CURRENT DEVELOPMENTS IN THE LAW REGARDING AGRICULTURAL COOPERATIVES

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This article addresses recent administrative, legislative, and judicial developments affecting agricultural cooperatives. Agricultural cooperatives are unique entities, formed to provide producers with a means of marketing or to supply them with needed inputs at lower cost. 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.[1]

As economic associations formed for mutual benefit, agricultural cooperatives

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1. *See generally Cooperative Principles and Legal Foundations*, COOPERATIVE INFORMATION REP. NO. 1 at § 1, (1977); Farmer Coop. Service, USDA, *Legal Phases of Farmer Cooperatives* (1976) [hereinafter *Legal Phases*]; EWELL ROY, COOPERATIVES: DEVELOPMENT, PRINCIPLES AND MANAGEMENT (1981); ISRAEL PACKEL, THE ORGANIZATION AND OPERATION OF COOPERATIVES (1970).

are intended to strengthen their members' economic position in the marketplace. The favorable governmental attitude toward this effort at the state and federal level is reflected by specialized state incorporation statutes,[2] unique federal income tax deductions,[3] partial antitrust exemptions,[4] and judicial recognition of the unique nature of the cooperative enterprise.[5]

I. RELATIONSHIP BETWEEN MEMBER AND COOPERATIVE

The relationship between member and cooperative differs in many respects from that between a shareholder and a 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. 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 or a membership interest, in contrast, generally receives one vote regardless of the number of shares held,[6] distributions of income based on patronage,[7] and the distribution of assets at dissolution in proportion to patronage.[8]

Furthermore, most of the equity invested by cooperative members is generated not by outright purchase, 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).[9] This investment, referred to as a patronage retain, is generally evidenced by common stock, preferred

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2. For a review of the state statutes governing agricultural cooperatives, see James Baarda, *State Incorporation Statutes for Farmer Cooperatives*, USDA/ACS, COOPERATIVE INFORMATION REP. NO. 30, Oct. 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 (1994). Additional deductions are available to cooperatives qualifying under 26 U.S.C. § 521 (1994). *See* discussion *infra* notes 56-78, and accompanying text.

4. The Capper-Volstead Act, codified at 7 U.S.C. §§ 291-292 (1994), was 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 44-55 and accompanying text.

5. *See, e.g.*, Claasen v. Farmers Grain Coop., 490 P.2d 376, 381 (Kan. 1971), in which the court recognizes that "[p]ermeating 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, Inc. v. Yankee Milk, Inc., 635 F.2d 1037, 1043 (2d Cir. 1980) ("It is apparent from these statutes that agricultural cooperatives were 'a favorite child of Congressional policy.'"), *cert. denied*, 464 U.S. 1043 (1984).

6. Baarda, *supra* note 2, § 11.01 and Table 11.01.

7. *See Legal Phases*, *supra* note 1, at 2-7.

8. 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. *See* Baarda, *supra* note 2, § 17.03.02 and Table 17.03.02.

9. *See generally Legal Phases, supra* note 1, at 471-80.

stock, or some type of equity certificate or book entry established for that member.[10] Unlike the permanent investment in a profit corporation, the equity invested in the cooperative in this manner generally is intended to be redeemed by the cooperative in the future.[11] At what point redemption takes place is a financial decision made by the board of directors. Cooperative members recoup the bulk of their investment not by sale in a market, therefore, but by redemption of shares or equity certificates by the cooperative.

A. *Right to Inspect Books and Records*

Although agricultural cooperatives are structured much differently than profit corporations, many of the traditional attributes of profit corporations carry over to cooperatives.[12] Corporate law generally supplements cooperative statutes either impliedly or expressly.[13] However, corporate law does not always provide an adequate framework to resolve cooperative issues.

The failure of corporate law to provide adequate protection for cooperative members was illustrated recently by *Shaw v. Agri-Mark, Inc.,*[14] a case certified to the Delaware Supreme Court in 1995. Certain Vermont dairy farmers brought suit to compel a milk marketing cooperative of which they were members to provide them access to its books and records. The members sought to examine the cooperative's membership list and to review salary information concerning the five highest-paid executives. The cooperative refused to permit inspection on the ground that the members were not shareholders of the cooperative. On appeal, the United States Court of Appeals for the Second Circuit certified the question of inspection rights to the Delaware Supreme Court.

The defendant, Agri-Mark, Inc., was organized as a stock-issuing cooperative. Rather than issuing shares of stock to each member in the typical cooperative manner, Agri-Mark issued stock only to its board of directors. A director paid one dollar for a share of stock at election to the board, and was required to sell that share back to the cooperative for the same price at the expiration of his term. Only directors were permitted to vote at annual or special meetings of the stockholders.

Cooperative members exercised their voting rights indirectly. Members were divided into regions, and each member was entitled to cast one vote for the election

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[10]. *See generally* Mary Beth Matthews, *Financial Instruments Issued by Agricultural Cooperatives*, USDA/ACS, COOPERATIVE INFORMATION REP. NO. 68, March 1988.

[11]. *See generally Equity Redemption--Issues and Alternatives for Farmer Cooperatives*, USDA/ACS, COOPERATIVE INFORMATION REP. NO. 23, 1982.

[12]. *See generally* Douglas Fee et al., *Director Liability in Agricultural Cooperatives*, USDA/ACS, COOPERATIVE INFORMATION REP. NO. 34, 1984.

[13]. For express statutory supplementation, see Baarda, *supra* note 2, § 1.04 and Table 1.04.01.

[14]. Shaw v. Agri-Mark, Inc., 663 A.2d 464 (Del. 1995).

of a director representing that region. Members further elected regional voting representatives. With respect to any matter as to which Delaware law guaranteed the stockholders a right to vote, the directors were required to vote in accordance with the instruction of the regional voting representatives as a group.

