

# The Status of an Agricultural Cooperative When a Farmer Member Experiences Financial Distress

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## INTRODUCTION

The 1970s marked a period of rapid growth in American agriculture. As the declining dollar made American exports progressively cheaper, farmers took advantage of accelerating inflation and low interest rates to embark on buying binges of land and equipment, even as land prices reached record heights.<sup>1</sup> But the predicted growth in domestic and foreign markets never materialized, and the 1980s marked a period of recession for American agriculture. Depressed land values, lost foreign markets, drought, depressed farm commodity prices, and increased costs combined to ravage agriculture.<sup>2</sup>

The economic downturn was felt not only by individual farm producers but also by the marketing, supply, and related service cooperatives to which they belonged.<sup>3</sup> Many cooperatives were not prepared to deal with their members' financial difficulties and consequently experienced mergers, takeovers, and bankruptcy.<sup>4</sup>

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<sup>1</sup> U.S. DEP'T OF AGRICULTURE, REP. NO. 568, HOW IS FARM FINANCIAL STRESS AFFECTING RURAL AMERICA 2 (June 1987).

<sup>2</sup> Bland, *Insolvencies in Farming and Agribusinesses*, 73 KY. L.J. 795, 796 (1985).

<sup>3</sup> "Cooperatives' share of farm marketing and farm production expenses declined to the 25% mark in 1987, after having been at higher levels earlier in the 1980s. Since 1984, cooperatives' share of farm marketings has continued to decline." Kraenzle, *Co-op's Share of Farm Business Declined Slightly During 1980s*, 56 FARMER COOPERATIVES 20, 21 (Oct. 1989).

<sup>4</sup> See Bland, *supra* note 2, at 796-97. Estimated net business volume for cooperatives climbed from 25.99 billion dollars in 1972 to 71.5 billion dollars in 1981, the peak year

But cooperatives need not be completely vulnerable to their members' financial difficulties. A cooperative may take measures to protect its financial interests before a financially distressed member files a bankruptcy petition. Even if the cooperative member seeks the protection of the bankruptcy courts, the cooperative retains certain rights and obligations. The cooperative should be cognizant of its rights and obligations.

This Article sets forth certain measures that cooperatives should consider taking before financially distressed members file for bankruptcy. This Article also explains what rights a cooperative may assert when a member does file for bankruptcy and what obstacles the cooperative may confront in a member's bankruptcy proceedings.

## I. PREPARING FOR THE BAD TIMES: SOUND FINANCE AND CREDIT PRACTICES

### A. *The Creditor-Debtor Relationship*

Cooperatives exist to provide their members with competitive market advantages.<sup>5</sup> The farmer members own the cooperative but they are obligated to patronize the cooperative, provide the cooperative with financing, and otherwise perform their contractual duties to the cooperative.<sup>6</sup> Members frequently become indebted to the cooperative. This debt may arise in a number of ways. For example, some cooperatives assess their members for capital improvements.<sup>7</sup> Also, marketing cooperatives often make advance payments to members. Members became indebted to the cooperative to the extent these advances exceed the amounts to which the members are entitled.<sup>8</sup> Some cooperatives even make loans of operating capital to members.<sup>9</sup>

Most commonly, debt arises when cooperatives extend credit to their members. Convenience credit is extended to members so that they do

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for cooperatives. By 1985, net business volume had decreased to 65.5 billion dollars. Net business is the value of the first level at which cooperatives transact business for farmers. See U.S. DEP'T. OF AGRICULTURE, AGRICULTURAL STATISTICS 1987 435-37 (1987).

<sup>5</sup> L. HULBERT & M. NEELY, LEGAL PHASES OF FARMER COOPERATIVES 16 (4th ed. 1976).

<sup>6</sup> *Id.* at 10-11. Some cooperatives are owned by other cooperatives, thus removing the farmer one step from the cooperative's management but continuing the farmer's obligations to the cooperative.

<sup>7</sup> *Id.* at 211.

<sup>8</sup> *Id.* at 194-98.

<sup>9</sup> Cobia & Brewer, *Equity and Debt*, in COOPERATIVES IN AGRICULTURE 243, 263-64 (1989).

not have to pay for merchandise every time it is delivered or picked up. Convenience credit appears on the cooperative's books as an account receivable. On the member's books convenience credit appears as an account payable.<sup>10</sup> The inability to collect such accounts has forced some cooperatives to liquidate. If large enough, a single uncollected account can render an entire cooperative insolvent.<sup>11</sup>

### B. Establishment of a Credit System

To deal with membership debt that arises out of the extension of credit, the cooperative must establish a credit system. Most cooperatives have no choice but to extend credit to members. Farmer members expect the extension of credit, and many members need such credit to stay in business. Because the members own the cooperative, they often feel justified in incurring high levels of debt. Members often feel that "they simply owe the money to themselves."<sup>12</sup>

High levels of debt endanger both the individual member and the cooperative as an entity. Therefore, it is critical that a cooperative establish a reasonable credit policy. At minimum, such a policy should include the following policies.

#### 1. Credit Limits

Credit limits should be established for all cooperative members. Limits should be based on a member's financial needs and ability to repay the debt. Adjustments of limits can be made as a member's financial circumstances warrant. To determine an individual member's credit limits, the cooperative must have in place a written credit application procedure. A credit application should solicit such information as the member's income sources, credit references, and the extent of the member's indebtedness to other creditors.<sup>13</sup>

Cooperatives should have persons responsible for the periodic review of credit applications and the members' accounts payable. A credit committee should be established to review credit requests, including applications and modifications, as well as the payment performance of individual members. Typically, the committee should be responsible for

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<sup>10</sup> Pullum & Middleton, *Proper Handling of Accounts Receivable, A Must Today*, in EXPANDING COOPERATIVE HORIZONS 392-93 (B. Stanton ed. 1979-1980).

<sup>11</sup> See Cobia & Brewer, *supra* note 9, at 263.

<sup>12</sup> *Id.*

<sup>13</sup> Svitavsky, *A Guide to Establishing a Credit Management System* 4,5,37,38 (April 4, 1986) (unpublished manuscript available through the National Center For Agricultural Law Research and Information, University of Arkansas).

establishing new lines of credit, reaffirming existing lines of credit, increasing credit, decreasing credit, and authorizing the collection of late accounts.

## 2. Securing Payment

Whenever possible, debts owed the cooperative should be guaranteed and/or collateralized. Securing the debt substantially increases the cooperative's prospects of collecting past due accounts. The more active the cooperative is in extending credit to members the greater the need for securing payment. Fortunately, cooperatives have a wide variety of options for securing membership debt.

In some instances, personal guarantees may be desirable, especially where credit is extended to a partnership or corporation. In such cases, it is advisable to have the individuals involved in the business entity sign personal guarantees for the payment of debts.<sup>14</sup>

### a. Patronage Liens

Patronage liens may be used to give the cooperative a first lien against a member's retained equities for debts owed by the member to the cooperative. Such liens are usually provided for in a cooperative's articles of incorporation and/or bylaws. As a general rule, cooperatives must comply with the perfection requirements of Article 9 of the Uniform Commercial Code. Otherwise, the cooperative's interest in the equities is unprotected against the claims of the member's other creditors.<sup>15</sup> As liens on general intangibles, patronage liens are not capable of being perfected by a cooperative having possession of the retained equities unless the equities are evidenced by something other than a book entry, such as a certificate.

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<sup>14</sup> *Id.* at 6.

<sup>15</sup> See *In re Beck*, 96 Bankr. 161, 163 (Bankr. C.D. Ill. 1988) (holding that cooperative was not entitled to setoff debtor's allocated retained earnings account against cooperative's claim as debtor's creditor); *In re Axvig*, 68 Bankr. 910, 918 (Bankr. D.N.D. 1987) (holding cooperatives were not entitled to setoff for indebtedness owed by debtor against debtor's capital stock); *In re Cosner*, 3 Bankr. 445, 449 (Bankr. D. Or. 1980) (holding equity credits could not be used as setoff against money due cooperative from bankruptcy). If the cooperative is incorporated, it also may want to retain liens in the stock of stockholders for debts due the cooperative. See L. HULBERT & M. NEELY, *supra* note 5, at 17.

*b. Agricultural Input Liens*

A number of states have passed legislation permitting agricultural suppliers to obtain liens against crops and livestock to secure payment for agricultural inputs. Agricultural inputs include chemicals, seed, petroleum products, and feed used in the production of crops and livestock.<sup>16</sup> An agricultural supplier is typically defined as any person, individual, corporation, partnership, association or other legal entity, that furnishes agricultural production inputs<sup>17</sup> to a farmer for agricultural purposes.<sup>18</sup> When a cooperative acts as an agricultural supplier and desires to perfect its agricultural input lien, the cooperative must follow the procedure set forth in the applicable state agricultural input lien statute.<sup>19</sup>

*c. Article 9*

To secure payment or performance of an obligation, a cooperative also may want to take advantage of Article 9 of the Uniform Commercial Code to create a security interest in a member's personal property. Under Article 9, the debtor provides the secured party with a written

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<sup>16</sup> Salsbery & Juhl, *Chapter 570A Crop and Livestock Lien Law: A Panacea or Pandora's Box*, 34 *DRAKE L. REV.* 361 (1984-1985).

