MEMBERSHIP AND STOCK POLICY

By

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It is my understanding that this clinic has in attendance representatives of many types of Indiana cooperatives. I assume that many of you who are representing a cooperative as a director are also members of other types of cooperatives and possibly a director of more than one type of cooperative. I recognize also that some cooperatives such as Federal Savings and Loan Associations, Production Credit Associations, Mutual Insurance, Federal Land Bank Associations, Rural Electric Cooperatives, and Credit Unions have specific membership requirements either established by the laws society has enacted for their incorporation and/or by the special nature of their business or service. I also recognize that Production Credit Associations, Federal Land Bank Associations, and the Bank for Cooperatives have federal charters and are part of a unique centralized cooperative system governed by Public Law 92-181 and Public Law 94-184[1/] that specifies their specific membership requirements.

The Indiana Agricultural Cooperative Act[2/] in Section 2-b defines members as; "The term, member, with respect to a non-stock, membership association shall be those admitted in accordance with bylaws and with respect to an association having capital stock shall be the holders of voting stock therein." Section 3 states "Five or more persons engaged in the production of agricultural products . . . may organize." Section 6, "under the terms and conditions prescribed by the bylaws adopted by it, an association may admit as members, or issue common and voting stock to, such individuals and/or politician subdivisions of the State of Indiana, as meet the requirements of the following paragraphs. . ."

I trust that you recognize that I cannot be specific in my remarks for your or any other one specific cooperative.

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[1/] Public Law 92-181, 92d Congress, S. 1483 December 10, 1971. Amended by Public Law 94-184, 94th Congress, H.R. 7862, December 31, 1975, Section 1.8, Section 2.1, Section 2.10, Section 3.8, Section 3.9 and other Sections.

[2/] Indiana Agricultural Cooperative Act, Being Chapter 20, Acts 1925, as amended by Chapter 34, Act 1931, Chapter 284, Acts 1935; Chapter 151, Acts 1939, Chapter 167, Acts 1949 and by Public Law 201, Acts 1971.

I did not write the laws under which your cooperative is incorporated, or your cooperative's bylaws or code of regulations which are the rules your cooperative members established for their directors to manage their cooperative within. I did not write the IRS laws and regulations under which farmers are taxed. Therefore, I do not feel compelled to defend them. As an Extension Economist I do feel a responsibility to assist farmers in the efficient operation of their "tool of modern farming--their cooperative" -- within the laws and regulations.

To me policies are:

Policies are statements in general terms which serve as guides to consistent decisions in recurring situations. Policies are a "map" that directors, management, employees and owners can follow to reach the goals of the cooperative.

Policies make it possible for a cooperative's employees, manager, members and board to work together to use their cooperative as a tool of modern agriculture.

The law under which your cooperative is incorporated gives the authority to manage the cooperative firm to the board of directors.

In the preparation of a membership or stock policy for your cooperative you must know and understand the rules and regulations for your specific type of cooperative within the laws and regulations for agricultural cooperatives. You must understand the concept of mutuality which establishes cooperatives as a tool of modern agriculture the same as the tractor or as some like to say, cooperatives as an extension of the farm fence.

According to John W. Holt, Director, Corporation Tax Division, Internal Revenue Service,[3/] "Profit margins in many areas, grain being one of them, have narrowed, leaving less room for error and causing problems for cooperatives competing with commercial operations. One such problem is the practice of marketing cooperatives paying the posted price for the grain that they acquire from their patrons. In addition, these competitive realities have combined with a presumably human factor that has led many patrons to tend to view their cooperative as just another way of doing business. This has been reflected in the members' apparent unwillingness to accept the limitations or restrictions on mutuality. Rather they require of their cooperative all the benefits they can achieve through a commercial enterprise, and also expect the additional benefits inherent in mutuality." (Such as patronage refunds and the cooperative financed by someone else.)

I feel I should also point out that most of us had our academic training based on investor-oriented business. This void in our academic training puts

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[3/] Holt, John W., Director, Corporation Tax Division, Internal Revenue Service, "Income Taxes--Farmers Cooperatives--Some Concepts." The Cooperative Accountant, 1976, page 2.

another demand upon us as we must adjust our thinking to the cooperative's way of doing business.