The Delaware Supreme Court concluded that under Delaware law, cooperative members were not entitled to inspection rights. The court stated that such rights were status-related and emphasized that the relevant statute accorded inspection rights only to stockholders of record--in this case, the directors. The court gave short shrift to the argument that a more expansive inspection right was accorded to cooperative members by common law. Refusing to address whether members of a nonstock cooperative would be entitled to inspection rights, the court stated that, because Agri-Mark was a stock corporation, "the rights of its members must be evaluated from this perspective."[15]

The Delaware Supreme Court acknowledged that the equity owners of the cooperative were being deprived of inspection rights, while the stockholder/directors being accorded those rights held "only a nominal ownership interest in the corporation."[16] However, the court stated that the producers' plight was of their own making, and that they had voluntarily chosen to become members in an organization designating others as stockholders.

It is perhaps not surprising that a corporations-oriented Delaware Supreme Court would reach a narrow interpretation of shareholder rights. In fact, the court expressed its reluctance to enlarge or expand corporate law lest it compromise the consistency and established reliability of that body of law. However, an expanded interpretation of member rights could have been fashioned specifically for the cooperative form of business. Several cooperative statutes specifically create inspection rights,[17] and courts in other states have allowed inspection rights to cooperative shareholders[18] and members of nonstock cooperatives.[19] Corporate law is intended to supplement cooperative law, not to contradict or supplant it in a manner inconsistent with the cooperative objective.

Rights of inspection are accorded to corporate shareholders as a safeguard for their financial interests. As the owners of the corporation, shareholders are entitled to be informed regarding its affairs. In the cooperative setting, however, members have

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15. *Id.* at 469.

16. *Id.* at 470.

17. *See* Baarda, *supra* note 2, § 11.12 and Table 11.12.03.

18. Funck v. Farmers' Elevator Co., 121 N.W. 53 (Iowa 1909) (holding that cooperative stockholder would have right to investigate books except for improper motive). *See also Legal Phases*, *supra* note 1, at 96-99.

19. State *ex rel.* Boldt v. St. Cloud Milk Producers' Ass'n, 273 N.W. 603, 607 (Minn. 1937) ("It would seem that if stockholders and members of a corporation are entitled to an inspection of its books because of the fact of ownership, that the reason obtains in full force in the case of cooperatives whether they be organized with or without capital stock."); Northern Wisconsin Coop. Tobacco Pool v. Oleson, 211 N.W. 923 (Wis. 1927) (deciding member entitled to inspect only books and records relevant to defense, not to engage in fishing expedition).

ownership status and provide equity by outright investment or by patronage retains. Whether that status is created by membership in a nonstock cooperative, by the purchase of a share in a stock cooperative, or by entering into a separate membership relationship in a stock cooperative, the substance rather than the form of the organization should be considered in assessing common law inspection rights.

The membership list and salary information that the members in *Shaw v. Agri-Mark* were seeking would not generally be publicly available. Such information would seem properly related to an owner's interest in overseeing management decisions and communicating with other owners. The Delaware court's decision seems somewhat ironic. Members are denied access to information made available to the directors who already have access to it and who presumably make it unavailable to the members.

B. *Equity Redemption*

The timely redemption of equity by agricultural cooperatives is an ongoing source of dispute between the entity and its members. The case law continues to reflect the occasional resort to the courts to resolve such controversies. Recently, Farmland Industries, Inc. members brought several suits to compel redemption of certain financial instruments known as "capital credits." The plaintiffs were inactive cooperative members of Farmland whose patronage retains were converted into capital credits when the cooperatives liquidated or ceased business as a result of the souring agricultural economy in the early 1980s.[20]

The cases provide some interesting guidance as to a variety of procedural issues that may arise in a suit to compel equity redemption. In *First National Bank & Trust v. Farmland Industries,*[21] for example, the receiver for a dissolved grain cooperative brought an individual action to recover capital credits on the theory that a Kansas statute entitled the member to recover "property interests" within one year of termination of membership. The district court held that the suit was barred by the statute of limitations, and the receiver appealed to the Tenth Circuit Court of Appeals.

The Tenth Circuit did not reach the merits of the suit regarding whether the statute was mandatory or permissive,[22] but addressed only the applicable statute of limitations and the time of accrual of the cause of action. The receiver argued for a

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20. For a discussion of this background, see Consumers Gas & Oil v. Farmland Indus., 863 F. Supp. 1357, 1359 (D. Colo. 1993).

21. First Nat'l Bank & Trust v. Farmland Indus., 3 F.3d 1366 (10th Cir. 1993).

22. For a discussion of the confusion surrounding the adoption of mandatory and nonmandatory provisions of the Standard Cooperative Marketing Act, see *Equity Redemption--Issues and Alternatives for Farmer Cooperatives, supra* note 11, at 117-21. Even should the Kansas statute be interpreted as mandatory, the court still might narrowly define the term "property interests" to exclude capital credits.

five-year statute of limitations applicable to written contracts, arguing that Farmland's bylaws incorporated the Kansas statute. Noting that such theory was not pled in the complaint, the Tenth Circuit Court of Appeals instead applied a three-year limitation applicable to breach of duty arising from statute.

To apply the three year limitation, the court had to determine when the cause of action arose. It was arguable that the action for Farmland's refusal to pay arose when the cooperative ceased to do business (May 1987), when the receiver first made demand for redemption of the capital credits (July 1987), or when Farmland converted the member's accumulated common stock and credits for common stock into capital credits (February 1988). Because the cause of action was based on mandatory payment under the statute at withdrawal or expulsion, the court examined Farmland's documents and the conduct of the parties to determine when either of those events took place.

The Tenth Circuit concluded that withdrawal or expulsion did not occur at the member cooperative's cessation of business. Although acknowledging that the cooperative no longer met Farmland's qualifications for membership, the court found that its membership was not automatically terminated. Instead, the cooperative remained a member until action was taken by Farmland's board to terminate its membership.

