

1-1967

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Recommended Citation

Francis Kerner, *Securities and Capital Structures of Farmer Cooperatives in California*, 19 HASTINGS L.J. 309 (1967).

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SECURITIES AND CAPITAL STRUCTURES OF FARMER COOPERATIVES IN CALIFORNIA

By FRANCIS KERNER*

FROM the bargaining cooperative¹ having minimum fixed assets and receivables to the substantial marketing or purchasing cooperative having extensive physical facilities and accounts receivable, each farmer cooperative² needs capital in order to function effectively as a business entity. Very few farmer cooperatives in the United States have tried with any success to obtain financing by public issuance of securities. Most often, the farmer-patron supplies the capital out of the proceeds or earnings generated by the cooperative itself.³

As is stated in the Agricultural Code, the cooperative associations are non-profit "inasmuch as they are not organized to make profit for themselves, as such, or for their members, as such, but only for their members as producers."⁴ The proceeds or earnings payable to the member-patron serve as a source of contributed capital. The member undertakes by contract to supply needed capital to the cooperative by authorizing it to deduct or retain part of the proceeds or earnings which are payable to him.⁵ The sums which are deducted or retained are then credited to the member's account, and he in turn receives a security for the retained amount. It is elementary that without contractual authority no such deduction or retention may be made.⁶

The discussion which follows is meant to serve as an introduction to the two types of capital structures used in nonstock cooperatives: the revolving fund capital form, and the base capital method. Also to be discussed are the characteristics of the securities which are issued to patrons pursuant to their contributions.

Capitalization of the Nonstock Cooperative

Although a cooperative organized under the Agricultural Code

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¹ CAL. AGRIC. CODE § 54401.

² The typical California farmer cooperative, the securities and capital structure of which will be discussed here, is a nonstock corporation organized under chapter 1, division 20 of the Agricultural Code.

³ Reinert v. California Almond Growers Exchange, 9 Cal. 2d 181, 186, 70 P.2d 190, 192 (1937).

⁴ CAL. AGRIC. CODE § 54033.

⁵ In Madison Avenue fashion farmer cooperatives have converted a verb into a noun so that in cooperative parlance, "retain" is that which is retained. Hence, the retentions or deductions are referred to as "retains."

⁶ Silveira v. Associated Milk Producers, 63 Cal. App. 572, 576, 219 P. 461, 463 (1923).

may have capital stock, the trend in California has been to incorporate nonstock farmer cooperatives. Many of the older capital stock cooperatives have been converted to nonstock associations. Hence, today we have relatively few California farmer cooperatives organized with shares of stock.⁷

The typical California nonstock farmer cooperative is capitalized with so-called revolving fund type capital. Unlike capital stock, revolving fund capital has no statutory sanction, although some recognition is found in the California Revenue and Taxation Code.⁸ It also has received some limited judicial acceptance at the appellate level.⁹

The base capital method is a second form of capitalization which is becoming more popular with nonstock cooperatives because of some adverse tax consequences involved in the revolving fund method.¹⁰ Since the revolving fund method is the one most often used, a larger part of the discussion will be devoted to this form of capitalization; only a limited examination of the base capital method will be presented here.

The Revolving Fund

The revolving fund capital form¹¹ is wholly contractual. Normally, it is elaborately provided for in the association's bylaws, with some treatment in the articles of incorporation. This fulfills the requirement regarding a statement of property rights and interests in the association.¹² The property rights and interest of each member of a nonstock association are usually unequal and are measured by, but not identified with, their revolving fund credits.¹³

The dual relationship of the farmer-member to his cooperative as a patron and investor serves as a sound basis for the revolving fund type of capital. During his patronage the member is currently con-

⁷ The capital structures of the stock cooperatives are, for the most part, conventional. However, holders of common or voting stock are required to be producers of agricultural products or associations of such producers. CAL. AGRIC. CODE §§ 54231-33. Preferred shares normally carry no voting rights, and dividends on any shares may not exceed 8 percent per annum. CAL. AGRIC. CODE § 54120. For those farmer cooperatives which are exempt from federal income tax under INT. REV. CODE OF 1954, § 521, there are further restrictions on nonvoting preferred shares, the holders of which may not share in the profits of the association in excess of permitted dividends (8 percent) on dissolution or otherwise.