<sup>17</sup> See *MINN. STAT. ANN.* § 514.950(13) (West Supp. 1990).

<sup>18</sup> A farmer is typically defined as any person engaged in business for an agricultural purpose. See *IOWA CODE ANN.* § 570A.1(5) (West Supp. 1989). Agricultural purchase may be defined as:

A purpose related to the production, harvest, marketing or transportation of agricultural products by a person who cultivates, plants, propagates or nurtures the agricultural products including agricultural, horticultural, viticultural, and dairy products, livestock, wildlife, poultry, bees, forest products, fish and shellfish, and any other product raised or produced on farms.

*Id.* § 570A.1(2).

<sup>19</sup> State statutes typically require that agricultural suppliers notify financial institutions that already have security interests in collateral owned by the farmer of the farmer's request for credit as to agricultural inputs. The notice consists of a certified inquiry as to whether the farmer has sufficient net worth, or a line of credit, to assure payment of the purchase price or the terms of the sale.

Financial institutions must respond to the request within a statutory time limit. If the institution gives a favorable report as to the farmer's financial status, then the institution's responsive memorandum becomes a letter of credit guaranteeing that the institution will honor the supplier's drafts or other demands for payment. A negative report means that the supplier must decide whether to extend credit. If the institution's negative report turns out to be erroneous, then the agricultural supplier can extend credit to the farmer and obtain a lien status equal to that of the financial institution. See *id.* §§ 570A.2(1)-(2), 3(1)-(2).

security agreement identifying the collateral. Personal property that may be used as collateral includes goods, documents, instruments, general intangibles, chattel paper, and accounts.<sup>20</sup> In the case of agricultural debts, such security interests are commonly used to secure repayment of operating loans or credit purchases for farm supplies. Agricultural creditors often take security interests in farm products, farm equipment, associated general intangibles, contract rights, documents of title, and warehouse receipts.<sup>21</sup>

A security agreement may secure not only an immediate debt owed to the secured party but also any future advances made to the debtor.<sup>22</sup> In addition, a security agreement may contain a clause which enables the security interest to attach to property obtained by the debtor after the execution of the security agreement.<sup>23</sup>

Perfection of the security interest is necessary to protect the creditor's interest vis-a-vis other creditors. Perfection is accomplished by taking possession of the collateral<sup>24</sup> or by filing a financing statement.<sup>25</sup> Most Article 9 lienholders perfect by filing a financing statement.<sup>26</sup>

The rights of a secured creditor may conflict with the rights of parties who purchased farm products from the debtor. Federal legislation

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<sup>20</sup> U.C.C. § 9-102(1)(a) (1986).

<sup>21</sup> Agricultural lenders also make substantial loans for purchases of real estate. However, such loans are commonly obtained from governmental or commercial lenders, rather than cooperatives. For that reason, real estate loans are not explored in this Article. Also, although Article 9 is used extensively by institutional lenders, especially those engaged in operational financing, it is doubtful that cooperatives have made extensive use of Article 9. Marketing cooperatives usually can assure repayment by deducting expenses of the proceeds received from products they sell for farmers. Supply cooperatives often function with open lines of credit. However, cooperatives are not precluded from using Article 9, and at times, the use of security agreements could prove to be invaluable to a cooperative.

<sup>22</sup> *Id.* § 9-204(3).

<sup>23</sup> *Id.* § 9-204(1).

<sup>24</sup> *Id.* § 9-305.

<sup>25</sup> *Id.* § 9-302(1). To be effective, a financing statement must state the debtor's name and address, as well as the creditor's name and address, and be signed by the debtor. Of course, the financing statement should adequately describe the collateral, and if the collateral is growing crops, describe the real estate on which the crops are growing or to be grown.

<sup>26</sup> A financing statement is filed in accordance with the procedure adopted by the state in which the collateral is located. Section 9-401 (1987) of the Uniform Commercial Code sets forth alternate filing sites for states. Some states require that financing statements be filed at the state level. Other states have adopted a county filing system for farm equipment, farm products, accounts arising from the sale of farm products by farmers, and general intangibles arising from the sale of farm products.

now governs the rights of buyers vis-a-vis secured parties. Section 1324 of the Food Security Act of 1985 provides that a buyer of farm products in the ordinary course of business takes the products free and clear of a security interest unless the secured party protects its interest. The protection method used will be governed by the choice the pertinent state has made under federal law. One method is to directly give a farm product purchaser written notification of the security interests that were perfected within one year prior to the sale.<sup>27</sup> Upon request, the debtor is obligated to furnish a secured party with a list of all potential purchasers.<sup>28</sup> Failure to reveal the actual purchaser subjects the debtor to potential criminal prosecution. Sales to undisclosed purchasers are nonetheless free and clear of the secured party's interest.

The other method of preserving a security interest involves filing an "effective filing statement" in a central filing system approved by the U.S. Department of Agriculture (USDA).<sup>29</sup> This method is available only if the state where the farm products are produced has established a central filing system that qualifies for USDA certification.<sup>30</sup> Prospective purchasers may register with the Secretary of State's office before purchasing agricultural products.<sup>31</sup> Receipt of a master list of liens gives notice to the purchaser and prevents the purchaser from extinguishing the lien of the secured party by purchasing the goods.<sup>32</sup> Unregistered buyers are on notice of effectively filed statements whether or not they have made special inquiry of the Secretary of State before making a particular purchase.

## II. DEALING WITH FINANCIALLY DISTRESSED MEMBERS IN A PRE-BANKRUPTCY SETTING

### A. *Collection of Accounts: Extra-Legal Proceedings*

#### 1. Informal Collection Practices

To recover delinquent accounts, cooperatives must take timely correction measures. Regardless of the unpleasantness of the situation, delay only increases the likelihood that the account will never be col-

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<sup>27</sup> 7 U.S.C. § 1631(e)(1)(A) (1988).

<sup>28</sup> *Id.* § 1631(h)(1).

<sup>29</sup> *Id.* § 1631(c)(2); 9 C.F.R. § 205.101 (1989).

<sup>30</sup> 7 U.S.C. § 1631(c)(2) (1988).

<sup>31</sup> *Id.* § 1631(e)(2); 9 C.F.R. §§ 205-208 (1989).

<sup>32</sup> 7 U.S.C. § 1631(e)(3)(A) (1988); *see* R. ROGERS, *COLLIER FARM BANKRUPTCY GUIDE* ¶ 1.04[5][b], at 1-79 to 1-83 (1st ed. 1989).

lected.<sup>33</sup> Collection letters, telephone calls, and even personal contact with members may be useful in collecting debts. These actions can be undertaken by the cooperative's personnel, by the cooperative's attorney, or by a private collection agency.<sup>34</sup>

Regardless of who undertakes the collection effort, the cooperative must be careful not to become involved in the use of improper debt collection practices. Under state law, improper debt collection practices include threatening the debtor with bankruptcy or criminal prosecution. Abusive language, harassing phone calls, or any other actions that coerce the debtor into paying or that subject the debtor to public ridicule and contempt are also impermissible.<sup>35</sup> Where improper and abusive debt collection practices have been used, debtors have successfully brought various causes of action against their creditors. Debtors have recovered for the intentional infliction of physical and emotional suffering, libel, slander, and invasions of privacy.<sup>36</sup>

## 2. Control of the Member's Business

If the cooperative's leadership believes that a member's financial difficulties are largely due to poor management and that the situation is correctable, the cooperative's leadership may be tempted to become involved in the member's business activities. While some financial advice and business guidance may be given with impunity, the cooperative must avoid becoming too involved in the member's business.<sup>37</sup> If the cooperative exercises too much control over a member's business affairs, the cooperative may incur substantial legal liability. Whether too much control is being exercised is always a fact question. Excessive control may entail the creditor deciding personnel and management problems, deciding which debts get paid, and deciding what inventory is purchased or sold. A creditor may even attempt to strengthen its own financial position by taking an assignment of certain debtor assets, such as accounts receivable. The bottom line is that, if the debtor is stripped of independent decisionmaking power, the cooperative is probably exerting excessive control.

Courts have repeatedly found that a creditor's control of a debtor's

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<sup>33</sup> Svitavsky, *supra* note 13, at 1, 17.

<sup>34</sup> *Id.* at 17.

<sup>35</sup> L. NELSON, CREDIT MANUAL OF COMMERCIAL LAWS § 23, at 1-7 (1988).