Nor did withdrawal occur upon demand by the receiver for redemption. Although such demand might signal an intention to terminate membership, the court did not find such demand in itself sufficient to cause termination. The Tenth Circuit held that the cause of action accrued at Farmland's affirmative act of converting the member's stock and credits into capital credits. Because Farmland's bylaws defined a member as a holder of common stock, the court concluded that the cooperative lost membership status at conversion of its stock even in the absence of a formal declaration of withdrawal or expulsion. Because that conversion occurred within the statutory period, the suit was not time-barred.

First National Bank & Trust v. Farmland Industries is valuable in illustrating that the choice of theory for equity redemption may be critical to the maintenance of the suit. A suit for equity redemption may be framed as a breach of contract if cooperative articles, bylaws, or other documents are violated;[23] as a breach of fiduciary duty if the board has abused its discretion;[24] as a breach of statutory duty if a statute mandates redemption as in the instant case; as securities fraud if misrepresentations have been made;[25] or even for restitution or RICO violations as

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[23]. Driver v. Producers Coop., Inc., 345 S.W.2d 16 (Ark. 1961) ("suit . . . to compel the association to comply with its charter and bylaws"); Southeastern Colorado Coop. v. Ebright, 563 P.2d 30 (Colo. App. 1977) (claim for set-off based on bylaws).

[24]. Hajmm Co. v. House of Raeford Farms, Inc., 403 S.E.2d 483 (N.C. 1991) (breach of fiduciary duty); Georgia Turkey Farms, Inc. v. Hardigree, 369 S.E.2d 803 (Ga. Ct. App. 1988) (abuse of discretion).

[25]. Rosenberg & Sons, Inc. v. St. James Sugar Coop., 447 F. Supp. 1 (E.D. La. 1976) (unsuccessful effort to characterize cooperative common stock as a security), *aff'd* 565 F.2d 1213 (5th Cir. 1977).

subsequently discussed.[26] The choice of theory may affect the statute of limitations, the choice of forum, and the measure of damages among other things.

First National Bank is also interesting for its discussion of the timing of membership termination. The point at which membership is terminated affects not only member rights to equity but also the status of the cooperative as a body of producers for a variety of statutory purposes. The court's conclusion that the cooperative remained a member of Farmland despite its cessation of business raises some interesting questions about its continued "producer" status under state and federal tax, antitrust, and general cooperative laws.

The Farmland controversy also generated case law relating to the redemption of equity by means of a class action. The plaintiff cooperatives in *Great Rivers Co-op. v. Farmland Industries*[27] filed an Iowa class action alleging that the failure to redeem capital credits constituted fraud as well as RICO and securities violations. In response, Farmland published a two-page opinion piece in its member newsletter denouncing the lawsuit. The district court ordered Farmland to refrain from future communications that could be construed as urging class members to opt out of the litigation, and required Farmland to publish a rebuttal article written by the plaintiffs. On appeal, the Eighth Circuit Court of Appeals reversed. Stressing the importance of First Amendment rights, the Eighth Circuit found insufficient findings of misrepresentation or abuse to warrant either mandate.

A second class action filed in Colorado, *Consumers Gas & Oil v. Farmland Industries,*[28] addressed the issue of attorneys' fees. The suit was based on unjust enrichment, RICO, and securities violations. The action was settled by an agreement of the parties that provided for the payment at par of all class equities within three years. Counsel for the plaintiffs subsequently requested an attorneys' fee of twenty-seven percent of all amounts paid by Farmland to class members as a result of the litigation. In a detailed analysis, the district court concluded that a percentage approach was an appropriate method of assessing attorneys' fees in a common fund case, but found that a reduced fee of twenty-four percent was the proper figure.

C. *Merger*

Disputes between cooperative and member also may arise during a merger. A question that frequently arises when cooperatives merge is whether cooperative members are entitled to dissenters' rights.[29] Traditional corporate law permits

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26. *See infra* notes 27-28 and accompanying text.

27. Great Rivers Coop. v. Farmland Indus., 59 F.3d 764 (8th Cir. 1995).

28. Consumers Gas & Oil v. Farmland Indus., 840 F. Supp. 794 (D. Colo. 1993).

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

shareholders dissenting from a merger to exercise appraisal rights to receive the value of their shares.[30] Whether such rights are afforded to cooperative members depends upon state law. Many state cooperative statutes contain specific references to merger,[31] although only a few detail the rights of members who dissent.[32] In the absence of a cooperative provision, general corporate law usually will be cited.[33] Although corporate law only applies if its provisions are not inconsistent with the cooperative statute, whether corporate appraisal rights apply to cooperatives still may be subject to dispute.[34]

The issue of dissenters' rights at a cooperative merger recently arose in the case of *Indiana Farm Bureau Cooperative Ass'n v. AgMax, Inc.*[35] AgMax, a cooperative member of Indiana Farm Bureau, was one of two members to vote against its proposed merger with Countrymark, Inc.[36] After approval of the merger by the remaining members, AgMax demanded payment of its entire interest in the cooperative. That interest included 1) one share of voting common stock issued at membership; 2) more than 28,000 shares of nonvoting preferred stock issued as patronage dividends; and 3) a proportional share of the allocated equity account and the unallocated general reserve.[37]

The Farm Bureau articles of incorporation neither required membership approval at merger nor mandated dissenters' rights. The articles were silent on the issue of merger. The Indiana Agricultural Cooperative Act required membership approval at merger, but did not mandate payment to dissenters.[38] However, the cooperative statute incorporated by reference the Indiana general business corporations statute. It was the corporate statute that mandated payment to dissenting shareholders at merger if the shareholder was entitled to vote on the merger. However, the cooperative statute did not mandate incorporation if "the provisions of the [corporate statute] are in conflict with or inconsistent with the express provisions of [the cooperative statute]."[39]

AgMax argued it was entitled to vote its Farm Bureau stock on the issue of merger, and was therefore entitled to dissenters' rights under the corporations law incorporated by reference into the Indiana cooperative statute. The Indiana appellate

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30. *See, e.g.*, Revised Model Business Corporation Act §§ 13.01-13.31 (1984), 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.