⁸ CAL. REV. & TAX. CODE §§ 17117.5, 24404.

⁹ For extant cases see text accompanying notes 43-53 *infra*.

¹⁰ See text accompanying notes 74-76 *infra*.

¹¹ Some cooperatives prefer "Investment Fund," "Capital Fund," or other designation.

¹² CAL. AGRIC. CODE § 54081.

¹³ CALIFORNIA FARM AND RANCH LAW § 11.15 (Cal. Cont. Educ. Bar ed. 1967).

tributing in accordance with a formula prescribed by the association's board of directors pursuant to bylaw authority. This formula invariably relates volume of patronage to the obligation to contribute capital by way of retains. When he ceases to be a patron-member, ideally his capital will be "revolved out" (paid to him serially in full).

If a cooperative has built up sufficient capital, which together with bank borrowings will adequately finance fixed assets and operations, it has reached a level of net worth which will justify the use of funds from current retains to retire or revolve out the revolving fund credits of the earliest year or priority. In this way, the capital goal is achieved according to predetermined need, and there is only a shift in the ownership of the revolving fund credits resulting from varying production from year to year and turnovers in membership. This is, of course, in tune with the concept of current patrons supplying the capital in relation to their current patronage.

The Nature of the Revolving Fund Credit

If revolving fund credits or capital credits must be classified or characterized, perhaps they can best be designated as hybrid securities. On an appropriate contractual foundation they are the net worth of the cooperative, and informed creditors so regard them.

Basis in the Bylaws

It is fair to say that the *typical* California nonstock farmer cooperative having the revolving fund form of capital, and those few stock cooperatives which also have revolving fund capital as well as shares of stock, provide in their bylaws for the following:

1. The cooperative has authority to make retains giving rise to the revolving fund credits.
2. The revolving fund credits are subject and subordinate to all other obligations and debts of the association.
3. The revolving fund credits carry no voting rights; only members vote. Nonmembers may hold revolving fund credits.
4. The credits do not mature until declared payable by the association's board of directors.
5. Revolving fund credits are subject to diminution for losses which the board of directors determines are not properly chargeable to operations (akin to reduction of stated capital to eliminate a balance sheet loss).¹⁴
6. Payment of "interest" on revolving fund credits may be provided for or prohibited.¹⁵

¹⁴ CAL. CORP. CODE § 1904 authorizes such diminution.

¹⁵ Although commonly referred to as interest, it is a dividend on capital.

7. Credits have an order of priority. Except on dissolution, the credits of one year may not be retired until the credits of all prior years have been paid. In some instances earlier payment to effect a compromise or settle a dispute with a holder of revolving fund credits is permitted. Under the adjusted balances or base capital method,¹⁶ the year of priority loses its significance and retirement is conditioned on amount of investment rather than year of priority.

8. Provision is made for issuance of statements or certificates to evidence revolving fund credits. These evidences of credits would ordinarily be expected to be either "qualified written notices of allocation" or "qualified per-unit retain certificates" as defined in the Internal Revenue Code.¹⁷

9. On dissolution all revolving fund credits (regardless of year of priority) are of equal status, but no payment or distribution may be made until all of the debts and liabilities of the association have been paid or adequate provision has been made for payment.

Characteristics of the Securities

The patrons may be said to be parties to a kind of continuous subscription agreement, resulting in an offset against proceeds or earnings which would otherwise be currently payable to them. It may be said that securities are issued as part of the cost of goods sold, or as a reduction or adjustment of the price of goods purchased, depending on whether the cooperative is a marketing association or a purchasing association.

It should be mentioned that not all member capital of farmer cooperatives is produced by the retain method. Particularly in the case of the new farmer cooperative, the first members make contributions to the capital of the organization, for which they receive securities. The funds thus contributed serve as sufficient net worth to merit bank financing with which to begin operations. Generally, the securities resulting from out-of-pocket capital contributions assume no different form from those arising as a result of retentions from proceeds or earnings. Some cooperatives require that the applicant for admission to membership make a capital contribution.