The February 7, 1977 issue of Business Week[4/] "Even the current power of the co-ops has led to increasing bitterness among the agribusiness companies that must compete with them in the manufacture of goods for farmers. Private businessmen find the competition unfair for two reasons:

1. The co-ops enjoy an enormous tax break because they do not have to pay federal income tax on profits returned to their owners. On the average, the tax rates of the cooperative are only about one-third those of their industrial competitors."

The fact is that IRS tax rates are based on the individual or firm's profits, thus some alert readers of the Business Week article[5/] might conclude that these industrial competitors of farmers are in fact ripping off farmers and consumers and these same investor corporations are in fact responsible for the high food costs while farmers and cooperatives are, based on IRS tax rates, attempting to move food and fiber from farmers to consumers in the most efficient way.

Wilmer A. Dahl and W. D. Dobson writing in the AAEA[6/] "Cooperatives are experiencing pressures to increase cash patronage refunds, reduce financing costs, and retire equity capital of farmer-members who die, retire or leave the cooperative's service area. ---." Many self-proclaimed cooperative finance experts who also write for newspapers and magazines have written simple complete solutions for the distribution back to farmers of the value added by cooperatives or savings from efficient marketing operations but most of these solutions can only result in disaster for farmers and their cooperatives. Like many self-made experts, they know the answer but not the problem.

A cooperative is operated for the mutual benefit of its members when no interests other than members share in the financial rewards of its business activities.

The excess proceeds of the firm over the cost of doing business or association expenses accrue only to the cooperative's member users not to outside investors. Cooperatives do have a unique way of obtaining equity capital from its member users. This is the distribution of a portion of the cooperative's margins in some form of equity and in some cases debt capital to member users not to investors. Not only does this method of distributing patronage refunds provide necessary equity capital for the cooperative but tends to keep the financing in the hands of current member users.

When the members of a cooperative are unable to provide the necessary financing required by their cooperative for the efficient servicing of its

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[4/] "The Billion-Dollar Farm Co-ops Nobody Knows," Business Week, page 54.

[5/] Ibid.

[6/] American Journal of Agricultural Economics, Volume 58, Number 2, May 1976, page 198.

members, the cooperative may offer its nonvoting stock or preferred stock for sale to the general public. The expected dividend rate on such stock together with the anticipated ability of the cooperative to earn sufficient margins to pay the dividend in the future influences the marketing of such stock. The dividend rate on equity capital must be high enough to attract investors but no higher than the 8% limit for most cooperatives. Margins used to pay stock dividends can reduce the amount paid out as patronage refunds, thus many members elect to receive little or no interest in order to receive and redeem stock.

Dividends on the cooperative's equity capital are generally limited to eight percent per annum. The eight percent limitation complies with practically all state statutes and is also one of the two optional requirements of the Capper Volstead Act and a requirement for membership by the Bank for Cooperatives.

I like to classify equity capital as that which does not have a due date.

Cooperatives that cannot or do not wish to qualify under Section 521 or so called "exempt cooperatives" may wish to have a higher percentage of their financial structure in debt capital. Exempt or interest does not mean the cooperative is exempt for IRS taxes--but means that the dividends or interest the cooperative pays on equity capital are exempt from IRS taxes the same as interest paid on debt capital. The cooperatives that do not have exempt status cannot deduct interest or dividends paid on equity capital from their taxable income. However, any cooperative can deduct interest paid on debt capital since it is considered by IRS as an annual operating expense. So if you elect not to or cannot meet the requirements for Section 521 and be a so-called "exempt" cooperative debt financing may be the route you should follow. As I stated earlier debt capital has a due date--that is the cooperative selling the bonds agrees to pay so much interest each year and to redeem the bond at its face value at a specified future date.

A recent study by Nelda Griffin, Senior Agricultural Economist-Finance with what was called Farmer Cooperative Service, reported in The Cooperative Accountant, Winter 1977, page 10,[7/] states that for the farm supply cooperatives in her study equity capital accounted for 43 percent of total assets, for marketing cooperatives equity capital was 30% of total assets--these were all cooperatives with over $50 million in assets. The report goes on to say that equity capital financed 52 percent of total capital needs of the 100 cooperatives in the study in 1962, 39 percent in 1970 and a little over 34 percent in 1976. A closer look at the equity capital of this group of 100 cooperatives shows that their total equity in 1976 was $3½ billion compared with $1.7 billion in 1970 and $1.2 million in 1962.