31. *See* Baarda, *supra* note 2, § 16.01 and Table 16.01.

32. *Id.* § 16.09 and Table 16.09.

33. *See supra* note 13 and accompanying text.

34. *See* Sedo, *supra* note 29, at 397-400.

35. Indiana Farm Bureau Coop. Ass'n v. AgMax, Inc., 622 N.E.2d 206 (Ind. Ct. App. 1993).

36. For a discussion of the merger, see Patrick Duffy, *Indiana, Countrymark Merging Common Cooperative Interests*, 44 FARMER COOP. 20 (July 1991).

37. *AgMax, Inc.*, 622 N.E.2d at 208.

38 IND. CODE ANN. tit. 15 §§ 7-1(1)-(34) (Michie 1993).

39 *Id.* § 7-1(28) (1993), *construed in AgMax, Inc.,* 622 N.E.2d at 209.

court disagreed. The corporations statute mandated payment of a shareholder's interest only if A) shareholder approval was required for the merger by the articles of incorporation or the Indiana corporations statute; and B) the shareholder was entitled to vote on the merger. The Indiana court concluded that AgMax could establish neither prong of subsection (A).

In reaching its conclusion, the court first considered whether the Farm Bureau Articles of Incorporation required shareholder approval. Because the Farm Bureau articles were silent on merger, the appellate court concluded that AgMax had failed to establish the first requirement of subsection (A). The court then considered whether the Indiana corporations statute mandated shareholder approval. Because AgMax was entitled to vote its common stock at merger under the Indiana cooperative statute, AgMax argued that shareholder approval was required by the Indiana corporations statute as set out in the second requirement of subsection (A). The Indiana appellate court acknowledged that the cooperative statute required approval of a merger by a majority of members but, that the right to vote arose under the cooperative statute rather than the corporations statute. The court held that AgMax had failed to prove shareholder approval was required by the *corporations* statute as set out in the second requirement of subsection (A).

AgMax next argued that the second requirement of subsection (A) was met because the Indiana corporations law required approval of the merger by the holders of *preferred stock*. AgMax held more than 28,000 shares of preferred stock issued as a result of patronage. Under Indiana corporations law, even nonvoting preferred stock was entitled to vote as a class on mergers affecting the rights of that class. Although acknowledging that preferred stockholders were entitled to such a vote under the Indiana corporations statute, the court found such a vote inconsistent with a cooperative structure based on one-member/one vote. The court feared that permitting non-member holders of the preferred stock to vote on the merger would undermine the democratic nature of a cooperative. In the face of that conflict, the court held that the cooperative statute prevailed and no vote of preferred stockholders was required for cooperative merger.

Because AgMax had failed to establish that the Farm Bureau articles or the Indiana corporations law required shareholder approval for cooperative merger, the court held the prerequisites for dissenters' rights had not been shown. It therefore denied to AgMax any recovery for the value of its common stock, its preferred stock, the allocated equity, or the cash reserve.

AgMax made a final plea for dissenters' rights based on common law. AgMax argued that to deny dissenters' rights would permit the cooperative to concentrate the shareholders' equity into nonvoting shares, and pay only a nominal sum to a dissenting shareholder. The court rejected this argument as well. Because cooperatives are bound by the specialized cooperative statute, the court stated,

"dissenters' rights are not available to agricultural cooperatives."[40] At merger, cooperative members are thus entitled only to payments that arise from cooperative articles or pursuant to corporate provisions not inconsistent with the cooperative statute.

Although the decision of the Indiana appellate court in *AgMax* is based on a technical reading of the Indiana appraisal statute, a narrow interpretation of dissenters' rights may be consistent with cooperative philosophy. Members contribute equity to the cooperative to receive an increased return on their product or a decreased cost for their supplies. Cooperative equity is not intended to generate a return on investment, and is to be redeemed when the board determines it is financially feasible for the cooperative to do so. The courts have demonstrated a marked reluctance to second guess a board's decision not to retire equity, and a determination that the cooperative is not in a position to retire equity at merger should arguably be given the same deference. The ability of the merged entity to survive may be impaired if members are given a unilateral right to cash out at such a critical stage.[41]

D. *Miscellaneous Disputes*

A variety of miscellaneous disputes between cooperative and member also are reflected in the case law of recent years. In *Demerath Land Co. v. Sparr,*[42] for example, a member launched an unsuccessful RICO suit against his cooperative for fraudulently inducing him to purchase and apply excessive herbicides. In *Ex parte Gold Kist, Inc.,*[43] the Alabama Supreme Court refused to decertify a class that had brought an action against a cooperative for shortchanging on feed deliveries. In *Gold Kist, Inc. v. Wilson,*[44] members commenced an action against their cooperative for breach of contract and fraud in connection with the termination of certain egg production enterprises.

II. ANTITRUST

Recent case law concerning agricultural cooperatives also has arisen in the antitrust area. In recognition of the fact that cooperatives are intended to encourage

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40. *AgMax, Inc.,* 622 N.E.2d at 211.

41. Sedo suggests the following additional arguments against dissenters' rights: (1) a cooperative member entitled to an equal vote has more protection from improper mergers than a shareholder exercising only a proportionate vote; (2) dissenters' rights are inconsistent with the cooperative requirement that transfers of membership and stock be approved by the board, and 3) an omission to address dissenters' rights in the cooperative statute represents a deliberate decision that members are otherwise adequately protected (particularly if the statute addresses merger). Sedo, *supra* note 29, at 398-400.

42. Demerath Land Co. v. Sparr, 48 F.3d 353 (8th Cir. 1995).

43. *Ex parte* Gold Kist, Inc., 646 So. 2d 1339 (Ala. 1994).

