Rural COOPERATIVES

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Co-ops should periodically evaluate their member equity practices

USDA graphic by Stephen A. Thompson

By David Cook

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In recognition of the remarkable assistance they provide to rural communities and their unique attributes, cooperatives receive various benefits under federal, state and local laws, such as tax exemption and deductions. One of the key attributes cited in support of these benefits is the return of earnings, or margins, to members and patrons on a patronage basis. Cooperatives generally accomplish the return of earnings and margins through patronage dividends (also called patronage refunds), per-unit retains, or retirement of capital credits.

This concept is best illustrated by contrasting cooperatives with for-profit companies. Unlike for-profit companies, which normally return equity (or accumulated earnings) in proportion to their owners' capital investment, cooperatives return equity in proportion to the amount of business conducted with or for each member or patron.

Courts and the Internal Revenue Service (IRS) have reasoned that return of equity on the basis of patronage is consistent with the idea that cooperatives are mere conduits or agents of their members and patrons. Accordingly, unlike for-profit companies, cooperatives should not pay taxes on patronage earnings.

The obligation of cooperatives to return equity on a patronage basis arises from a variety of sources, such as state laws, federal tax laws, bylaws and contracts with members and patrons. Whatever the source, cooperatives generally have a legal obligation to return their earnings on a patronage basis when they are financially capable. This article addresses the importance of returning earnings to members and patrons within a reasonable time. It also discusses the risks associated with failure (or a perceived failure) to do so.

Environment of increased risk

In general, cooperative members and patrons recognize the tremendous benefits provided by cooperatives. Cooperatives are owned and effectively controlled by members, who also are their customers. Thus, it should come as no surprise that a huge majority of patrons and members are deeply dedicated to their cooperative and satisfied with the services it provides.

At the same time, cooperatives have long faced the risk that members and patrons will allege mismanagement of the equity of members and patrons ("member equity"). Such allegations of mismanagement have involved, for example, the timeliness of returning member equity, discounting member equity, setting off member equity with outstanding debts of members and patrons, and discrimination in the return of member equity.

In recent years, some cooperatives have faced increased complaints and litigation, including class action lawsuits, arising from alleged mismanagement of member equity. For instance, plaintiffs in these lawsuits have alleged:

- A cooperative failed to retire member equity despite having the financial wherewithal to do so;

- A cooperative violated its own member equity policy;
- A cooperative violated a state statute concerning return of member equity;
- A cooperative's bylaws violated public policy because they effectively resulted in forfeiture of member equity;
- A cooperative had no system in place to routinely return member equity;
- A cooperative did not notify its members and patrons of their member equity allocations;
- A cooperative's practices discriminated against classes of members (e.g., former members) in favor of other members;
- A cooperative maintained an excessive amount of member equity or unusually high equity-to-asset ratio, suggesting that it was not properly and timely returning member equity;
- A cooperative improperly discounted member equity and retained the discount as permanent equity; and
- A cooperative's board of directors had concealed the amount of each member's equity by preventing access to the cooperative's books and records and denying members access to board meetings.

These are serious allegations against any cooperative. But given the large amount of member equity held by some cooperatives, they can have a significant impact on a cooperative's finances and member relations. Damages awarded in class action lawsuits involving member equity can be substantial, so the risk of such complaints should be evaluated and mitigated.

What are the risk factors?

While most cooperatives will never face such a complaint, all cooperatives should evaluate their member equity practices to limit their risk — and to promote goodwill with patrons and members. As with any risk analysis, the starting point is to identify and quantify the risk factors. The following are potential risk factors to consider:

- Magnitude of member equity: A higher balance of member equity in comparison to debt indicates higher risk.
- Age of member equity and length of rotation periods: The longer a cooperative retains member equity, the greater the risk.
- Turnover and contested elections: Intense election contests, and a high turnover of directors and management, generally indicate higher risk.
- Member or patron satisfaction: As members and patrons feel less satisfied with their cooperative, the risk level increases.
- Cost/benefit comparison: When customers perceive less benefit in relation to cooperatives' fees, the risk level increases.
- Competitor pricing comparison: When customers perceive the cooperative's costs and fees as greater than the fees of local competitors, risk increases.
- Economic conditions of the community: When the economy of the cooperative's community declines, risk increases.
- Media exposure: Negative media exposure can increase risk.

After evaluating these and other factors, cooperatives should look at their current policies and practices to mitigate their risk.

Tips for effective management of member equity

There are several ways to reduce the risk of complaints concerning member equity management. The first, and most important, method is to document and adhere to a rational member equity management plan. Such plans are normally adopted by the cooperative's board of directors, board of trustees or similar board through a bylaw provision or board policy.

Second, cooperatives should appoint someone, preferably from the board or management, to oversee compliance with the plan. Since some board members may not be as familiar with cooperative principles, they may not understand the importance of following a member equity management plan. The appointed person should become familiar with the plan and periodically review the cooperative's practices to verify the cooperative's adherence to the plan.

Third, the cooperative's financial officer or accountant should specifically dedicate a portion of his or her time to evaluating the cooperative's ability to return member equity and explaining such evaluation to the board. Any decision to return member equity will necessarily impact the cooperative's financial situation. As a result, a cooperative's board should consult with its financial advisors about the propriety of any decision concerning member equity.

Fourth, cooperatives should educate their board members, management and staff, along with their members and patrons, about the role of member equity. Cooperative boards and management need to understand the importance of member equity management, and the associated legal requirements and restrictions.

Just as important, cooperatives should educate their members and patrons about member equity and its eventual return. It not only serves to reduce the risk of unfounded complaints, but it also can be used to illustrate the unique benefits of being a cooperative member or patron — especially in contrast to for-profit companies.

Finally, there is no better way to educate members than by sending them a check in return of member equity, along with an explanation of why they are receiving the check.

Cooperatives provide valuable benefits to their members and patrons in a manner that justifies special benefits under the law. Although most cooperatives will never face complaints over member equity mismanagement, it would benefit any cooperative to evaluate its current policies and practices to ensure their legal compliance and — just as importantly — promote goodwill with members and patrons. ■

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