Each of us have our own preferences. Having lived through the great depression, I am conservative. If possible I would prefer my cooperative use equity financing over debt financing, recognizing the value for a combination

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[7/] The Cooperative Accountant, Winter 1977, page 10.

of the two. I would prefer if possible to obtain my borrowed capital from the Bank for Cooperatives, or Commercial Bank first and my second choice would be debt securities such as bonds.

There is another out I could use as a cooperative director. I could promote a ten year limit on the time a person could serve as a director, - then have the cooperative sell a lot of 10 year bonds, so we could build facilities, etc., since I couldn't be a director 10 years from now someone else could have the honor of raising the funds to pay off those bonds 10 years from now.

The Capper Volstead Act does not exempt cooperatives from antitrust acts but does permit farmers to join together in associations. Marketing associations have some special limitations under the Capper Volstead Act, one being non-member business. For example, a marketing association must not "deal in" the products of nonmembers to a greater extent than in the products of members. While there is much that could be discussed about this point in the Capper Volstead Act. The Bank for Cooperatives requirements for membership and a loan are:

1. 80% of voting control in the hands of farmers (for REC's 70%).
2. 50% of business by members.
3. One member, one vote or 8% limit on equity capital dividends.

As a cooperative member user I would prefer to receive my patronage refunds in stock, either common or preferred. I would like the stock not to bear interest. I would even be willing to add sufficient cash to my patronage refund to permit insuring me a full share of stock.

"A director has a fiduciary duty to the corporation and to its stockholders to manage the affairs of the corporation in a manner which is consistent with their interests. Any breach of his fiduciary duty may subject him to personal liability to both shareholders and the corporation."[8/]

Now for some of my biases about cooperative membership.

Directors should conduct annually a selective membership campaign. Directors should visit all patrons that are not members of the cooperative to determine if the patron is eligible for membership and if the director feels the patron would make a desirable member of the cooperative invite the patron to apply to the board of directors for membership. This activity in the early days of your cooperative by knowledgeable, committed and informed board members was, I believe, an activity that contributed heavily to the success of your cooperative. Cooperatives are different one from another and Rural Electrics, for example, will find this membership campaign not applicable.

I used to be astonished by young farmers asking how they could join a

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8/ Law Director, Stevens Fefets, page 60.

cooperative. Again, I turn to the Business Week[9] article of a year ago. "Until recently, this growth has been one of the best-kept secrets in the U.S., largely because co-ops maintained a low profile. ---" A study conducted by Gallup Opinion Poll for the Advertising Council of Cooperatives International should, among others, quote position public opinions of cooperatives that generally the more people know about co-ops, the better they liked them.

Therefore, I think a part of our membership policy should include directors securing new members and telling prospective and new members what the cooperative way of doing business is and how it operates. So before you conduct your membership campaign you need to know your cooperative's policy for membership -- who is eligible and what the requirements are.

As a part of your membership policy, I recommend that a membership application form be prepared and used. This form sets forth the requirements for membership and how the applicant meets them as well as obtaining consent for IRS taxations.

For requirements, why not consider commitment? Let's say a sizable financial commitment of $1,000 to $50,000 or more for a voting share or a membership. History has shown us that in too many cases cooperative membership has been too easy. If we consider the cooperative as a tool of modern agriculture, few farmers will spend $50,000 for a tractor and use it to plow only a fraction of their farm and put it up on jacks and hire their neighbor to come in and plow for them. Yet some farmers use their co-op this way. They expect their cooperative to be ready to function as a tool of modern agriculture when they cannot get service anywhere else. For most of you this suggestion may not be timely.

I have never favored members earning their membership by the accumulation of patronage refunds or in one cooperative that I know of membership is obtained by simply endorsing the check that patrons received for products they delivered to the cooperative. Make the cooperative membership something special -- which it is. I recognize that some cooperatives such as PCA and FLB have a sent requirement for member financing.