<sup>36</sup> *Id.*

<sup>37</sup> Umbaugh Pole Bldg. Co. v. Scott, 58 Ohio St. 2d 282, 390 N.E. 2d 320 (1979) (holding that cooperative did not create fiduciary relationship merely by advising farmers).

business affairs may create a fiduciary relationship that modifies the traditional creditor-debtor relationship. Because of the fiduciary character of the relationship between the parties, the creditor is no longer free to deal with the debtor on a strictly creditor-debtor basis. Instead, the creditor owes the debtor a special obligation and fidelity, and the creditor may be held liable for violation of its duties as a fiduciary.<sup>38</sup>

Closely analogous to the fiduciary relationship created by a creditor's excessive control of a debtor's business affairs is the obligation of good faith and fair dealing. A number of courts have held that there is an implied duty of good faith and fair dealing between a creditor and debtor. This duty may be violated by a creditor's excessive control of a debtor's financial affairs.<sup>39</sup>

Not only may a cooperative be liable to the debtor for excessive control but it may also find itself vicariously liable for the member's debts to third parties. A cooperative's excessive control of a member's internal affairs may create an agency relationship in which the cooperative, as principal, becomes liable for the member's debts to third parties.<sup>40</sup>

### B. Workouts Outside of Bankruptcy

Although cooperatives should avoid taking control of members' businesses, a cooperative may enter into a workout agreement with a member without exposing itself to liability. A workout is an agreement between two or more parties to alter the terms of one or more credit transactions. Some workouts take place in formal bankruptcy proceedings, usually in chapter 11 or chapter 12 but occasionally in chapter 13. More frequently, workouts take place outside of bankruptcy through formal or informal negotiations as the parties seek to avoid bankruptcy proceedings. Informal workouts allow the parties to avoid significant

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<sup>38</sup> *In re American Lumber Co.*, 5 Bankr. 470, 478 (Bankr. D. Minn. 1980).

<sup>39</sup> *State National Bank of El Paso v. Farah Mfg.*, 678 S.W.2d 661 (Tex. App. 1984) (writ dismissed by agreement of parties). In *Farah Mfg.*, several institutional lenders were found guilty of breaching their obligation of good faith and fair dealing by using tactics of fraud and duress to control the C.E.O. position at Farah Manufacturing. The lenders had threatened to call their loans if the previous C.E.O. regained control of the company. By use of their coercive tactics, the lenders were able to prevent the previous C.E.O. from being reelected. Instead, the creditors were able to put in their own hand-picked team. Since business losses were suffered while the creditors were in control, the trial court eventually rendered a verdict of over eighteen million dollars against the lenders for their bad faith tactics. *Id.* at 667-68.

<sup>40</sup> *A. Gay Jenson Farms v. Cargill, Inc.*, 309 N.W.2d 285, 291 (Minn. 1981) (finding that financial and managerial control established agency relationship between parties).

litigation costs, such as foreclosure and liquidation proceedings, lost time, and lost business opportunities.<sup>41</sup>

For a workout agreement to succeed, the member's debts must be manageable. In addition, the cooperative must bear in mind that it is probably just one of the member's many creditors. The cooperative will need the full cooperation of other major creditors to prepare a successful workout agreement. Furthermore, even when the other creditors are amenable to a workout agreement, they may impose financial conditions on the debtor that make a workout plan impractical and result in further financial losses for the cooperative.<sup>42</sup> To determine whether a workout plan is feasible and what sort of plan would best serve the needs of all the parties, the cooperative must have a complete picture of the member's assets and debts.<sup>43</sup> The information needed to attempt a workout includes the member's accounts receivable, accounts payable, notes, security agreements, mortgages and deeds of trust, and financial statements.<sup>44</sup>

The specific elements of a workout agreement may be as varied and creative as the parties to the agreement desire. For example, the parties may agree to include interest payments only for a period of time, or they may even agree to a temporary payment moratorium.<sup>45</sup> Other terms that can be put into a workout agreement include extension of payment terms, partial liquidation of assets, streamlining business operations, and the giving of new or additional collateral. While the parties are free to be as creative as possible, the cooperative must always avoid taking control of the debtor's business affairs.<sup>46</sup>

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<sup>41</sup> Lander, *Agricultural Loan Workouts*, in AGRICULTURAL LOAN WORKOUTS AND BANKRUPTCIES 13-14 (1987).

<sup>42</sup> *In re Brame*, 23 Bankr. 196 (Bankr. W.D. Ky. 1982), is an example of a self-defeating workout agreement that made a bankruptcy petition inevitable. The farmer-debtor attempted a workout agreement with his creditors. One of the creditors, a production credit association, required as part of the workout plan that the farmer halt all capital improvements, pay the association all proceeds received from livestock commodity sales, submit his cash flow to strict supervision by the association, and negotiate with the Farmers Home Administration for the refinancing of the debtor's farm mortgages. The farmer was unable to satisfy the debilitating terms of the workout agreement and eventually filed a bankruptcy petition. *Id.*

<sup>43</sup> Lander, *supra* note 41, at 16.

<sup>44</sup> *Id.* at 16, 17.

<sup>45</sup> *Id.* at 24.

<sup>46</sup> Sterling, *The Workout Alternative to Bankruptcy*, THE COLORADO LAWYER 620 (Business Law Newsletter, Apr. 1984).

### C. Legal and Equitable Proceedings

#### 1. Monetary Judgments

A cooperative that decides to forgo a workout agreement and finds that other collection measures are inadequate has a number of other recourses available. However, the cooperative must be mindful that these alternative courses of action may leave the cooperative member no choice but to seek the protection of a bankruptcy court.

Monetary judgments may be useful in collecting a past-due indebtedness, depending upon the extent of the member's financial difficulties and the availability of assets upon which the cooperative can levy a judgment. The cooperative is entitled to file suit and to obtain a judgment for a member's unpaid accounts, delinquent yearly assessments, and overdue loans. Furthermore, if a cooperative member breaches a marketing contract, the cooperative also may seek compensation for any damages experienced by the cooperative as a result of the breach.<sup>47</sup>

If a cooperative sues to recover debts, the member might seek to raise a setoff defense. In such cases, the members seek to setoff their equities retained by the cooperatives against the debts they owe the cooperatives. As a general rule, a setoff requires a due and payable debt owed by the creditor to the debtor. Patronage equity, because it is contingent and not immediately payable, lacks the "due and payable" characteristics required for a setoff.<sup>48</sup> For this reason, cooperative members have not been successful in using the setoff defense when sued by their cooperatives on past due accounts. Disruption of the cooperative's plan for revolving out patronage equity could threaten the cooperative's financial well-being and, in some cases, its very existence.<sup>49</sup>

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<sup>47</sup> See, e.g., *Poultry Producers of Central Cal. v. Nilsson*, 197 Cal. 245, 239 P. 1086 (1925) (holding defendant liable for damages resulting from breach of a marketing agreement); *Washington Coop. Egg and Poultry Ass'n v. Taylor*, 122 Wash. 466, 210 P. 806 (1922).

<sup>48</sup> *Howard v. Eatonton Coop. Feed Co.*, 226 Ga. 788, 177 S.E.2d 658 (1970) (holding that defendants could not setoff patronage allocations); *Forrest County Coop. Ass'n v. Manis*, 235 So. 2d 925, 926 (Miss. 1970) (stating that amount allegedly owed to member could not be used as setoff against cooperative's claim); *Clarke County Coop. v. Read*, 243 Miss. 879, 139 So. 2d 639, 641 (1962) (holding that patron could not use credits as a setoff because patronage equity does not reflect a due and payable debt).

<sup>49</sup> *Atchison County Farmers Union Coop. Ass'n v. Turnbull*, 241 Kan. 357, 736 P.2d 917 (1987), is typical of setoff cases. The cooperative member purchased farm products and materials from the cooperative on an open account. Because the farmer did business through the cooperative, a portion of the cooperative's net margins were allocated to the farmer's equity credit account. When the farmer ceased farming and left the cooperative, the cooperative sued on the indebtedness. The farmer claimed that

However, courts have not completely foreclosed the member's right to raise a setoff defense. If a member can show that an equitable setoff meets the cooperative's requirements for equity redemption and that the cooperative's refusal to setoff constitutes an abuse of discretion, a successful setoff defense is at least theoretically possible.<sup>50</sup>

## 2. Lien Foreclosures

Lien foreclosure is an invaluable tool in collecting debts owed by a member to a cooperative. Patronage liens, agricultural input liens, and Article 9 security interests can be foreclosed to the extent of the member's indebtedness. Patronage liens constitute a first lien on a member's retained equities. The cooperative forecloses a patronage lien simply by claiming the member's retained equities to the extent of the member's debt to the cooperative. Patronage liens have not fared well in bankruptcy proceedings, especially if the cooperative failed to perfect its security interests in accordance with Article 9 of the Uniform Commercial Code.<sup>51</sup> Agricultural input liens are foreclosed in accordance with the applicable state statutes. Such statutes usually incorporate Article 9 foreclosure procedures.

The enforcement of an Article 9 lien involves use of the following procedure. The cooperative must gain possession of the collateral, either through voluntary surrender of the goods, self-help measures, or judicial repossession actions such as replevin.<sup>52</sup> Once possession is gained,

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the indebtedness was satisfied by his retained equities. The trial court permitted the setoff even though it was contrary to the cooperative's bylaws and state law. The trial court felt it was inequitable to permit the cooperative to sue on the debt, and at the same time, to retain the former member's equity credits. *Id.* at 358, 736 P.2d at 919.