44. Gold Kist, Inc. v. Wilson, 444 S.E.2d 338 (Ga. Ct. App. 1994).

collective action by producers, cooperatives generally have been granted at least partial relief from antitrust regulation at federal and state levels. Congress enacted the Capper-Volstead Act[45] in 1922 to permit producers meeting certain conditions to act together in associations to collectively process and market agricultural products.[46] However, the courts made it 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 nonproducers,[47] to predatory tactics,[48] or to entities not composed of "persons engaged in the production of agricultural products."[49]

In determining whether an entity is entitled to Capper-Volstead protection, the courts have struggled with the definition of "persons engaged in the production of agricultural products." The United States Supreme Court addressed the issue of producer status in the landmark case of *National Broiler Marketing Ass'n v. United States*.[50] After a careful review of the broiler industry, the court concluded that members of NBMA who "owned neither a breeder flock nor a hatchery, and that maintained no grow-out facility," were not producers within the meaning of the Capper-Volstead Act.[51] Because three NBMA members flunked those criteria, the

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45. *See supra* note 4 and accompanying text.

46. *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); David L. Baumer et al.,*Curdling the Competition: An Economic and Legal Analysis of the Antitrust Exemption for Agriculture*, 31 VILL. L. REV. 183 (1986); Thomas W. Paterson & Willard F. Mueller, *Sherman Section 2 Monopolization for Agricultural Marketing Cooperatives*, 60 TUL. L. REV. 955 (1986); A. S. Klein, Annotation, *Monopolies: Construction of § 1 of the Capper-Volstead Act Authorizing Persons Engaged in the Production of Agricultural Products to Act Together in Association*, 20 A.L.R. FED. 924 (1974).

47. United States v. Borden Co., 308 U.S. 188 (1939) (involving a conspiracy including distributors, labor officials, and municipal officials).

48. Maryland & Virginia Milk Producers Ass'n 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); *see* Fairdale Farms, Inc. v. Yankee Milk, Inc., 635 F.2d 1037 (2d Cir. 1980).

49. Case-Swayne Co. v. Sunkist Growers, Inc., 389 U.S. 384 (1967); National Broiler Mktg. Ass'n v. United States, 436 U.S. 816 (1978). An interesting question arose recently in regard to whether a cooperative which included an extension specialist as an "associate member" was composed of producers within the meaning of the antitrust exemptions. In an unreported opinion, the New York federal district court in *Agritronics Corp. v. National Dairy Herd Ass'n*, 914 F. Supp. 814 (N.D.N.Y. 1994) concluded that the nonproducer associate member was not a member for antitrust purposes. Because the extension specialist had no control over the affairs of the association, the court decided his inclusion did not cause a forfeiture of the cooperative's antitrust exemption.

50. National Broiler Mktg. Ass'n v. United States, 436 U.S. 816 (1978). For further discussion of this case, see Worth Rowley & Marvin Beshore, *Chicken Integrators' Price-Fixing: A Fox in the Capper-Volstead Coop,* 24 S.D. L. REV. 564 (1979).

51. *National Broiler Mktg. Ass'n*, 436 U.S. at 827.

Court concluded that NBMA was not exempt from civil liability for violations of the Sherman Act.[52]

A majority of the Supreme Court specifically declined to address the status of the fully integrated producer -- one who not only produces the agricultural product but also engages in its processing or manufacture.[53] In a concurring opinion, however, Justice Brennan took the next step.[54] After reviewing the history and purpose of the Act, Justice Brennan concluded that the Capper-Volstead Act was not intended to shield persons engaged in processing and handling of the agricultural product. In fact, abuses by such middlemen had been the primary impetus for its passage. Therefore, Justice Brennan concluded that the fully integrated producer was *not* a person entitled to protection within the meaning of the Capper-Volstead Act.

The issue the majority declined to address in *National Broiler Marketing* arose recently in a criminal context in *United States v. Hinote,*[55] a case decided by a federal district court in Mississippi. In that case, the president and CEO of Delta Pride Catfish, Inc. was charged with violating the Sherman Act by conspiring to fix the prices of catfish products. Delta Pride was a catfish processor incorporated in Mississippi. Defendant Hinote sought dismissal of the indictment on the ground that any conspiratorial price-fixing was exempt under the Capper-Volstead Act or its counterpart, the Fisherman's Collective Marketing Act.[56] Hinote asserted that Delta Pride and its co-conspirators were engaged in catfish farming or fishing which makes them producers within the meaning of the antitrust exemptions.

The federal district court scrutinized two of the six parties with whom Delta Pride had allegedly conspired. The two entities, which were subsidiaries of large food conglomerates, were "integrated" in that they were involved in more than one of the stages of catfish production, and they owned and operated processing plants. The court further stressed that both entities purchased substantial amounts of catfish for processing from independent farmers on the open market. Relying heavily upon Justice Brennan's concurrence in *National Broiler Marketing*, the court concluded that neither entity was a producer within the meaning of the antitrust exemptions. The court stated that such fully integrated producers were "acting as traditional 'middlemen,' the very group that Congress viewed as exploiting the true farmers it sought to protect under the Capper-Volstead Act." [57]

The court noted it was not the activity of the processors acting as farmers being challenged in that case, but rather their conduct in selling the finished catfish products. The court further expressed its fear that should fully integrated

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52. 15 U.S.C. §§ 1-11 (1994).

53. *National Broiler Mktg. Ass'n*, 436 U.S. at 828, n.21 ("Thus we need not consider here the status under the Act of the fully integrated producer that not only maintains its own breeder flock, hatchery, and grow-out facility, but also runs its own processing plant.").

54 *Id.* at 829-40.

55. United States v. Hinote, 823 F. Supp. 1350 (S.D. Miss. 1993).

56. 15 U.S.C. § 522 (1994). The Fisherman's Act is patterned after the Capper-Volstead Act but is made applicable to fishermen and aquatic products.

57. *Hinote*, 823 F. Supp. at 1358-59.

agribusinesses be classified as producers, any manufacturer or processor could claim antitrust exemption by the mere expedient purchasing of a *de minimus* interest in a farming operation. Based on these conclusions, the court denied Hinote's challenge to the indictment.