Members should be committed to using their cooperative as well as financing it. Our history of agricultural cooperatives has too many obituaries of cooperatives that tried to serve their members, as a tool of agriculture, only when the member couldn't take his business somewhere else. I feel that in our present economy it would be prudent for directors of cooperatives to establish and carry out a policy of expelling members who have not used their cooperative during the business year. I like those state cooperative acts that permit the board of directors may expel those who have not used the cooperative for a period of one or two years. Some of you like Rural Electrics, PCA's, Savings and Loan, Mutual Insurance, FLB's and BC's have this provision built in and it works because you never did it any other way.

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[9] Ibid., page 24.

I am firm in my conviction that every cooperative board of directors should at least once a year review the entire membership of their cooperative.

1. To make sure all members meet the eligibility requirements of the law, regulations, bylaws, etc. (persons no longer farming or deceased)

2. That voting membership or voting stock is in the hands of eligible members.

3. That deceased members are properly removed from the records and the cooperative's obligations paid.

These policies should be written after a careful study of the cooperative's financial condition and provided for in the cooperative's long-range plans and annual budget.

The board should prepare a policy that sets forth the responsibility of members that are not "natural persons" to designate to the secretary of the cooperative who is to represent the member and vote for the member. This would be for all Mr. and Mrs. members, partnership members, joint members, corporation members -- and that failure to do so would constitute grounds for denial of voting rights.

Before considering my biases on retiring stock, cash payment, etc., I want to caution each director to objectively study his cooperative's financial structure, long and short range, plans, cash flow and all other factors that may affect the financial health of his cooperative not only this year but in 5, 10, 15, 20, and 25 years into the future. You have a legal responsibility to safeguard the financial well being of your cooperative.

I never expected to hear farmers complain about getting too much patronage refund from their cooperative as they did a couple of years ago. I was surprised at the number of farmers who stated to me that they had an IRS tax rate higher than the percent of patronage their cooperative paid them in cash. Again, I did not write the IRS law or regulations. The 1964 IRS act said cooperatives are an extension of the farming operation and that income farmers received from their cooperative would be returned to them as income in the year earned and taxed at the individual farmer's tax rate in the year it was allocated. Farmer testimony was that the 20 percent rate was the most representative of farmers' adjusted gross income, thus the 1964 act specified 20% cash refund to be used to pay IRS.

You might want to survey your membership to determine what your members most representative tax rate is. Keep in mind that 39 percent rate is for adjusted gross income of $28,000 to $32,000; 45 percent rate is $36,000 to $40,000; 50 percent is for $44,000 to $52,000; 60 percent is for $88,000 to $100,000. Last year I wrote for this meeting -- Don't be surprised if the results of your survey are different than what IRS gets from the same respondents, I think that would also apply in 1978--but maybe in reverse.

We hear some economists talking about opportunity costs of money and what good use farmers could make of the patronage they have invested in their cooperative. These same persons fail to do an opportunity cost of money for non-cooperatives who keep the overcharges or underpayments that they did not return to their customers but paid taxes on and put in their corporate treasurer and stockholders pocket. A good case can be made that the cheapest source of capital for a firm, even a cooperative, is tax paid earnings. The one-time 50 percent tax is cheaper than a 10 percent selling cost and let's say 10 percent annual interest for four years. Before you write a policy on cash refunds, and stock or patronage redemption, a study of your cooperative's financial structure must be made to determine the cash flow needs of your firm and how much of this cash can be used to pay the cash portion of your patronage. Some of you might find the loan representative of the BC helpful. Directors who jeopardize the financial well being of their cooperative by over-committing the cooperative's cash for patronage refund or interest may place themselves in a libelous position.

Let me give you an example of how cooperative boards can create problems for themselves. Let's say a cooperative sells a $10 membership stock--say 40 years ago. The board of this "coop" elects to play with the investor oriented corporate tax rules rather than the rules for cooperatives. That is, not keep patronage records but pay corporate taxes, give contributions to charity, etc. In some years this cooperative had earnings of $200,000 paid $100,000 to IRS and the "co-op" kept the other $100,000. After 40 years operation they followed my suggestion to purge their membership -- so they call in this $10 membership stock and redeem it at $10 -- in a coop that has allocated earnings to patrons over the years this is OK as the cooperative itself has no earnings, but what should a so-called coop that has paid corporate income taxes and kept the earnings pay for this stock? Each share of common stock is now worth about $500.00. How can the board correct such an error, I don't know. Know the rules of the game and play the game fairly.

