equity held by inactive, nonvoting members.

The concept of a revolving finance plan evolved in an attempt to systematically manage these tendencies. It aligned active patron member control and equity participation by returning, or "redeeming", older retained equities and replenishing the capital base with retained allocations from more recent patron activity. This approach developed over two decades in the early 20th century. Although its acceptance was slow, it is now a widely accepted cooperative practice.²¹

Revolving finance plans are one way to address the unique relationship in cooperatives between equity and ownership. Generally defined, equity is what belongs to the owners of an enterprise after the debt and other obligations have been paid. Ownership is determined by equity capital contributions, which give control rights and claims to residual equity.

In the case of a cooperative, however, the relationship between equity and ownership is more complicated, because member ownership and control is also tied to active patronage. The ability of a cooperative to redeem

equity on a revolving basis aligns active patronage and equity participation. In more recent times, the designation of retained patron equity has been compared to "temporary" equity; it is capital at risk, but it also carries some expectation of redemption.

Successful implementation of revolving finance plans is challenging. It is conditioned by the vagaries inherent in the business cycle, and in the market conditions that drive cooperative member participation. Cooperatives have patron equity redemption cycles that can range from several to 25 years or more. Some cooperatives only revolve out retained patron equity at patron retirement, or as part of an estate settlement. The longer the cycle to redeem equity, the less a revolving fund meets its goal of aligning patronage and equity participation, and the more the retained patron equity functions like permanent equity.

Bylaws typically grant cooperatives wide discretion in exercising patron equity redemption decisions, and there is not a general legal requirement for patron equity redemptions. These conditions give cooperatives the flexibility to meet the collective needs of their members. It is critical to maintain communication and education with all of the cooperative's stakeholder groups about the ongoing tradeoffs between cooperative and member financial interests.

¹ *Cooperative Financing and Taxation, Farmer Cooperatives in the United States*, USDA Cooperative Information Report Section 9, 11.

<http://www.rd.usda.gov/files/cir1sec9.pdf>

² James R. Baarda, *State Incorporation Statutes for Farmer Cooperatives*, USDA Cooperative Information Report 30, 1987. This publication provides a broad overview and specifically compares statutes that cover farmer cooperative activity. Business and securities law have continued to evolve, and statutes may have amended or replaced with new statutes. Statements about statutes made in this article are based on this publication unless otherwise noted, since it is the only compendium of state cooperative statutes available.

<http://www.uwcc.wisc.edu/issues/Legal-Tax/>

³ Part 1 Carroll's Kentucky Statutes Annotated. 1936 Revision Containing all Laws to October 1936 8th, William Edward Baldwin & Richard Priest Dietzman eds. 1936, 461. <http://heinonline.org>

⁴ Baarda, USDA CIR 30, xii.

⁵ Baarda, USDA CIR 30, xiii.

⁶ *Ibid*, 113.

⁷ *Ibid*, 56.

⁸ *Ibid*, 115.

⁹ *Ibid*, 60.

¹⁰ *Ibid*, 112.

¹¹ *Ibid*, 55.

¹² James Baarda, "Farmer Cooperative Equity Conflicts: Judicial Decisions in the 1980s," *Hamline Law Review* 12 699, (1989): 706.

http://nationalaglawcenter.org/publication/baarda-farmer-cooperative-equity-conflicts-judicial-decisions-in-the-1980s-12-hamline-l-rev-699-723-1989/wppa_open/

¹³ *Ibid*, 707

¹⁴ *Sanchez v. Grain Growers Ass'n*, 126 Cal. App. 3d 665 (3rd App. Dist. 1981)

¹⁵ Baarda, "Farmer Cooperative Equity Conflicts," 707.

¹⁶ *In re Shiflett*, 40 B.R. 493 (Bankr. WD Va. 1984)

¹⁷ Baarda, "Farmer Cooperative Equity Conflicts," 711.

¹⁸ *Atchison County Farmers Union Co-op Ass'n v. Turnbull*, 241 Kan. 357 (1987)

¹⁹ Jeffrey S. Royer, "Cooperative Principles and Equity Financing: A Critical Discussion," *Journal of Agricultural Cooperation* 79 (1992), 82.

²⁰ Henry E. Erdman and Grace H. Larsen, *Revolving Finance in Agricultural Cooperatives* (Madison, WI: Mirmir Publishers Inc. 1965), 69.

²¹ *Ibid*, 70.