In reversing the trial court's decision, the Kansas Supreme Court concluded that the state's paramount concern was not the advancement of an individual's interest in a cooperative but the preservation of such organizations in general. A member cannot be permitted to withdraw the member's financial interest at the expense of the association's financial welfare. *Id.* at 358-59, 736 P.2d at 922. Because equity credits are not cooperative indebtedness presently due and owing, the former member lacked the right to setoff his credits against the debt due the cooperative. *Id.* at 359-60, 736 P.2d at 920.

<sup>50</sup> See *Southeastern Colorado Coop. v. Ebright*, 38 Colo. App. 326, 563 P.2d 30 (1977).

<sup>51</sup> See *infra* notes 103-11 and accompanying text.

<sup>52</sup> U.C.C. § 9-503 (1987); see ANDERSON, UNIFORM COMMERCIAL CODE, §§ 9-503:22, 23 (3d ed. 1987). The use of self-help measures can be legally precarious because virtually all jurisdictions forbid self-help that involves a breach of the peace. Since crops and livestock are commonly surrounded by fences or locked, using self-help with regard to such items seems doubtful from a practical standpoint. It would be virtually impossible to obtain possession of such items without cutting a fence or break-

the cooperative must notify the debtor and other creditors of the impending sale. Notification is not required if the goods are perishable goods, or goods that will decline speedily in value, or goods of a type commonly sold on a recognized market.<sup>53</sup> Failure to conduct a commercially reasonable sale can result in the loss of a deficiency judgement.<sup>54</sup> It also can subject the creditor to damage actions, including actions for punitive damages.<sup>55</sup>

### 3. Specific Performance and Injunctive Relief

A cooperative can seek specific performance against a member who has breached, or who threatens to breach, a contract with the cooperative, especially a marketing contract that calls for the delivery of agricultural products. From a practical standpoint, specific performance is a meaningless remedy if the member lacks the ability to perform. State cooperative statutes often grant cooperatives a right to specific performance.<sup>56</sup> Even in the absence of such statutes, courts may employ their equitable powers to order specific performance because the nature of the cooperative form of doing business may make other remedies, such as damages, inadequate.<sup>57</sup> For example, cooperatives, by statute, charter, bylaws and contracts with the cooperative's members, are often restricted to purchasing crops from cooperative members. When a member defaults on a contract, a cooperative may be legally precluded from seeking a replacement crop on an open market.<sup>58</sup>

Courts also have noted that a cooperative's success is dependent upon its members honoring their cooperative contracts. For a cooperative to carry out its objectives and purposes — the marketing of members'

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ing a lock. Either act constitutes a breach of the peace.

<sup>53</sup> U.C.C. § 9-504(3) (1987).

<sup>54</sup> Anderson, *supra* note 52, § 9-504:91.

<sup>55</sup> *Id.* § 9-504:93; *see also* U.C.C. § 9-507(1) (1987).

<sup>56</sup> For an explanation of state statutes, *see* HULBERT & NEELY, *supra* note 5, at 246-49.

<sup>57</sup> Arkansas Cotton Growers' Coop. Ass'n v. Brown, 168 Ark. 504, 270 S.W. 946 (1925). In *Brown*, the cooperative contracted with individual members for the delivery of all of their cotton grown during a season. The cooperative then would contract with third parties for future deliveries of cotton. The court enjoined a cooperative member who attempted to sell directly to third parties to obtain a better price. The court noted that the failure of cooperative members to deliver their cotton to the cooperative would thwart the cooperative's marketing scheme. Furthermore, the injury done to the cooperative could not be repaired by an award of damages. *Id.* at 522, 270 S.W. at 953.

<sup>58</sup> *See, e.g.*, Kansas Wheat Growers' Ass'n v. Schulte, 113 Kan. 672, 216 P. 311 (1923) (noting that marketing cooperative could not seek replacement crops on open market).

products for the members' mutual benefit — the cooperative must enter into contracts for those products. Before a cooperative can safely commit to such contracts, it must be assured that its members will deliver their products to the cooperative.<sup>59</sup> In light of such business considerations, damage awards may provide inadequate and incomplete relief. In sum, specific performance may be the most appropriate remedy because of the perishable nature of the products handled, the uncertainty of market conditions and prices, the cooperative's inability to purchase replacement products from nonmembers, and the constraints of a limited growing season.<sup>60</sup>

In addition to the right to specific performance, cooperatives often succeed in obtaining injunctions against members who have breached their cooperative contracts. These injunctions prevent the breaching member from selling the produce covered by the contract to third parties. Not only have courts on occasion enjoined the breaching party from disposing of a crop covered by the contract, they also have enjoined the breaching party's third party purchasers from accepting or disposing of the product.<sup>61</sup>

#### 4. Receiverships

In some cases the cooperative member's financial difficulties may warrant the appointment of a receiver for the cooperative member's business. A receiver is an impartial person appointed by a court to receive or preserve the debtor's property. A receiver represents the interests of all the parties and preserves property *pendente lite*, or after judgment, or until disposed of as directed by the court.<sup>62</sup> A receivership is equitable in nature, and the receiver is appointed only if injunctive or other relief would be ineffective.<sup>63</sup> An applicant for receivership must demonstrate the existence of a present danger of the property being lost, removed or materially damaged.<sup>64</sup>

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<sup>59</sup> Oregon Growers' Coop. Ass'n v. Lentz, 107 Or. 561, 212 P. 811 (1923) (stating that damages are an inadequate remedy in view of perishable nature of product, uncertain market conditions, and cooperative's need to enter into contracts for disposal of product).

<sup>60</sup> *Id.* at 564, 212 P. at 817.

<sup>61</sup> See HULBERT & NEELY, *supra* note 5, at 252.

<sup>62</sup> Security Trust Co. v. Lipscomb County, 142 Tex. 572, 180 S.W. 2d 151 (1944) (stating that receiver is legal representative of creditors through whom court acts).

<sup>63</sup> McCauley v. Arkansas Rice Growers' Coop. Ass'n, 171 Ark. 1155, 287 S.W. 419 (1926) (stating that receivers should be appointed only when no injunction or other remedy is available).

<sup>64</sup> Massad v. Wilson, 83 S.W.2d 806, 807 (Tex. Civ. App. 1935) (stating that to

While courts are reluctant to appoint receivers, they will do so in appropriate cases. The cooperative form of doing business may actually encourage such appointments, especially in cases involving insolvent cooperatives.<sup>65</sup> Consequently, cooperatives arguably should be able to use receiverships to protect their interests in the assets of insolvent members. A receivership would be especially appropriate if the assets involved are perishable agricultural commodities to be delivered under a marketing contract or represent collateral for a debt.

#### D. *Expulsion of Members: Pre-Bankruptcy*

Because of a lack of confidence in a member's ability to survive a financial crisis, a cooperative may decide to terminate its relationship with that member by expelling the member from the cooperative. While expulsion is a harsh remedy with immediate financial consequences for the member and possible legal consequences for the cooperative, expulsion may sometimes be the cooperative's best course of action.

##### 1. Authority and Grounds for Expulsion of Members

State law often allows cooperatives to provide for the expulsion of members in their articles of incorporation and bylaws. Some statutes give cooperative boards discretionary power to expel members,<sup>66</sup> leaving it to the cooperative to more clearly define its expulsion authority in its charter and bylaws.

A typical situation in which a cooperative may want to expel a member arises when the member fails to patronize the cooperative. Cooperative members have an obligation to patronize their cooperative by acquiring supplies and services from or through the cooperative. In the

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obtain appointment of receiver, plaintiff must show an interest in property, defendant's past wrongful management, and present danger of property being lost, removed or materially injured).

<sup>65</sup> See, e.g., *Davis v. Bargloff*, 200 Iowa 1160, 206 N.W. 251 (1925); *Emmet State Bank v. Emmett Farmers' Union Coop. Elevator & Mercantile Co.*, 116 Kan. 550, 227 P. 257 (1924); *In re Community Coop. Indus.*, 279 Mich. 610, 273 N.W. 287 (1937).

<sup>66</sup> Typical of such statutes is the following Alabama provision:

Each association, under its by-laws, may also provide for any or all of the following matters: (11) The conditions upon which and the time when membership of any member shall cease; (12) The automatic suspension of the rights of a member when he ceases to be eligible to membership in the association and the mode, manner and effect of the expulsion of a member.