It should be noted that the membership fee device has long been in disuse among farmer cooperatives in California.¹⁸

¹⁶ Text accompanying notes 74-76 *infra*.

¹⁷ INT. REV. CODE OF 1954, §§ 1388(c) (1) (B), (h) (1).

¹⁸ See, e.g., *DeMello v. Dairyman's Co-operative Creamery*, note 68 *infra*.

Statutory Exemptions

The Agricultural Code¹⁹ exempts from the Corporate Securities Law²⁰ any securities of cooperatives organized or existing under chapter 1, division 20, of the Agricultural Code.²¹

A farmer cooperative which is exempt from federal income tax²² is also exempt from regulation under the Securities Act of 1933.²³ For an agricultural cooperative association as defined in the Agricultural Marketing Act,²⁴ there is an exemption from registration requirements by virtue of the Securities Act amendments of 1964.²⁵ The Agricultural Marketing Act definition of a farmer cooperative is less rigid than that found in the Internal Revenue Code;²⁶ hence, more cooperatives are able to qualify for exemption under the amendments than under the 1933 statute.

The Analogy to Shares

The Corporations Code²⁷ equates memberships of nonstock corporations with shares, but revolving fund credits are not memberships. In one case,²⁸ the court stated that the revolving fund credits which were the subject of litigation were analogous to shares. There is no California case holding that the securities of a nonstock cooperative are shares, although there have been at least two cases²⁹ in which plaintiff-holders of revolving fund credits have alleged that they were entitled to assert the rights of shareholders under the applicable sections of the Corporations Code.

In one case,³⁰ plaintiffs who held one-third of the revolving fund credits (but not one-third of the memberships) of a California farmer cooperative sought involuntary dissolution of the defendant cooperative.³¹ The case was settled (without defendant's dissolution) before

¹⁹ CAL. AGRIC. CODE § 54201.

²⁰ CAL. CORP. CODE §§ 25000-26104.

²¹ CAL. AGRIC. CODE §§ 54001-294.

²² INT. REV. CODE OF 1954, § 521.

²³ 15 U.S.C. § 77c(a) (5) (1964).

²⁴ 12 U.S.C. § 1141j(a) (1964).

²⁵ 15 U.S.C. § 781(g) (2) (E) (1964).

²⁶ INT. REV. CODE OF 1954, § 521.

²⁷ CAL. CORP. CODE §§ 103, 115.

²⁸ *Placerville Fruit Growers' Ass'n v. Irving*, 135 Cal. App. 2d 731, 735, 287 P.2d 793, 797 (1955), discussed in text accompanying notes 35-41 *infra*.

²⁹ *Community Grape Corp. v. California Wine Ass'n*, No. 71778 (San Joaquin County Super. Ct., filed May 10, 1960) (settled before trial); *Shannon v. California Farm Bureau Marketing Ass'n*, No. 63924 (Tulare County Super. Ct., filed Aug. 17, 1966).

³⁰ *Community Grape Corp. v. California Wine Ass'n*, No. 71778 (San Joaquin County Super. Ct., filed May 10, 1960) (settled before trial).

³¹ Involuntary dissolution of a corporation is dealt with in CAL. CORP. CODE § 4650.

trial. In another case,³² the plaintiff-holders of revolving fund credits of the defendant cooperative took the position that they were entitled to be considered dissenting shareholders in a corporate consolidation.³³ A demurrer to the second cause of action in the complaint incorporating the dissenting shareholder theory was sustained. Plaintiffs amended the complaint by eliminating the second cause of action. The action is still pending in the superior court.³⁴

The case of *Placerville Fruit Growers' Association v. Irving*,³⁵ involved a dispute between the son and daughter of a deceased patron of the cooperative. Both claimed the sum due their father which appeared on the books of the cooperative in the form of revolving fund credits. The decedent had instructed the cooperative's management to pay the sum due him to his daughter when he died. The decision of the court was that the cooperative held the credits as trustee and that they may be the corpus of an express trust.³⁶

The nature of the credits was carefully considered, and the contractual basis of securities as laid down in the association's bylaws was summarized.³⁷ It can fairly be said that the bylaws of Placerville Fruit Growers are representative of the bylaws of California farmer cooperatives.³⁸ Although the revolving fund credits are characterized as an indebtedness, it is a kind of indebtedness that does not fit the usual definition. There is no maturity date. The association's *policy* of having a 5-year revolving cycle is of course neither inflexible nor enforceable by the holder of revolving fund credits.