III. TAXATION

In recognition of their conduit nature, cooperatives are granted under Subchapter T of the Internal Revenue Code[58] certain deductions not available to profit corporations. These deductions consist of amounts returned to cooperative patrons as a portion of the earnings or savings generated by their patronage.[59] The effect of Subchapter T is that such "patronage dividends" are taxed once -- at the patron level -- rather than taxed twice as with corporate dividends.[60] Cooperative tax treatment has been the subject of legislative and judicial interest in the past few years.

A. *Operating on a Cooperative Basis*

The first cooperative tax issue addressed recently is the meaning of "operating on a cooperative basis."[61] To receive favorable tax treatment under Subchapter T, a cooperative must meet that statutory test. The phrase has not been defined by statute or regulation, and its proper interpretation has generated considerable dispute.

1. *Member v. Nonmember Business*

One element of the controversy has been whether "operating on a cooperative basis" requires that a cooperative do more member than nonmember business. For many years, the Internal Revenue Service took the position that a cooperative must do more than fifty percent in value of its business with members to qualify under Subchapter T.[62] In 1978 in *Conway County Farmers Ass'n v. United States*,[63] the Eighth Circuit Court of Appeals disagreed. Finding that Congress imposed no quantitative requirement in Subchapter T, the court held that a cooperative could

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58. 26 U.S.C. §§ 1381-1388 (1994).

59. The definition of "patronage dividends" contained in 26 U.S.C. § 1388(a) (1994), 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."

60. As recognized by the United States Tax Court in *Kingfisher Cooperative Elevator Ass'n v. Commissioner*, 84 T.C. 600, 613 (1985), "the foundation of subchapter T is a single level of tax."

61. 26 U.S.C. § 1381(a)(2) (1994) states "[t]his part shall apply to . . . any corporation operating on a cooperative basis . . . ."

62. Rev. Rul. 72-602, 1972-2 C.B. 510.

63. Conway County Farmers Ass'n v. United States, 588 F.2d 592 (8th Cir. 1978).

operate on a cooperative basis as to less than fifty percent of its business.

The IRS expressed its non-acquiescence in *Conway County*,[64] but subsequently lost two more cases.[65] In 1993, the IRS conceded in Revenue Ruling 93-21[66] that "a cooperative that operates on a for-profit, nonpatronage basis with nonmembers will not be precluded from being considered 'operating on a cooperative basis' simply because it does less than 50-percent [sic] in value of its business with members on a patronage basis."[67]

2 *Statutory Definition*

As a result of such disagreements over interpretation, the IRS Farmer Cooperative Industry Specialist in an internal working paper recently proposed alterations of the Subchapter T definitions. The modifications apparently define "operating on a cooperative basis" according to the guidelines espoused in a 1965 United States Tax Court case, *Puget Sound Plywood, Inc. v. Commissioner*.[68] The National Council of Farmer Cooperatives[69] and a number of senators (constituting half of the members of the Senate Finance Committee) recently have written the Treasury Department to express disagreement with the need for any such modification.[70] The basis of objection is that a potentially more restrictive statutory definition would impair cooperative flexibility in accommodating a wide range of business interests.

B. *Patronage v. Nonpatronage Income*

A second cooperative tax issue currently being debated is whether the income generated by the sale of a cooperative asset should be classified as patronage or

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64. Tech. Adv. Mem. 84-02-009 (Sept. 23, 1983).

65. *See* Conway County Farmers Ass'n v. Commissioner, 588 F.2d 592 (8th Cir. 1978), *action on decision*, 1991-018 (Oct. 22, 1991) *available in* LEXIS, Tax Library, RIA File (citing Columbus Fruit & Vegetable Coop. Ass'n v. United States, 7 Cl. Ct. 561 (1985) and Geauga Landmark, Inc. v. United States, No. 81-942 (N.D. Ohio 1985)).

66. Rev. Rul. 93-21, 1993-1 C.B. 188.

67. *Id.* at 189.

68. Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305 (1965). To meet the test for operating as a cooperative within the meaning of that case, a cooperative must have the following characteristics: (1) subordination of capital; (2) democratic control; and (3) vesting of net profits in members in proportion to participation. *Id*. at 308. Part of the concern expressed by opponents to the proposal was that the democratic control discussed in *Puget Sound Plywood* is based solely on one member/one vote. The exact wording of the internal working paper itself is unclear. Representatives of the National Council of Farmer Cooperatives indicate that a Freedom of Information Act effort to acquire access to the document was unsuccessful.

69. The National Council of Farmer Cooperatives sent a letter to a tax specialist in the Treasury Department in January 1995. *See* 48 COOPERATIVE ACCOUNTANT 52 (Summer 1995).

70. Letter of April 12, 1995 to Leslie B. Samuels, Assistant Secretary for Tax Policy, U.S. Treasury Department. *See* COOPERATIVE ACCOUNTANT, *supra* note 69.

nonpatronage income. To qualify as "patronage dividends" eligible for the Subchapter T deduction, cooperative earnings must be generated by business done with or for patrons.[71] Only as to those funds does the cooperative act as a channeling agent. Nonpatronage income, in contrast, is taxed at the cooperative and patron levels like the earnings of any profit corporation. Furthermore, to prevent distortions of income, the cooperative is prohibited from using gains or losses generated by nonpatronage business to offset gains or losses generated by patronage business.[72] 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 characterized as patronage or nonpatronage income has been a basis for 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.[73] However, the courts on occasion have found that the sale of assets used in the cooperative's business can be patronage sourced.[74] The test adopted by the courts and by the Revenue Rulings for categorizing cooperative income as patronage sourced generally has been whether the transaction facilitates the basic purchasing, marketing, or service activities of the cooperative rather than merely enhancing its overall profitability.[75]

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[71]. 26 U.S.C. § 1388(a) (1994) (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.")