ALA. CODE § 2-10-58 (1977); see also J. BAARDA, ACS REP. NO. 30, STATE INCORPORATION STATUTES FOR FARMER COOPERATIVES 401-04 (1982).

case of marketing cooperatives, members have a duty to patronize by delivering their products to the cooperative for marketing. Patronage not only inures to the benefit of the member in terms of savings and market access but also constitutes the cooperative's life blood. When a member suffers severe financial distress, the member may cease to patronize the cooperative. In such a case, the cooperative may be justified in expelling the member. State cooperative statutes, cooperative charters, and cooperative bylaws frequently provide that a cooperative member may be expelled for failing to patronize the cooperative for a particular period of time, twelve months for example.<sup>67</sup>

Moreover, a cooperative member who ceases to patronize the cooperative may have ceased agricultural operations. Agricultural cooperatives receive significant tax benefits and antitrust exemptions, provided that the membership is composed of agricultural producers. Consequently, state cooperative statutes, as well as cooperative charters and bylaws, frequently condition cooperative membership upon agricultural production.<sup>68</sup> Marketing cooperatives are especially insistent that their members continue to engage in farming operations. Marketing contracts are essential to the operation of marketing cooperatives. A member's financial situation may force a curtailment in her farming operations, leaving the member unable to satisfy her contractual obligations. Since a marketing cooperative must be able to rely on deliveries by its members before it can enter into sales contracts with third parties, a member's cessation of farming operations is especially threatening to a marketing cooperative. Threat of expulsion is one method available to marketing cooperatives to ensure their members diligently attempt to fulfill their contracts. The failure to fulfill a contract can result in the expulsion of the member.<sup>69</sup>

## 2. Due Process Requirements

Just as a cooperative must have sufficient grounds for expelling a member, the cooperative must handle the expulsion in a permissible manner. Cooperative membership is a valuable right, and members

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<sup>67</sup> See, e.g., PA. STAT. ANN. tit. 15, §§ 12115(b), 12116(a) (Purdon Supp. 1989).

<sup>68</sup> See, e.g., HAW. REV. STAT. § 421-10(a) (1985).

<sup>69</sup> Nebraska Wheat Growers' Ass'n v. Smith, 115 Neb. 177, 212 N.W. 39 (1927). However, if the state cooperative statute is silent as to expulsion, the cooperative may be unable to expel a member for failing to honor a marketing contract. See *Frezza v. Delaware Mushroom Coop. Ass'n*, 38 Del. Ch. 375, 152 A.2d 303 (1959) (statute prohibits cooperative from adopting a bylaw providing for dismissal of members even for cause).

must be accorded minimum due process prior to expulsion.<sup>70</sup> Although expulsion proceedings do not have to be conducted in accordance with the strict rules employed in judicial proceedings, cooperatives still must adhere to basic principles of fairness and due process that laypersons can understand and administer.<sup>71</sup>

A basic element of procedural due process is that the member facing expulsion must be given notice of the pending charges.<sup>72</sup> In addition, the member must be given an opportunity to prepare and present a defense.<sup>73</sup> Furthermore, due process requires more than a superficial following of procedural guidelines. Impartiality and fair play are mandated.<sup>74</sup>

The expulsion of a cooperative member without minimum due process can have serious consequences for the cooperative. The most obvious consequence is a judicial order that the expulsion is void and that the expelled member must be reinstated.<sup>75</sup> In addition, a wrongfully expelled cooperative member may have a cause of action against the cooperative for damages.<sup>76</sup>

An even more serious consequence for the cooperative is the possibility of an antitrust violation. At least one court has found that the expulsion of a cooperative member without procedural due process consti-

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<sup>70</sup> *Swital v. Real Estate Comm'r*, 116 Cal. App. 2d 677, 679, 254 P.2d 587, 588 (1953).

<sup>71</sup> *Normali v. Cleveland Ass'n of Life Underwriters*, 39 Ohio App. 2d 25, 315 N.E. 2d 482 (1974).

<sup>72</sup> *Swital*, 116 Cal. App. 2d at 680, 254 P.2d at 588.

<sup>73</sup> *McCreery Angus Farms v. American Angus Ass'n*, 379 F. Supp. 1008, 1010 (S.D. Ill. 1974), *aff'd. without op.*, 506 F. 2d 1404 (7th Cir. 1974).

<sup>74</sup> *Van Daele v. Vinci*, 51 Ill. 2d 389, 282 N.E.2d 728, *cert. denied*, 409 U.S. 1007 (1972). The cooperative expelled two members who had filed derivative class action suits against the cooperative's board of directors. The members claimed that financial losses suffered by the cooperative were due to the mismanagement of the cooperative's building program. The members were charged with disrupting cooperative business, impeding the resolution of problems associated with the cooperative's construction program, spreading false rumors, and making untrue statements about the cooperative's directors and officers. Although the cooperative gave members notice of the pending charges and a hearing on the matter, the Illinois Supreme Court concluded that the proceedings had not been conducted in good faith. The hearing constituted no more than an attempt to silence and censor dissident association members. *Id.* at 393, 282 N.E.2d at 731.

<sup>75</sup> *See Benson Coop. Creamery Ass'n v. First Dist. Ass'n*, 276 Minn. 520, 151 N.W. 2d 422 (1967).

<sup>76</sup> *Trautwein v. Harbourt*, 40 N.J. Super. 247, 259-60, 123 A.2d 30, 37, *cert. denied*, 22 N.J. 220, 125 A.2d 233 (1956).

tutes a group boycott and is a *per se* violation of the antitrust laws.<sup>77</sup> The United States Supreme Court has thus far rejected this *per se* approach. The Court has held that cooperative expulsion practices do not raise a probability of anticompetitive effect unless the cooperative possesses dominant market power or exclusive access to an element essential to competition.<sup>78</sup>

### 3. Satisfaction of Property Interests

A critical issue that must be addressed whenever a cooperative member is expelled is the satisfaction of the member's financial interests in the cooperative. The member's financial interests may consist of shares of stock in an incorporated cooperative or membership certificates in an unincorporated cooperative. Almost certainly, the member will claim patronage dividends that have been retained by the cooperative to accumulate working capital. Some cooperative bylaws provide for the forfeiture of an expelled member's financial interests in the cooperative if the expulsion results from a contractual breach.<sup>79</sup> However, unless the cooperative's bylaws provide for a forfeiture, expelled members are entitled to receive their patronage dividends or other financial investments in the cooperative.<sup>80</sup> Since expelled members are entitled to no greater payment rights than continuing members, the board of directors usually retains discretion as to when the former members receive their patronage dividends.<sup>81</sup>

#### *E. Involuntary Bankruptcy*

In some circumstances, it may be to the cooperative's advantage for a member, or former member, to go through the bankruptcy process. An orderly liquidation of the member's assets may be necessary, and the member may be resisting liquidation. Generally, creditors of insolvent

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<sup>77</sup> *McCreery Angus Farms*, 379 F. Supp. at 1017.

<sup>78</sup> *Northwest Wholesale Stationeries v. Pacific Stationary & Printing Co.*, 472 U.S. 284 (1985).

<sup>79</sup> *Loomis Fruit Growers' Ass'n v. California Fruit Exch.*, 128 Cal. App. 265, 16 P.2d 1040 (1932); *Rusconi v. California Fruit Exch.*, 100 Cal. App. 750, 281 P.2d 84 (1929).

<sup>80</sup> *See Adams v. Sanford Growers' Credit Corp.*, 135 Fla. 513, 514-15, 186 So. 239, 240-41 (1938).

<sup>81</sup> *Sanchez v. Grain Growers Ass'n*, 123 Cal. App. 3d 444, 176 Cal. Rptr. 655, *modified and reprinted*, 126 Cal. App. 3d 665, 179 Cal. Rptr. 459 (1981). For a more detailed discussion of the expulsion of cooperative members, see Copeland, *Expulsion of Members by Agricultural Cooperatives*, 1 J. AGRIC. COOP. 76 (1986).

debtors may commence involuntary bankruptcy proceedings under chapters 7 or 11.<sup>82</sup> Farmers, however, are exempt from involuntary bankruptcy proceedings.<sup>83</sup> The Bankruptcy Reform Act of 1978 defines farmers as persons who received eighty percent of their total gross income from a farming operation during the taxable year immediately preceding the filing of the petition. A farm operation includes the "tillage of the soil, dairy farming, ranching, the production or raising of crops, poultry or livestock."<sup>84</sup> A financially distressed member, or former member, who no longer meets the definition of a farmer may be subject to involuntary bankruptcy. Courts generally have been reluctant to allow such involuntary proceedings and have classed as farmers persons who were temporarily not engaged in farming.<sup>85</sup>

### III. MEMBER BANKRUPTCIES: SPECIAL PROBLEMS FOR COOPERATIVES

#### A. Background

In many cases, despite the best efforts of the member and the cooperative, bankruptcy becomes inevitable. If the cooperative member goes into bankruptcy, either voluntarily or involuntarily, the cooperative must be prepared to deal with the complexities of bankruptcy law. The following is a brief overview of four of the more common bankruptcy problem areas with which cooperatives are forced to deal. These matters can arise in all types of bankruptcy proceedings where a farmer debtor is the petitioner: chapter 7,<sup>86</sup> where orderly liquidation is sought; chapter 11,<sup>87</sup> where a "larger" farm operation needs to reorganize and continue the business; chapter 12,<sup>88</sup> which is designed specifically for rehabilitation of family farm debtors with regular annual income; and

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<sup>82</sup> If the debtor has twelve or more creditors, the debtor may be forced into bankruptcy if at least three creditors, whose claims aggregate at least five thousand more than any lien held by creditors on the debtor's property, filed the bankruptcy petition. 11 U.S.C. § 303(b)(1) (1988). If the debtor has fewer than twelve creditors, a single creditor may put the debtor into involuntary bankruptcy, provided that the creditor holds a claim that is at least five thousand more than the value of any lien held by a creditor on the debtor's property. *Id.* § 303(b)(2).