The bylaws provided that the retained funds could be commingled and used for corporate purposes and that the money retained need not be physically segregated or set apart. It should be emphasized that the bylaws clearly provided that the revolving fund shall *not* be deemed a *trust fund*³⁹ held for the holders of the revolving fund credits, and that on dissolution all debts and liabilities shall be paid or provided for before any distribution of assets to holders of revolving fund credits.

The court said that "[t]he property interest of members whose funds had been thus retained by the corporation was remarkably analogous to the property interest of shareholders in an ordinary com-

³² Shannon v. California Farm Bureau Marketing Ass'n, No. 63924 (Tulare County Super. Ct., filed Aug. 17, 1966).

³³ Dissenting shareholders are treated in CAL. CORP. CODE §§ 4300-18.

³⁴ Shannon v. California Farm Bureau Marketing Ass'n, No. 63924 (Tulare County Super. Ct., filed Aug. 17, 1966).

³⁵ 135 Cal. App. 2d 731, 287 P.2d 793 (1955).

³⁶ *Id.* at 736, 287 P.2d at 797.

³⁷ *Id.* at 732, 287 P.2d at 794-95.

³⁸ See discussion of typical bylaws at text accompanying notes 14-17 *supra*.

³⁹ Cf. text accompanying notes 47-52 *infra*.

mercial corporation"⁴⁰ The court went on to say that the amounts declared payable (in the revolving process) are like dividends paid out of surplus of the commercial corporation.⁴¹ It appears that the analogy falls short of the court's approach. It is submitted that declaring payable revolving fund credits of the earliest priority is more analogous to a commercial corporation's calling a series of redeemable preferred shares.

It would seem that although revolving fund credits have characteristics of both share of stock and indebtedness, they are not properly designated as either; they are *sui generis*.⁴²

The Case Law

The following cases help to clarify the nature of the retains out of proceeds or earnings. In addition many point up the need for an appropriate contractual basis for the hybrid securities which farmer cooperatives issue.

In *Loomis Fruit Growers' Association v. California Fruit Exchange*,⁴³ the court quoted at length from the bylaws of the fruit exchange. The bylaws indicated that the withholdings out of earnings were retains for an account designated "Withholdings Repayable." The bylaws provided that the retains would mature in 5 years from the last day of the year of withholding.⁴⁴ Needless to say, the concept of a maturity date on revolving fund credits is frowned upon by any lender if the only capital of the association is represented by such a capital fund. However, in the principal case, defendant was organized with capital stock and presumably its issued and outstanding shares served as an adequate net worth.

In *Mountain View Walnut Growers Association v. California Walnut Growers Association*,⁴⁵ a local cooperative of walnut growers sought recovery of retains made by a central marketing cooperative. The fund resulting from retentions from proceeds by the central cooperative was described as "a reserve fund to carry on its future operations."⁴⁶ This fund was not created pursuant to particular contractual authority; hence, defendant was willing to stipulate that the fund was a trust fund. Prior to suit, the defendant association saw the error of its ways in becoming a fiduciary of the retains for the local cooperative, and in 1925 revised its contracts with its members to pro-

⁴⁰ 135 Cal. App. 2d 731, 735, 287 P.2d 793, 797 (1955).

⁴¹ *Id.* at 735-36, 287 P.2d at 797.

⁴² *Tomlinson v. Massey*, 308 F.2d 168 (5th Cir. 1962); *Greenville Corp. v. Comm'r*, 40 T.C. 926 (1963).

⁴³ 128 Cal. App. 265, 16 P.2d 1040 (1932).

⁴⁴ *Id.* at 269, 16 P.2d at 1042.

⁴⁵ 19 Cal. App. 2d 227, 65 P.2d 80 (1937).