Rather than use the maximum cash flow available to pay the cash portion of a patronage refund, evaluate the possibility of redeeming past patronage allocations. Redeemed past patronage allocations is tax free money to farmers since they paid taxes on this income in the year it was allotted. By redeeming old allocations you can accomplish several good points for your cooperative. You can demonstrate that there is value to the cooperative's paper. At the same time you can more equitably have the cooperative financed by current members. You may be surprised how far your current available cash flow will go in picking up old allocations since in some past years earnings were too large for many co-ops.

I think your most important policy is one that sets forth your cooperative's intention toward redeeming patronage refund allocation to settle estates of deceased members.

A clear policy statement should be prepared for the redemption of obligations persons no longer qualifying for membership to include those who have moved out of the area or retired and taken social security benefits. To maintain the financial stability of the cooperative it may be necessary to go to the active membership and ask them to purchase equity stock to replace that redeemed from inactive members. Some cooperatives may find older members reluctant to leave their cooperative and may want to consider an associate membership stock to permit these loyal long time members to continue their association with their cooperative.

How about associate members? Can non-farmers who use your cooperative share in the patronage? We non-farmers, of course, don't have to pay income tax on our patronage refunds since the law and regulations do not permit us to deduct our expenditure in arriving at our adjusted gross income.

You need to evaluate how much equity capital should be used to finance your cooperative and write a policy setting forth the ratio of debt to equity capital you desire. We could inform the writers for Business Week that equity capital does not have a due date. Cooperatives, of course, can deduct interest paid on debt capital as an annual operating expense, this is about the same so-called tax advantage as provided in Section 521 -- which permits agricultural cooperatives that qualify to deduct interest paid on equity capital before computing their taxable income.

Let me give you something to think about and cuss and discuss. Now don't be too quick to reach your position on this. We have farmers who don't want to receive patronage refunds which are extra payments for their wheat or a refund on their fertilizer because it makes them pay too much income tax, and I recognize that many find themselves pushed into a higher income bracket. Then we have articles like the one in Business Week that says co-ops have an unfair tax advantage. Then some U.S. government agencies say co-ops should register all patronage refunds as they are a security. This act, in my opinion, could cost more than the total earnings of the cooperative, thus, there would be no patronage dividend. So why not use that old tried and proven cooperative practice of pooling. Rather than charge competitive prices and aim for a plus margin to be allocated as patronage, price for a small negative margin and bill the patrons at the end of the year so the cooperative will break even. This might sound pretty wild at first but it is not an unusual practice as there are some cooperatives here today that tell me they can hit it right on the nose and break even every year thereby never having to pay patronage.

In conclusion, let me point out that there is no one membership and stock policy that will satisfactorily serve all cooperatives. That is the responsibility of the board of directors to establish membership and stock policies that will safeguard the financial structure of the cooperative be in the best interest of the majority of members. Directors should not be stampeded into writing a policy by a few uninformed members. It will be prudent for many cooperative directors to conduct educational programs for members and employees to teach the concept of mutuality. There may even be directors who do not realize the uniqueness of the cooperative way of doing business.

The popular issue today is the demand that cooperative directors pay a larger percentage of the cooperative's patronage in cash. A policy on cash allocation greater than 20 percent should be written only after careful study of the cooperative's financial position and future capital requirements.

Before increasing the cash portion of the patronage refund the board should carefully evaluate the benefit to be obtained from other uses of the available cash. Among the uses for available cash, the board is encouraged to evaluate the advantages of redeeming past patronage allocations.

Make the cooperative membership meaningful and your cooperative an effective tool of modern agriculture. Referring again to the current Business Week article, "Indeed, some agribusiness executives admit to ambivalance 'The co-ops can make things happen for your products in the marketplace' says one, 'but I have mixed emotions about dealing with them because I feel I'm helping to build a monster that will eventually get me.'"

Well thought out logical policies are problem preventers rather than problem solvers.

Once these policies are prepared, discussed, published, and used cooperative directors should also put into operation a policy to tell members, employees and the public about the good things the cooperative does. Imagine a caption in the local paper that reads, "E. W. Ware Receives $29,600 from Co-op Stock Redemption at his Retirement." "Co-op Redeems Patronage Stock Issued in 1958--1200 Local Farmers Receive $240,000." Policies are only worthwhile if they are used.