[72]. *Id.* § 1388(j)(1) (1994) (specifying that the net earnings of the cooperative may be determined "by offsetting patronage losses . . . against patronage earnings . . . ."). Section 1388(j)(4) states that 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).

[73]. 26 C.F.R. § 1.1382-3(c)(2) (1995) (describing nonpatronage income). It states:

> "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.

[74]. *See, e.g.*, St. Louis Bank for Coop. v. United States, 624 F.2d 1041 (Ct. Cl. 1980) (ruling that profit from the sale of an automobile used in the business of the cooperative patronage sourced); Cotter & Co. v. United States, 765 F.2d 1102 (Fed. Cir. 1985) (ruling that interest earned on commercial paper and rental income patronage sourced).

[75]. *See* Rev. Rul. 69-576, 1969-2 C.B. 166 (ruling patronage allocations paid by bank for cooperative qualified as patronage dividends when distributed by recipient cooperative); Rev. Rul. 74-160, 1974-1 C.B. 246 (ruling interest earned on loans to keep principal supplier in business qualified as patronage dividends); Rev. Rul. 75-228, 1975-1 C.B. 278 (ruling dividend received by cooperative from its Domestic International Sales Corporation qualified as patronage dividend); St. Louis Bank for Coop.

An unsuccessful effort was made in 1991 to address the sale of assets issue by federal enactment.[76] A similar bill was proposed in 1993,[77] and has since been the subject of hearings before the Senate Subcommittee on Energy and Agricultural Taxation.[78] The 1993 bill provides that a cooperative may elect to include gain or loss from the sale of an asset in net earnings of the organization from business done with or for patrons if it was used by the organization "to facilitate the conduct of business done with or for patrons."[79] The proposed statute would codify the test developed administratively and judicially, and would provide a greater degree of certainty to cooperatives attempting to ascertain the tax consequences of asset dispositions.

Despite the proposal, cooperative sources indicate that no immediate action is expected. The impetus for the sale of assets legislation was a ruling by the IRS concerning the gain realized by Farmland Industries on the sale of certain stock of Terra Resources, a wholly-owned subsidiary engaged in oil and gas exploration.[80] Because the case is currently pending in the United States Tax Court, no legislative action appears forthcoming from the current Congress.

C. *Section 277*

A third cooperative tax issue recently addressed is whether Internal Revenue Code section 277[81] applies to agricultural cooperatives. Section 277 provides that "[i]n the case of a social club or other membership organization which is operated primarily to furnish services or goods to members," deductions attributable to that activity are allowed only to the extent of income from member transactions for that year.[82] These deductions may be carried forward to succeeding years, but may not

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v. United States, 624 F.2d 1041 (Ct. Cl. 1980); Cotter & Co. v. United States, 765 F.2d 1102 (Fed. Cir. 1985).

76. H.R. 2361, 102d Cong. (1991). The Senate counterpart was S. 1522, 102d Cong. (1991).

77. S. 545, 103d Cong. (1993). *See* Proceedings and Debates of the 103d Cong. 139 CONG. REC. S2641-42 (daily ed. March 10, 1993) (introduction by Sen. Boren).

78. A representative of the National Council of Farmer Cooperatives testified in support of the legislation at hearings before the Senate Subcommittee on Energy and Agricultural Taxation. *See* NATIONAL COUNCIL OF FARMER COOPERATIVES, 1994 ANNUAL REPORT 3 (1995).

79. S. 545, 103d Cong. (1993). The bill proposed to amend 26 U.S.C. § 1388 by adding a new subsection (k), which would provide in part as follows:

> A farmer cooperative may elect to include gain or loss from the sale of other disposition of any asset (including stock or any other ownership or financial interest in another entity) 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 full text of S. 545, see 139 CONG REC. S2641-42 (daily ed. March 10, 1993).

80. *See* FARMLAND INDUSTRIES, 1992 ANNUAL REPORT 36 (1993).

81. 26 U.S.C. § 277 (1994).

82. *Id*. Section 277(a) states in part:

be carried back. The section was added to the tax code in 1969[83] to prevent social organizations from creating losses by furnishing services to members at less than cost, and using those losses to offset other income.

The Internal Revenue Service has used section 277 to deny cooperatives the right to carry back losses or to take the dividends received deduction.[84] The United States Tax Court recently addressed the issue in a test case financed by members of the National Council of Farmer Cooperatives,[85] *Buckeye Countrymark, Inc. v. Commissioner.*[86] In that case, the Tax Court concluded that section 277 was inapplicable to nonexempt cooperatives operating under Subchapter T.

The taxpayer in *Buckeye Countrymark* was a grain and supply cooperative that had carried back losses generated in 1980 against income generated in 1977. The loss and the income against which it was set off were derived from business done with patrons. Claiming that section 277 prohibited such carrybacks, the IRS assessed a deficiency against the cooperative. The Tax Court concluded that application of section 277 to cooperatives would lead to "absurd or futile results."[87] Acknowledging that cooperatives already were precluded by Subchapter T from offsetting patronage losses against nonpatronage income, the court concluded that application of section 277 was not necessary to meet the objectives of that statute, and would in fact lead to conflicting results.

> In the case of a social club or other membership organization which is operated primarily to furnish services or goods to members and which is not exempt from taxation, deductions for the taxable year attributable to furnishing services, insurance, goods, or other items of value to members shall be allowed only to the extent of income derived during such year from members or transactions with members (including income derived during such year from institutes and trade show which are primarily for the education of members). If for any taxable year such deductions exceed such income, the excess shall be treated as a deduction attributable to furnishing services, insurance, goods, or other items of value to members paid or incurred in the succeeding taxable year.

26 U.S.C. § 277(a) (1994).

83. It was a portion of the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 540 (1970).

84. *See* NATIONAL COUNCIL OF FARMER COOPERATIVES, *supra* note 78. The dividends received deduction is a measure that affords affiliated corporations relief from double taxation by permitting the receiving corporation to deduct certain percentages of dividends received from a domestic corporation. 26 U.S.C. § 243. (1994).