⁴⁶ *Id.* at 228, 65 P.2d at 81.

vide "for a reserve or other fund."⁴⁷ The demand of plaintiffs was confined to the pre-1925 retains. The court held that the plaintiffs could not recover the retains until the new 15-year contract made in 1925 had run its course.⁴⁸ The trust fund had existed at the time of execution of the 1925 contract and was commingled with the fund authorized under the contract. It therefore became a part of the fund and subject to the contract.⁴⁹

It is unfortunate to characterize a capital fund as a trust fund, and careful draftsmanship can readily eliminate this hazardous consequence.

Although California Walnut Growers Association (hereinafter referred to as "Central") was not a party to the action, its retains were also involved in *Bogardus v. Santa Ana Walnut Growers Association*.⁵⁰ The "Present Operative Reserve Fund" of Central credited to the defendant was created by retains from proceeds of walnuts received from defendant's grower members and marketed through Central. Plaintiff was such a grower member who sought to enjoin the defendant from paying to growers who were no longer members of defendant their share of Central's retains which had been declared payable. The court took the position that when the retains were revolved or declared payable, they resumed their original character and thus were deferred sales proceeds; the revolved amounts were payable to the growers (whether or not their status as members continued) from whose walnut proceeds the retains or deductions were originally made. Here again the court referred to the fund as a trust fund.⁵¹

The court distinguished between the revolving fund of the local association (*i.e.*, the defendant) and Central's fund. In this reference it held that the "Present Operative Reserve Fund" of Central was not the property of the local association.⁵² Of course, another result can be achieved by contract, whether expressed in bylaws or otherwise. The revolving fund of a central marketing association may be made to be an investment reflected in the local association's revolving fund or net worth in the same manner as its packing plant or other facility.

Per-Unit Retains

The case of *Reinert v. California Almond Growers Exchange*,⁵³

⁴⁷ *Id.* at 229, 65 P.2d at 81.

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ 41 Cal. App. 2d 939, 108 P.2d 52 (1940).

⁵¹ *Id.* at 949, 108 P.2d at 58.

⁵² *Id.* at 949-50, 108 P.2d at 58.

⁵³ 9 Cal. 2d 181, 70 P.2d 190 (1937).

illustrates the so-called "per-unit retain allocation" (1 cent per pound of almonds) which is now defined in the Internal Revenue Code,⁵⁴ as opposed to the allocation which is a patronage dividend and is determined with reference to the net earnings of the cooperative.⁵⁵ The plaintiff almond grower brought an action for an accounting of the retains made by the marketing cooperative out of proceeds due plaintiff's assignor. The court said:

Admittedly the appellant has a right to a substantial amount of money representing a proportionate interest in the accumulations of the exchange from the contributions of its members.⁵⁶

The court went on to state that the amounts to which plaintiff is entitled as well as time of payment are issues that have to be passed on by the trial court on retrial.⁵⁷

The precision now required of cooperatives under the Internal Revenue Code⁵⁸ and the awareness of need for precise accounting which results from the development of cooperative tax law generally,⁵⁹ seem to make less likely the uncertainty of a patron's interest in a cooperative's capital funds exhibited in the *Reinert* case.

*Driscoll v. East-West Dairymen's Association*⁶⁰ is another case dealing with a per-unit retain. These retains were created by deducting from proceeds of milk and milk products one-half cent per pound of butterfat delivered to the defendant cooperative association by its members. The bylaws of the association designated the retains as membership fees and the court called them "dues."⁶¹ The plaintiff-member of the dairymen's cooperative brought the action for moneys paid to the cooperative by plaintiff's assignors who withdrew from the cooperative. The plaintiff's right and interest as a contributor to the fund were conceded, but the court held that the association was not obliged to distribute any amount represented by the fund until dissolution of the association.⁶²

Actually the rights of the holder of revolving fund credits in the average farmer cooperative in California are the same as those of the plaintiff *Driscoll*. However, in most instances there is some plan of revolving, although it is not obligatory.⁶³

⁵⁴ INT. REV. CODE OF 1954, § 1388(f).

⁵⁵ INT. REV. CODE OF 1954, § 1388(a). See *Loomis Fruit Growers' Ass'n v. California Fruit Exch.*, 128 Cal. App. 265, 16 P.2d 1040 (1932).

