



RETAINED COOPERATIVE EARNINGS: REDEMPTION VS. SECURITIES EXPOSURE

Agribusiness cooperatives differ from their investor-owned corporate counterparts. Some differences may be subtle, cosmetic, and nearly insignificant. Others are more substantial and complex. One of the most important distinguishing features of an agribusiness cooperative is the fact that member-patrons help to finance the businesses operation, thereby serving as both customers of, and investors in, the cooperative. Most commonly, member-investment in the cooperative results from the cooperative's act of retaining a portion of each year's savings or earnings, declared and allocated as patronage dividends. Such retains are normally referred to as retained patronage dividends and evidenced as qualified written notices of allocation (certificates) in compliance with Subchapter T of the IRS Code. Many cooperatives follow this practice because section 1382 of the tax code provides that qualifying patronage dividends shall not be taken into account in determining a conforming cooperative's taxable income. In a sense, patronage earned and allocated to cooperative patrons is treated as a price rebate, such that a corporate profit therefore ceases to exist and the patronage received by the member is treated (and taxed) as personal income. In most cases, not all earned and allocated patronage is returned to cooperative members in cash. A portion is retained and credited to each member's investment in the cooperative.

The act of retaining patronage for purposes of enhancing cooperative investment capital (equity) must be evidenced by written notices of allocation in the form of capital stock, revolving fund certificates or retain certificates. The IRS requires that such written notices of allocated but retained patronage may not exceed 80% of total patronage dividends; i.e., at least 20% must be received by member-patrons in cash or its equivalent. It has

long been argued that such tax provisions provide for the cooperative a comparative advantage over investor-owned corporate counterparts.

Opposing views on this issue are well documented and are not the intended topic of this discussion.

Research has shown that most retained patronage dividends are interest-free investments by patrons and carry no maturity date; i.e., they may be redeemed only at the discretion of the cooperative's board of directors. As such, they constitute an important source of equity capital for cooperatives. Of course, because they are interest-free and not due-dated, some cooperatives have so structured their operations as to habitually retain the maximum allowable amount, while becoming somewhat absent-minded about redeeming the aging certificates even for those cooperative patrons long retired from farming, or possibly even deceased.

A Cooperative Quagmire

Any cooperative, which routinely retains the maximum allowable patronage while not providing for the timely redemption of older certificates, is entrapped in a financial quagmire. Legislative and judicial officials have recently suggested that such actions are unfair and inequitable. Some states and even the U.S. Congress have considered legislation that would reduce the maximum retains level from 80 to 50%. The General Accounting Office and the Department of Justice have suggested that limits be placed on the equity capital revolve period. Finally, some cooperative patrons have appealed to the courts for relief from their cooperative's practice of never redeeming certain retained equities.¹ Elsewhere, groups of cooperative patrons, in search of some immediate liquid value for their aging certificates, have asked

¹ Abrahamsen, Martin. *Cooperative Business Enterprise*, New York. McGraw-Hill, 1976.

their cooperative to offset unpaid accounts receivable with the face (or discounted) value of long-held equity certificates. All things considered, the issue of cooperative equity and its treatment is a problem for which there doesn't seem to be an answer.

Treatment as a Security

In search of an answer, some cooperative researchers have suggested that retained patronage dividend certificates could be regulated by the terms of our federal Securities Acts.² Since such certificates evidence an investment of members' capital in their cooperative, it could be argued that such an investment is similar to investments governed by the Acts. The objective of this discussion is to consider the basis for such a proposed application of the Acts. Further, I shall attempt to assess several professional views regarding cooperatives' exposures, should any restrictions on cooperative equity certificates apply.

The Security Acts of 1933 and 1934 sought to address excesses and public abuses commensurate with the uncontrolled sale of securities in the marketplace. The term "security" was defined to mean any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation, trust certificate, or investment contract. Since the categories listed are not meant to be mutually exclusive, a brief review of case law suggests that the "investment contract" category is most likely to include cooperative patronage dividends.³ The Acts contain several stated exemptions, two of which apply specifically to cooperatives. Section 3(a)(5)(B) of the 1933 Act exempts securities issued by cooperatives operating under Section 521 of the Internal Revenue Code, except where the cooperative commits a fraudulent act in the issuance of its securities. Section 12(g)(2)(E) of the 1934 Act exempts cooperatives organized under the 1929 Agricultural Marketing Act from the Act's registration requirements, reporting requirements, proxy regulations, and insider trading provisions.