85. The NCFC's Board of Directors by resolution in 1987 authorized the Legal, Tax and Accounting Committee to coordinate a group effort to secure favorable resolution of the issue. More than seventy cooperative members made contributions of up to $5000 to finance the project. *Buckeye Countrymark* was selected as the test case after a review of several pending cases. NATIONAL COUNCIL OF FARMER COOPERATIVES, 1994 ANNUAL REPORT 8 (1995).

86. Buckeye Countrymark, Inc. v. Commissioner, 103 T.C. 547 (1994).

87. *Id.* at 581.

IV. MISCELLANEOUS

A. *Federal Legislation*

Some miscellaneous federal statutes impacting cooperatives also have been enacted recently. One such statute is the Farm Credit System Agricultural Export and Risk Management Act of 1994.[88] This statute expands the authority of the National Bank for Cooperatives to finance agricultural exports, even though the bank may not be able to certify cooperative origin.[89] However, the statute makes it clear that cooperative-sourced commodities must receive priority.[90] The statute further expands the authority of the National Bank for Cooperatives to finance cooperative joint ventures and partnerships. The new act authorizes financial assistance to any domestic or foreign party in which a cooperative has an ownership interest if the purpose is to facilitate the business operations of the association.[91]

A second piece of legislation that may affect cooperatives at least indirectly is the Department of Agriculture Reorganization Act of 1994.[92] Pursuant to that statute, the Agricultural Cooperative Service has been restructured as an independent program of the Rural Development Administration, reporting to the Under Secretary

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[88]. Pub. L. No. 103-376, § 4, 108 Stat. 3498 (1994) (amending various sections of the Farm Credit Act of 1971) (codified at 12 U.S.C. §§ 2001-2279 (1994)).

[89]. The Farm Credit System Agricultural Export and Risk Management Act amended 12 U.S.C. § 2128 (1994) to provide that:

> A bank for cooperatives may make or participate in loans and commitments to, and extend other technical and financial assistance to--(i) any domestic or foreign party for the export, including (where applicable) the cost of freight, of agricultural commodities or products thereof, farm supplies, or aquatic products from the United States under policies and procedures established by the bank to ensure that the commodities, products, or supplies are originally sourced, where reasonably available, from one or more eligible cooperative associations described in section 2129(a) of this title on a priority basis . . . .

Id. § 2128(b)(2)(A)(i). See further, 140 CONG. REC. S14,235-36 (daily ed. Oct. 5, 1994).

[90]. 12 U.S.C. § 2128(b)(2)(A)(i).

[91]. 12 U.S.C. § 2128 (1994) provides that:

> A bank for cooperatives may make or participate in loans and commitments to, and extend other technical and financial assistance to--(ii) except as provided in subparagraph (B), any domestic or foreign party in which an eligible cooperative association . . . has an ownership interest, for the purpose of facilitating the domestic or foreign business operations of the association, except that if the ownership interest by an eligible cooperative association, or associations, is less than 50 percent [sic], the financing shall be limited to the percentage held in the party by the association or associations.

Id. § 2128(b)(2)(A)(ii).

[92]. Pub. L. No. 103-354, 108 Stat. 3209 (1994) (codified at 7 U.S.C. §§ 6901-7014 (1994)). The Act provides "the Secretary of Agriculture with the necessary authority to streamline and reorganize the Department of Agriculture to achieve greater efficiency, effectiveness, and economies . . . ." *Id.* § 6901.

for Small Community and Rural Development.[93]

A third statute that has been introduced but not yet enacted pertains to the small ethanol producer credit, a credit intended to stimulate ethanol production for small producers.[94] The proposed statute would permit cooperatives to pass the ethanol producer credit to their members rather than allow it to be underutilized at the cooperative level. As proposed, cooperatives would be granted the option of apportioning the credit among their patrons on the basis of patronage.[95]

B. *Federal Litigation*

Finally, a couple of miscellaneous cases involving the federal government and agricultural cooperatives should be mentioned. After ten years of negotiation, the bankruptcy court in *In re Energy Cooperative, Inc.,*[96] approved a settlement of environmental claims filed by the United States against a cooperative refinery. In the second case, *Minn-Dak Farmers Cooperative v. Espy,*[97] a North Dakota district court determined that the Secretary of Agriculture did not act arbitrarily or abuse his discretion in imposing marketing allotments on sugar beet and sugarcane processors.

V. CONCLUSION

This review of current developments illustrates the variety of cooperative issues addressed by different branches of government in only a short space of time. Federal and state courts have addressed inspection rights, procedural issues for equity redemption suits, membership termination, the definition of a producer for antitrust purposes, and the application of certain tax provisions to cooperatives. The Treasury Department has promulgated a new revenue ruling and considered internally a proposal to modify cooperative tax law. Congress has enacted or contemplated legislation in regard to cooperative taxation, the ability of cooperatives to borrow from the National Bank for Cooperatives, and ethanol tax credits. As this review indicates, the law applicable to agricultural cooperatives remains a vital and evolving area of law.

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93. *See* USDA/RBCDS, COOPERATIVE SERVICES PROGRAM ACCOMPLISHMENTS 4-5 April 1995.

94. S. 1248, 104th Cong. (1995). The small ethanol producers tax credit was created in 1990 to provide a $.10 per gallon tax credit on the first 15 million gallons produced by ethanol plants producing less than 30 million gallons annually. For the text of the proposed bill, see 141 CONG. REC. S13662 (daily ed. Sept. 15, 1995). The House counterpart is H.R. 2322, 104th Cong. (1995).

95. The proposal would add a new subsection 6 to 26 U.S.C. § 40(d) (1994).

96. *In re* Energy Coop., Inc., 173 B.R. 363 (Bankr. N.D. Ill. 1994).

97. Minn-Oak Farmers Coop. v. Espy, 851 F. Supp. 1423 (D.N.D. 1994).