<sup>83</sup> *Id.* § 303(a).

<sup>84</sup> *Id.* §§ 101(17)-(20).

<sup>85</sup> See *Middleton v. Farmers State Bank of Fosston*, 45 Bankr. 744, 747 (Bankr. D. Minn. 1985); *In re Pommerer*, 10 Bankr. 935, 942 (Bankr. D. Minn. 1981).

<sup>86</sup> See R. ROGERS, *supra* note 32, ¶¶ 2.05(1), 6.01-04.

<sup>87</sup> *Id.* ¶¶ 2.05(2), 3.01-11.

<sup>88</sup> *Id.* ¶¶ 2.05(3), 4.01-11.

chapter 13,<sup>89</sup> which may be used by individual farmers with a relatively small debt load.

## B. Retained Equities

### 1. Bankruptcy Estate

By operation of law, the filing of a bankruptcy petition creates an estate.<sup>90</sup> This estate is administered during the bankruptcy action, and creditor's claims are satisfied from this estate. In chapter 7 proceedings, the trustee liquidates the estate to satisfy creditor claims. In chapters 11, 12, and 13 bankruptcies, creditors must receive from the estate at least as much as they would have received under a chapter 7 liquidation.<sup>91</sup> The estate consists of all the legal and equitable interests of the debtor in property at the time the bankruptcy action is commenced. With few exceptions, property includes both tangible and intangible interests.<sup>92</sup> In an agricultural setting, tangible property includes farmland, farm equipment, growing crops, farm supplies, and the debtor's personal possessions. Intangible property includes such items as crop receivables, income tax refunds, government farm program benefits, insurance policies, and causes of action.<sup>93</sup>

If a trustee is administering the estate, the debtor must immediately turn over to the trustee all the estate property in the debtor's possession.<sup>94</sup> Similarly, other individuals or entities that have possession of the debtor's property, including any debts owed to the debtor, also must turn that property over to the trustee.<sup>95</sup> The turnover directives are mandatory and the Bankruptcy Code provides for very few exceptions.

### 2. Redemption

The broad definition of what constitutes the property of a debtor's estate, combined with the turnover requirement, has caused cooperatives some concern as to retained equities. Cooperatives retain sums

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<sup>89</sup> *Id.* ¶¶ 2.05(4), 5.01-.05.

<sup>90</sup> 11 U.S.C. § 541(a) (1988).

<sup>91</sup> *Id.* §§ 1129(a)(7), 1225(a)(4), 1325(a)(4).

<sup>92</sup> *See, e.g., In re Scanlon*, 10 Bankr. 245, 247 (Bankr. S.D. Cal. 1981).

<sup>93</sup> R. ROGERS, *supra* note 32, ¶ 2.08(1). Section 541(a) does not create any substantive rights. The interest of the estate is limited to the debtor's interest at the time the petition was filed. For example, if the debtor had only a legal interest in property, then the estate is limited to a legal interest. The same would hold true if the debtor had only an equitable interest, as the estate's interest would also be equitable in character.

<sup>94</sup> 11 U.S.C. §§ 521(4), 541(a) (1988).

<sup>95</sup> *Id.* §§ 542(a), 543(b)(1).

from business done by their members through the cooperative, thereby gradually accumulating working capital and reserves. These gains or savings are variously described as net earnings, net margins, profits, surpluses, but most commonly as patronage dividends. Payment for commodities marketed is usually made to a member in a combination of cash and equity credits. These equity credits accumulate on the books of the cooperative and over a period of time can represent a substantial investment on the part of members.

Equity credits are redeemed — returned to members — under a variety of plans. A majority of cooperatives use a revolving fund plan, whereby retained equities are redeemed in the order in which they are allocated.<sup>96</sup> Under this plan, unless special provisions are made for redeeming the equities of retiring, deceased or ineligible members, such savings may be retained by a cooperative almost indefinitely.<sup>97</sup> Some cooperatives use a “percentage of all equities” plan. These cooperatives redeem a certain set percentage of retained equities each year, regardless of the year of allocation.<sup>98</sup> Finally, some cooperatives use a base capital plan whereby patronage equity is adjusted on an annual basis according to the cooperative’s capital needs and the proportion of business done by each cooperative member through the cooperative.<sup>99</sup> The inability of cooperative members to freely redeem their equity credits increasingly has become a source of conflict between cooperatives and their members. Faced with rising costs and interest rates and the ongoing need for capital improvements, cooperatives have been reluctant to redeem equity credits.<sup>100</sup> Cooperative members, faced with their own financial difficulties, have become increasingly vocal about demanding redemption.

It is not surprising that the redemption question has been addressed on a number of occasions in the bankruptcy setting. Upon the filing of

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<sup>96</sup> U.S. DEP’T OF AGRIC., REP. NO. 23, EQUITY REDEMPTION, ISSUES AND ALTERNATIVES FOR FARMER COOPERATIVES 22-25 (1982) [hereafter REP. NO. 23].

<sup>97</sup> Hamilton, *Cooperative Member Relations and Members’ Rights in Retained Equity-Setoffs and Other Approaches*, 6 J. AGRIC. TAX’N & L. 603, 607 (1984).

<sup>98</sup> *Id.* at 607; see also REP. NO. 23, *supra* note 96, at 41-44.

<sup>99</sup> REP. NO. 23, *supra* note 96, at 26-41; see also Hamilton, *supra* note 97, at 607.

<sup>100</sup> The seriousness of the equity redemption problem is reflected in a 1979 General Accounting Office report to Congress which suggested legislation to require cooperatives to pay interest or dividends in retained equities and/or retire them at a set time. The report suggested that a cooperative’s failure to comply with the provision should result in a loss of Internal Revenue Code § 521 status. In response to the equity redemption crisis, a number of states have passed legislation requiring redemption under certain circumstances. See REP. NO. 23, *supra* note 96, at vii, 4.

bankruptcy petitions by cooperative members, bankruptcy trustees have repeatedly sought possession of the members' retained equities as part of the debtors' estates. A bankruptcy trustee's attempts to reach a debtor's retained equities raises two questions. First, do the retained equities actually constitute a property interest composing a portion of the debtor's estate? Second, if retained equities constitute a part of the debtor's estate, what rights does the trustee have in the equities?

As to the first question, the majority of courts that have addressed the issue have found that retained equities constitute a property interest that becomes part of the debtor's estate upon the filing of the bankruptcy petition.<sup>101</sup> However, the majority of courts have not characterized retained equities as a debt owed to the debtor by the cooperative. These courts have defined the equity as a contingent interest which is redeemed at the discretion of the cooperative's board of directors.

As to the second question, because equity credits vest at the discretion of the cooperative's board of directors, the retained equities are not due and payable simply upon the filing of the bankruptcy petition. Nor are the equities redeemable upon the demand of the debtor or the bankruptcy trustee. To the extent that an interest is limited in the hands of the debtor, it also is limited in the hands of the trustee. The bankruptcy trustee, in exercising control over the debtor's retained equities, is bound by the cooperative's articles of incorporation and bylaws and by state law.<sup>102</sup>

### 3. Setoffs

Having generally failed to convince the courts to order the redemption of member's retained equities as part of the bankruptcy proceedings, trustees have attempted to use a setoff approach to obtain the equivalent of equity redemption. Under the setoff approach, whenever a cooperative attempts to collect a member's debt, the trustee raises the defense that the cooperative owes the member the amount of the retained equities on the cooperative's books. The trustee argues that, as a consequence, the retained equities should be available as a setoff

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<sup>101</sup> See, e.g., *In re Lamar Farmers Exch.*, 76 Bankr. 712, 716 (Bankr. W.D. Mo. 1987); *In re Schauer*, 62 Bankr. 526, 529 (Bankr. D. Minn. 1986).

<sup>102</sup> In *In re Schauer*, the Eighth Circuit Court of Appeals found that a chapter 7 trustee could not transfer a debtor's patronage certificates without the cooperative board's permission because cooperative's bylaws vested the board with discretion over the certificates. Furthermore, the court found that state law restrictions on the estate's interest were preempted by the Bankruptcy Code. *Schauer*, 62 Bankr. at 531.

against the member's debts.<sup>103</sup>

On occasion, cooperatives also have sought setoff rights as to debts owed by members to the cooperative. As previously explained, cooperatives frequently take first liens against members' retained equities to assure the payment of any debts incurred by the members. When a cooperative seeks a setoff, it attempts to setoff a member's equity against the member's debt owed the cooperative.

As a general rule, trustees and cooperatives both have failed in their setoff attempts. A setoff is not available unless mutually due and payable debts exist. As already explained, equity credits lack the due and payable characteristic required for setoffs. As a result, courts have routinely denied setoff requests by cooperative members and their bankruptcy trustees.<sup>104</sup> The same also has been true for setoff requests by cooperatives, even where cooperatives have asserted patronage liens.<sup>105</sup> However, a recent Fourth Circuit Court of Appeals decision has given new life to setoff claims made by cooperative members, at least in chapter 11 proceedings.