² Centner, T. J. "Agricultural Cooperatives: Retained Patronage Dividends and the Federal Security Acts." *N.C. Journal of Agr. Econ.*, Vol. 6, No. 1, January 1984.

³ Weiss, J. P. "Fact vs. Fiction in Regulation of Agricultural Cooperative Securities." *The Cooperative Accountant*, 31(1978):12-42.

The congressional intent of these exemptions remains unclear, but many would argue that they were designed to address only the sale of general cooperative membership stock. In search of a clarification of this issue, a researcher reviewed SEC actions and rulings only to conclude that, "The SEC has demonstrated a chameleon-like quality in changing its interpretation of statutory provisions..."⁴ Subsequently, he concluded that cooperatives were not shielded from the provision of the Acts, particularly those addressing fraudulent practices.

On the basis of this review, a cooperative member holding retained equity certificates could allege federal jurisdiction under terms of the Acts and sue for the immediate redemption of his/her certificates. The courts would then decide whether or not retained patronage was a security, as defined by the Acts, and whether a fraudulent act had been committed with its issuance. Membership charges might focus on the following issues:

Nonregistration: Any cooperative not operating under section 521 could be found to violate the registration requirements of the 1933 Act. The member's contention would be that certificates had been issued without registration and that the mails and/or other means of interstate commerce had been used in their delivery. In a similar context, those cooperatives not organized under the 1929 Act could be found in non-compliance with the registration requirement of the 1934 Act.

Errors and Omissions: Without exception, all cooperatives are subject to the test of honesty and accuracy in the act of issuing equity certificates. Omitting a material fact or issuing an untrue statement of fact will subject the cooperative to terms of section 12(2) of the 1933 Act. If the cooperative's retained dividends are judged to be securities and there is an omission of a material fact associated with their issuance, the cooperative may be liable for the immediate payment of these dividends plus interest for the period such securities were held by the patron.

Fraud: The failure of a cooperative to allocate patronage dividends or to fully disclose the board of directors' discretionary authority to redeem such securities evidencing the dividends could be found to comprise an act of deceit or fraud. Either the SEC or a cooperative member could bring

⁴ Centner, T. J. Op. cit., p. 39.

legal action to enjoin such a practice and damages could be awarded under section 17 of the 1933 Act.

Antifraud: Finally, the failure of a cooperative to provide for the orderly redemption of retained patronage dividends of former patrons could be found to be manipulative and deceptive, where that cooperative is subject to section 10(b) of the 1934 Act.

Are Retained Patronage Dividends Really Securities?

Regarding all the legal exposures noted above, the paramount question is whether or not a cooperative's retained patronage dividends are defined as securities. The Supreme Court cases of *United Housing Foundation v. Forman and Marine Bank v. Weaver* are often cited. In the former case, members of a housing cooperative were found to have purchased shares of stock in order to secure a place to live. Such shares, therefore, did not possess the characteristics normally associated with a security. In the latter case, certificates of investment in a federally regulated bank were not found to be liable under the Securities Acts. While only a skilled attorney can evaluate the peculiarities of these and other cases, Centner has offered some analogies within which to determine whether or not retained patronage dividends are securities, as defined by the Acts.⁵

Consumptive Use: Investment which has as its primary objective the securing of an object, product, or commodity for the consumptive use of the investor should not be considered a security. Quite clearly this interpretation would normally provide a substantial protection for farm supply and marketing cooperatives. In such a case, retained dividends are cooperative investments made concomitant with the act of procuring farm supplies or marketing crops. Patronage dividends arise from the act of purchasing supplies. Such dividends represent a portion of the price of products purchased by patrons. Within this context, such dividends constitute an investment, but there exists no profit, as such dividends are eventually returned to the patrons without interest earned or any appreciation in value. Therefore, patronage dividends are not an investment

contract within the definition of a security where a profit incentive is presumed.