⁵⁶ 9 Cal. 2d 181, 189, 70 P.2d 190, 194 (1937).

⁵⁷ *Id.*

⁵⁸ INT. REV. CODE OF 1954, §§ 1382-88.

⁵⁹ See *Pomeroy Cooperative Grain Co. v. Comm'r*, 288 F.2d 326 (8th Cir. 1961).

⁶⁰ 52 Cal. App. 2d 468, 126 P.2d 467 (1942).

⁶¹ *Id.* at 471, 126 P.2d at 468.

⁶² *Id.* at 474, 126 P.2d at 470.

⁶³ See *Loomis Fruit Growers' Ass'n v. California Fruit Exch.*, 128 Cal. App. 265, 16 P.2d 1040 (1932), concerning revolving fund credits with a 5-year maturity.

The court in *Driscoll* identified the retained amounts with the "property rights and interests"⁶⁴ of members in the association.⁶⁵ Ordinarily, the "property rights and interests" of a member in a nonstock cooperative (whatever they may be) are measured by the member's revolving fund credits, but not identified with such credits.⁶⁶ In practice, "property rights and interests" of members have little significance in an operating cooperative. On dissolution they may become meaningful if there are residual assets to distribute after payment of debts and revolving fund credits. Again, stress should be laid on the necessity and advisability of providing for such matters contractually. The litigated cases, for the most part, illustrate structural weakness.

Reorganization

Not all California cases involving so-called "retains" of farmer cooperatives reflect what has come to be the basic legal structure of the typical California farmer cooperative. The successive changes in the tax laws have caused cooperatives to become more introspective. Many more lawyers and accountants have become familiar with cooperatives and their operations as well as the need for an appropriate contractual basis for the relationship between the cooperative and its farmer-members.⁶⁷

Perhaps *DeMello v. Dairyman's Co-operative Creamery*⁶⁸ is most important as a constitutional precedent involving the reserved power of a corporation to amend its financial structure.⁶⁹ To one interested in the law relating to cooperatives, however, it presents an account of a reorganization of a cooperative whose corporate structure was outmoded and whose tax status was unfavorable.

The original bylaws of the cooperative provided that each member pay \$100 for his membership on which he would receive 8 percent per

⁶⁴ CAL. AGRIC. CODE § 54081(e).

⁶⁵ 52 Cal. App. 2d 468, 471, 126 P.2d 467, 468 (1942).

⁶⁶ See text accompanying note 13 *supra*.

⁶⁷ Perhaps the most influential instrument in bringing about the improvement of legal structures in California agricultural cooperatives has been the Berkeley Bank for Cooperatives, one of 12 district banks for cooperatives organized in 1933 pursuant to the Farm Credit Act of 1933 (12 U.S.C. §§ 1134-1134m) to carry on the lending functions of the old Federal Farm Board on a decentralized basis. The Berkeley Bank for Cooperatives, which is wholly owned by its borrowers, makes sound business loans to farmer cooperatives as defined in the Agricultural Marketing Act (12 U.S.C. § 1141j). Its thorough examination of each applicant's legal structures and its awareness of the needs of sound cooperatives have produced admirable results among borrowing and nonborrowing farmer cooperatives.

⁶⁸ 73 Cal. App. 2d 746, 167 P.2d 226 (1946).

⁶⁹ For authorization to amend corporate articles, see CAL. CONST. art. XII, § 1; CAL. CORP. CODE §§ 3600-801.

annum. Provision was also made for the return of the \$100 on withdrawal of the member. As the cooperative continued to market milk products, numerous members went out of the dairy business, and others marketed elsewhere without withdrawing their membership. By 1944, there were 425 members with only 150 delivering their products to the association. About 550 nonmembers delivered their products to the cooperative. The association was also compelled to pay federal income taxes.⁷⁰