In *In re FCX, Inc.*,<sup>106</sup> the Fourth Circuit affirmed a modified chapter 11 plan that authorized a debtor to setoff a portion of its retained equities against a cooperative's secured claim. The case involved a farm supply cooperative organized under Minnesota law. The cooperative issued to its members patronage certificates that were redeemed on a first issued, first redeemed basis. The cooperative's articles of incorporation granted the cooperative a first lien on its members' unredeemed patronage certificates to secure the members' debts. The articles also vested the cooperative's board with discretion to setoff a member's indebtedness against the member's patronage certificates.<sup>107</sup>

The cooperative challenged a bankruptcy court ruling that permitted a cooperative member who filed a chapter 11 proceeding to surrender a portion of its patronage certificates in satisfaction of the cooperative's

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<sup>103</sup> Hamilton, *supra* note 97, at 613-15.

<sup>104</sup> See *Howard v. Eatonton Coop. Feed Co.*, 226 Ga. 788, 177 S.E. 2d 658, 662 (1970); *Forrest County Coop. Ass'n v. Manis*, 235 So. 2d 925, 926 (Miss. 1970); *Clarke County Coop. v. Read*, 243 Miss. 879, 139 So. 2d 639, 643 (1962). *But see* *Southeastern Colo. Coop. v. Ebright*, 38 Colo. App. 326, 563 P.2d 30 (1971) (holding that retained equities were eligible for setoff).

<sup>105</sup> *In re Beck*, 96 Bankr. 161, 163 (Bankr. C.D. Ill. 1988); *In re Axvig*, 68 Bankr. 910, 918-19 (Bankr. D.N.D. 1987); *In re Cosner*, 3 Bankr. 445, 449 (Bankr. D. Or. 1980).

<sup>106</sup> 853 F.2d 1149 (4th Cir. 1988).

<sup>107</sup> *Id.* at 1151.

secured claim.<sup>108</sup> The cooperative contended that the order denied the cooperative's board of directors freedom to exercise its discretion in redeeming the patronage certificates.<sup>109</sup>

In accordance with previous court decisions, the Fourth Circuit found the patronage certificates to be a contingent entitlement that vests at the discretion of the cooperative's board of directors. The court went on to conclude that, since the entitlement was created by state law, it could be preempted by federal bankruptcy law. The court then relied upon Bankruptcy Code Section 1123(a)(5)(D) which provides that "notwithstanding any otherwise applicable nonbankruptcy law, a plan shall . . . provide adequate means for the plan's implementation such as . . . the distribution of all or any part of the property of the estate among those having an interest in such property of the estate."<sup>110</sup> The court interpreted section 1123(a)(5)(D) as overriding nonbankruptcy law that purports to restrict the distribution of collateral to satisfy secured claims. The statute therefore superseded the discretionary power over the surrender of patronage certificates bestowed on the cooperative's board of directors by state law and the cooperative's bylaws.<sup>111</sup>

### C. Executory Contracts

#### 1. Defining Executory Contracts

The Bankruptcy Code does not define the term "executory contract." Based upon the legislative history of section 365, the term has been interpreted in accordance with the concept of mutuality of obligation.<sup>112</sup> That is, a contract that has been fully performed by either the debtor or the other contracting party is not "executory" for bankruptcy purposes.<sup>113</sup> For a contract to be executory, some aspect of performance must remain due by both parties.<sup>114</sup>

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<sup>108</sup> *Id.* at 1152-53.

<sup>109</sup> *Id.* at 1153.

<sup>110</sup> 11 U.S.C. § 1123(a)(5)(D) (1988).

<sup>111</sup> *In re FCX Inc.*, 853 F.2d 1149, 1153 (4th Cir. 1988).

<sup>112</sup> The legislative history of § 365 states that, although "there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides." A note is usually not an executory contract if the only performance that remains is repayment. Since performance on one side of the contract would have been completed, the contract would no longer be executory. H.R. 595, 95th Cong., 2d Sess. 347, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS. 5787, 6303-04.

<sup>113</sup> Countryman, *Executory Contracts in Bankruptcy*, 57 MINN. L. REV. 439, 450-60 (1973).

<sup>114</sup> *See In re Garnas*, 38 Bankr. 221, 223 (Bankr. D.N.D. 1984).

## 2. Section 365 Powers

With certain important exceptions, section 365 gives the trustee in bankruptcy the power, subject to bankruptcy court approval, "to assume or reject any executory contract or unexpired lease of the debtor."<sup>115</sup> Clearly, exercising this power can have far-reaching consequences for the estate.

Assumption of the contract by the trustee obligates the estate to perform the contract. Accordingly, the expenses and liabilities that are incurred pursuant to the contract become those of the estate.<sup>116</sup> In addition, assumption has been held to apply to all the obligations created by the contract. The trustee cannot assume part and reject part of the same contract.<sup>117</sup>

Section 365 also gives the trustee the power to assign an assumed contract to a third party.<sup>118</sup> In situations where the trustee holds the debtor's interest in the contract on behalf of the bankruptcy estate, assignment is likely. The trustee will sell the estate's interest in the contract to the highest bidder.

Rejection of a contract by the trustee rescinds any rights that the debtor had under the contract and constitutes a breach of the contract.<sup>119</sup> The Bankruptcy Code provides that this breach is deemed to have occurred immediately before the filing of the bankruptcy petition.<sup>120</sup> This puts the other contracting person in the position of a general unsecured creditor with a claim under section 502.<sup>121</sup> If there are insufficient funds in the bankruptcy estate to pay all of the unsecured claims, and this will generally be the case, the claim will go unsatisfied.<sup>122</sup>

Court approval of the assumption or rejection of an executory contract is required.<sup>123</sup> The Bankruptcy Code provides no specific guidance

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<sup>115</sup> 11 U.S.C. § 365(a) (1988).

<sup>116</sup> *In re Coast Trading Co.*, 744 F.2d 686, 692-93 (9th Cir. 1984).

<sup>117</sup> *Richmond Leasing Co. v. Capital Bank*, 762 F.2d 1303, 1311 (5th Cir. 1985); *In re Cutters, Inc.*, 104 Bankr. 886 (Bankr. M.D. Tenn. 1989); *In re Nitec Paper Corp.*, 43 Bankr. 492, 498 (S.D.N.Y. 1984); *In re Rovine Corp.*, 6 Bankr. 661, 666 (Bankr. W.D. Tenn. 1980).

<sup>118</sup> 11 U.S.C. § 365(f) (1988).

<sup>119</sup> *Id.* § 365(g)(2)(B).

<sup>120</sup> *Id.*

<sup>121</sup> *Id.* § 365(g)(1); *In re Carrere*, 64 Bankr. 156, 160 (Bankr. C.D. Cal. 1986).

<sup>122</sup> 11 U.S.C. §§ 727, 1141 (1988). For an analysis of this process, see *Lubrizol Enters. v. Richmond Metal Finishers*, 756 F.2d 1043 (4th Cir. 1985). *But see In re Aslan*, 65 Bankr. 826 (Bankr. C.D. Cal. 1986).

<sup>123</sup> 11 U.S.C. § 365(a) (1988).

as to the appropriate standard for judicial review of the trustee's decision. To fill this void, courts have developed the "business judgment test." The court will grant the trustee's motion to reject the contract if the trustee can show that in her "business judgment," rejection would benefit the estate.<sup>124</sup> Courts have generally applied this test leniently.<sup>125</sup>

In some situations, courts also have considered the harm that rejection may cause to the creditors who were parties to the contract.<sup>126</sup> This harm is weighed against the benefit that may result for the estate. Courts may sometimes consider whether the parties acted in good faith.<sup>127</sup>

Timing issues are also important to the trustee's section 365 powers. Unless the court grants additional time, the trustee in a chapter 7 bankruptcy case must act within sixty days of the order for relief. If the sixty days pass without trustee action and assuming that the contract has been properly scheduled by the debtor, the contract is deemed rejected.<sup>128</sup>

In cases under chapters 11, 12 or 13, the trustee may assume or reject the contract any time before confirmation of the plan.<sup>129</sup> On the request of a party to the contract the court may set a more specific time period.<sup>130</sup>

### 3. Contracts Between the Member and the Cooperative

There are two major types of member-cooperative contracts that may be subject to the executory contract provisions of section 365: (1) the membership agreement evidencing the member's interest in the cooperative, and (2) the more traditional purchase and sale contracts. Important characteristics of each type will be discussed, focusing only on the contractual obligations most likely to be at issue under section 365 in a member's bankruptcy.

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<sup>124</sup> *In re Cutters, Inc.*, 104 Bankr. 886 (Bankr. M.D. Tenn. 1989).

<sup>125</sup> *Id.*; see also *Lubrizol Enters.*, 756 F. 2d at 1046-47.

<sup>126</sup> *Aslan*, 65 Bankr. at 831; see also *In re Chinichian*, 784 F.2d 1440 (9th Cir. 1986).