Partnerships: A court may find that cooperatives are comparable with partnerships, whose partnership interests have been judged to be securities. The critical question here is whether or not a partner (patron) lacks the right or ability to participate in the management of the firm (cooperative). While cooperative patrons have the right to vote and participate in the affairs of the business, their rights are restricted, both legally and functionally. The board of directors is generally empowered to control the cooperative and other members may have little control over their investments, which would suggest that they might be defined as securities. Opposition to this argument would contend that all cooperative patrons participate in the management of the firm and that directors serve only as their elected spokesmen.

Taxable Income: Centner's review of the Forman case suggested that the creation of a taxable income defines an investment as a security. In this regard, cooperatives are unique as patronage dividends are the net earnings (or savings) of the cooperative and some might refer to them as profits. Subchapter T, however, allows cooperatives to deduct dividends from taxable income, passing such dividends on to patrons where they are reported as personal income. Cooperative profits, therefore, do not exist. However, a court might rule that the receipt of patronage dividends constitutes an income gained by patrons largely as a result of the efforts of others. If this constitutes a profit incentive for investors, the dividends could be defined as a security.

Debt or Risk Capital: Courts have found that cooperative patronage interests do not constitute a present debt.⁶ However, notes which evidence risk capital suggest an investment purpose and, therefore, might be defined as a security. Cooperative patrons may contend that retained dividends also constitute risk capital since the cooperative's other financial obligations must first be met before equity capital can be returned to members.

Investment of Pool Proceeds: Some marketing cooperatives may retain a portion of commodity

⁵ Centner, T. J. Op. cit., p. 41.

⁶ *Claasen v. Farmers Grain Coop.*, 208, Kan. 129, 490, F. 2d 376(1971).

marketing pool proceeds as membership investment. In a recent case involving a grain marketing cooperative, the resultant patron investment was judged not to be a security insofar as "actual money" was not involved (rather a portion of the commodity pool comprised the investment). However, this may not greatly protect other cooperatives where member- or commodity check-off assessments (real money) comprise the investment.

A Difficult Choice

Quite clearly, agricultural cooperatives face a difficult choice; i.e., risk the chance of a securities exposure under the Acts, or incur the added cost of compliance with the Acts, while not knowing their degree of applicability. Most cooperatives have chosen the former option, hoping that litigation is unlikely, or would prove less costly. Researchers have argued that the subjective probability of litigation is positively related to the size of the cooperative. As cooperatives grow larger, there is an ever-increasing chance that a dissatisfied patron will elect to commence litigation. In a similar context, it has been argued that dividends of the larger cooperatives are less likely to be exempted from the terms of the Acts as such cooperatives are more likely to conduct interstate business.

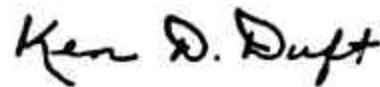
It is not my purpose to suggest that all cooperatives, en masse, file registration statements for public security issues. Each cooperative board of directors must sit in judgment of their best option, and the courts will likely rule upon the facts of each individual case litigated. As a general rule, the most likely justification for a court finding that retained dividends are securities under the Acts is that the cooperative has no systematic equity redemption program and has taken no steps to provide for the redemption of certificates held by inactive, retired, or deceased members. A second justification for an unfavorable court ruling would be the obvious presence of promotional efforts undertaken by the cooperative to induce patron investors. The length of the period of equity revolve, the membership involvement in cooperative management, and the amount of financial information disclosed routinely to cooperative members are other factors that might impact a court ruling.

Summary

The practice of retaining patronage dividends is deeply ingrained in agricultural cooperatives. In the absence of such member investment, cooperatives would be ill prepared to provide those products and services required by members. Yet the act of retaining dividends and issuing equity certificates to member-patrons should not be taken lightly, as such instruments may be judged to be securities under the federal Securities Acts of 1933 and 1934.

The indefinite nature of risks under the Acts and the expense of compliance have confronted cooperatives with a difficult choice. Most have decided to accept the risks of potential liability to dissatisfied members. However, a review of court cases would suggest that all cooperatives should look at their current operations and practices regarding this possible securities exposure. While no court has yet ruled the retained patronage dividends of a cooperative constitute a security under terms of the Acts, the mere threat of litigation may be a sufficient incentive to initiate precautionary measures.

Sincerely,



Ken D. Duft
Extension Marketing Economist