In 1944, the board of directors with the written consent of two-thirds of the members reorganized the cooperative under chapter 4 of division 6 of the Agricultural Code. Auditors determined the net worth of the association and fixed the amount at \$1065 per member. For the membership fee and allocable surplus each holder of a membership was given \$100 in cash plus securities in the form of revolving fund credits aggregating \$965, even though under the previous membership fee structure the \$100 membership fee was the measurement of a member's rights in the cooperative. In this way, the cooperative could revolve out the members who were no longer patronizing the association, but who still had memberships outstanding.⁷¹

Plaintiffs contended that they were forced out of the association by the reorganization and that they held a vested interest in its property which was appropriated by the association.⁷² The court found for the defendant-association saying that the members were not forced out; that they were given an option to remain members with \$1065 credits or to take the \$1065 revolving fund credit (which was \$965 more than their initial membership interest of \$100) and withdraw; and that changes in the rights of outstanding shares are not unconstitutional if they can be justified as necessary to meet the exigencies of the corporation.⁷³

The Base Capital Method

Because of federal income tax considerations which call for current taxability of retains either to the patron or the cooperative,⁷⁴ some cooperatives are treating the revolving fund differently from the method described above. Prior to the incorporation of subchapter T⁷⁵ into the Internal Revenue Code in 1962, retains of the kind credited to their patrons by most California farmer cooperatives were not currently taxable at either the cooperative or patron level.⁷⁶

⁷⁰ 73 Cal. App. 2d 746, 748, 167 P.2d 226, 227 (1946).

⁷¹ *Id.*

⁷² *Id.* at 749, 167 P.2d at 227.

⁷³ *Id.* at 751, 167 P.2d at 228-29.

⁷⁴ INT. REV. CODE OF 1954, §§ 1382, 1385.

⁷⁵ INT. REV. CODE OF 1954, §§ 1382-88.

⁷⁶ Long Poultry Farms, Inc. v. Comm'r, 249 F.2d 726 (4th Cir. 1957);

Now the associations, with few exceptions, take the steps necessary to impose that current taxability on their patrons. The effect of old untaxed retains being revolved out in the same year that taxable retains are evidenced to the patrons is to produce a doubling up of taxation. The old retains not previously taxed become taxable upon retirement, and the current retains are likewise taxable under subchapter T.

Because of this doubling up of taxation, a trend may be developing toward a more permanent type of capital to which the patron will currently contribute only if the capital he has already invested is short of an amount prescribed by formula. If his capital is in excess of the amount required by the patronage formula, his investment will be reduced through payment by the cooperative or sale to a member whose capital is short. In other words, there are no payments of credit or current retains except in individual cases where the patronage is not in balance with the capital previously contributed or retained. There results a substantial avoidance of the tax on old retains.

This "adjusted balances" or "base capital" concept is not new, but its use now has appeal particularly to producers with large retain accounts in one or more cooperatives. Private Internal Revenue rulings have indicated that the adoption of this method by a cooperative which formerly retired all retains of the earliest priority with funds made available from current retentions will not have adverse tax consequences.

Conclusion

Among California farmers and ranchers who extend their business into cooperative marketing and purchasing associations designed and operated for the benefit of their members as producers, there has developed a distinct preference for the cooperative corporate form of the nonstock association.

A unique and workable means of capitalization has evolved for the farmer cooperative wherein the member-patrons of the association are holders of hybrid securities which in form are neither shares of stock nor true debt. These securities represent the net worth of the organization. The amount of such securities held is related as nearly as practicable to the holder's patronage of the cooperative.

Most commonly the capital fund is called a revolving fund, and the interests of the members are referred to as revolving fund credits. The basis of the revolving fund and revolving fund credits is

Moe v. Earle, 226 F.2d 583 (9th Cir. 1955); Carpenter v. Comm'r, 219 F.2d 635 (5th Cir. 1955); Estate of Caswell v. Comm'r, 211 F.2d 693 (9th Cir. 1954); San Joaquin Valley Poultry Producers' Ass'n v. Comm'r, 136 F.2d 382 (9th Cir. 1943).

wholly contractual. The cases and the practical experience of the farmer cooperatives have led to a development of safeguards which are normally incorporated into the association's bylaws. The capital structure so provided serves as a bulwark against unwarranted assaults by disgruntled members or former members as well as a substantial foundation which is respected by banks and creditors.