<sup>127</sup> Some courts have used the good faith analysis in refusing to allow contract rejection in situations where the rejection was the sole reason for the bankruptcy. See *In re Carrere*, 64 Bankr. 156, 159-60 (Bankr. C.D. Cal. 1986). Other courts, however, have found it permissible to file bankruptcy for this purpose alone. *In re Bofill*, 25 Bankr. 550 (Bankr. S.D.N.Y. 1982); *In re Noonan*, 17 Bankr. 793, 800 (Bankr. S.D.N.Y. 1982).

<sup>128</sup> 11 U.S.C. § 365(d)(1) (1988).

<sup>129</sup> *Id.* § 365(d)(2).

<sup>130</sup> *Id.*

a. *The Membership Agreement*

Membership in a cooperative is essentially the contractual association of one member to the other members in the cooperative. It usually is evidenced by either a share of stock or a membership agreement. In either case, membership arises from a contractual relationship between the individual and the cooperative.<sup>131</sup>

In many cooperatives, initial membership requirements will be set forth in the cooperative's bylaws.<sup>132</sup> Courts have upheld the use of these requirements to restrict membership.<sup>133</sup> Similarly, the cooperative will probably wish to restrict the transferability of membership and the benefits thereof. Courts have upheld transfer restrictions in the cooperative bylaws.<sup>134</sup>

Once membership has been established, the member has certain rights under the membership agreement and other agreements with the cooperative, and as created by the nature of the member-cooperative relationship. Because this relationship has been characterized as a fiduciary relationship, a broad range of member rights have been found.<sup>135</sup>

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<sup>131</sup> *Pink v. A.A.A. Highway Express*, 314 U.S. 201, 205 (1941); *Constructors' Ass'n v. Furman*, 165 Pa. 248, 67 A.2d 590, 591 (1949).

<sup>132</sup> Some states cooperative statutes explicitly authorize this type of provision in the bylaws. *See, e.g.*, KY. REV. STAT. ANN. §§ 272.151, 272.191 (Michie/Bobbs-Merrill 1981).

<sup>133</sup> *See, e.g.*, *Gold Knob Outdoor Advertising Co. v. Outdoor Advertising Ass'n*, 225 S.W.2d 645, 646-47 (Tex. Ct. App. 1949) (holding that voluntary association may deny membership rights to applicant).

Taking a more intrusive approach, another court examined the cooperative bylaws to determine whether membership denial was appropriate. In *Meyers v. Lux*, 75 N.W. 2d 533 (S.D. 1956), the court found that the cooperative did not have the authority to exclude certain applicants from membership. The applicants had fully complied with the application requirements contained in the cooperative's bylaws. Once full compliance was achieved and absent a board of directors approval requirement, the directors were not authorized to refuse membership. *Id.* at 536-37. It should be noted that the court also was influenced by the fact that the cooperative at issue was an electric service cooperative. The court mentioned that the public service nature of the cooperative and the state benefits bestowed upon the cooperative were distinguishing features. *Id.* at 536.

<sup>134</sup> For example, in the case of *Carpenter v. Dummit*, 297 S.W. 695 (Ky. 1927), the court upheld a provision in the cooperative's bylaws that prohibited the transfer of the association's stock to "[p]ersons not engaged in the production of agricultural products handled by the association." *Id.* at 697.

<sup>135</sup> *See, e.g.*, *Rhodes v. Little Falls Dairy Co.*, 230 A.D. 571, 245 N.Y.S. 432, 435 (1930), *aff'd*, 256 N.Y. 559, 177 N.E. 140 (1931). For an analysis of the fiduciary duty theory as applied to cooperative lenders, see B. Hoekstra, *Beyond Lender Liability: The Cooperative Fiduciary Duty Owed by the Farm Credit System Cooperatives to*

Courts have held that the duties of the cooperative under its articles and bylaws can only be enforced by members.<sup>136</sup>

*b. Whether Member-Cooperative Contracts Are Executory Contracts Under the Bankruptcy Code*

As long as a farmer's membership has not been terminated, the membership agreement may continue to impose certain duties on the cooperative in favor of the farmer. These duties may include a general obligation to conduct the operations of the cooperative using good business judgment. These duties also may include specific obligations such as those governing the payout of patronage dividends. Note that the patronage dividends owed by the cooperative to the member often simply represent the member's right to payment for past patronage. Similarly, the holding of patronage certificates by the member will represent the cooperative's obligation to redeem the certificates. In this situation, the cooperative may have a lingering duty to the member. This duty may remain after the filing for bankruptcy, but it is not necessarily indicative of an executory contract.<sup>137</sup> For the membership contract to be an executory contract, the member must have a corresponding performance obligation due to the cooperative.

The member may be under such a corresponding performance obligation. In most situations, this obligation will relate to specific marketing or purchasing agreements that the member has made with the cooperative.<sup>138</sup> Absent these contracts, the member may not have any unperformed duties under her membership agreement. Thus, even though the rights of membership may pass to the bankruptcy estate, an executory contract may not exist.

When a member joins a cooperative, both the member and the cooperative agree to be bound by the articles of incorporation and the bylaws. As long as the membership continues, duties under the articles and bylaws also continue. To the extent that they are active and continuing, these duties could be considered executory. In practical terms,

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Its Member/Borrowers (Nov. 28, 1988) (unpublished manuscript available through the National Center for Agricultural Law Research and Information, University of Arkansas).

<sup>136</sup> See *Gold Knob Advertising*, 225 S.W.2d at 645.

<sup>137</sup> For an analysis of this situation in bankruptcy, see *In re Schauer*, 62 Bankr. 526 (Bankr. D. Minn. 1986); *In re Cosner*, 3 Bankr. 445 (Bankr. D. Ore. 1980).

<sup>138</sup> The membership and marketing or purchasing contracts may be combined. This discussion attempts to analyze each separately to isolate the obligations associated with each form.

however, any executory duties referred to in the articles or bylaws may be meaningless absent a specific marketing-purchasing contract.

*c. Agreements Regarding the Purchase and Sale of Supplies and Commodities*

Cooperatives enable their members to act together to achieve economies of scale. In this regard, the two main types of agricultural cooperatives are marketing and supply cooperatives.<sup>139</sup> Each is created to strengthen the member's position in the marketplace, either by enhancing the price received by the member-producer or by decreasing the input costs needed for production.

In addition to the membership agreement and the provisions of the articles of incorporation and bylaws, cooperatives frequently enter into specific contracts with their members. Marketing cooperatives generally require members to promise to sell all or some of their commodities through that cooperative. In return, the cooperatives agree to use their best efforts to market the commodities. The payment terms, including the patronage dividend arrangements, also may be agreed upon as part of this contract.<sup>140</sup> For a marketing cooperative to achieve its purpose of obtaining a favorable price for its members' commodities, it is essential for it to have firm commitments from its members for the delivery of commodities. Without the assurance that it will have a certain volume of commodities to deliver, the cooperative will be unable to negotiate a favorable price through ongoing marketing arrangements or future contracting. Also, a cooperative's credibility as a market source may be diminished as to future transactions if its members fail to deliver their promised commodities. For these reasons, courts have frequently interpreted members' marketing contract obligations strictly. As previously explained, in breach of contract actions brought against cooperative members, courts have granted cooperatives' requests for orders of specific performance.<sup>141</sup> Indeed, some state cooperative statutes specifically

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<sup>139</sup> Frequently a cooperative will be both a marketing and a purchasing cooperative. For purposes of analyzing the different functions, however, they will be discussed separately.

<sup>140</sup> Sample marketing contracts can be found in L. HULBERT & M. NEELY, *supra* note 5, at 554-59. Note that these examples show combined membership and marketing contracts. These two types of contracts may be, and frequently are, separated into two separate agreements.

<sup>141</sup> See, e.g., *Carolinas Cotton Growers Ass'n v. Arnette*, 371 F. Supp. 65 (D.S.C. 1974).

authorize this form of relief.<sup>142</sup>

Liquidated damages also are obtained frequently by cooperatives in breach of contract actions against members. Again, courts have recognized the financial need for cooperatives to be able to rely on the delivery of promised commodities by their members. In recognition of the potential harm a nonperforming member may do to a cooperative, and in general support for the cooperative structure, many courts have enforced liquidated damages clauses in cooperative marketing agreements.<sup>143</sup> Moreover, many of the state agricultural cooperative statutes specifically authorize inclusion of such clauses in marketing contracts.<sup>144</sup>

Purchasing or supply cooperatives may also have contracts with their members, although these agreements generally will not be as specific. Provided that the farmers retain their membership status, they may be assured of getting a certain discount price at the cooperative. It is also possible for the cooperative to require the member to purchase a certain volume or percentage of goods through the cooperative. Arrangements regarding patronage dividends may be specified as well.

The purchasing or supply functions of cooperatives have not generated nearly as much litigation as their marketing functions. As indicated earlier, contracts between members and purchasing cooperatives may be much less specific and may involve fewer explicit obligations. Controversies that develop are most likely to involve patronage distribution<sup>145</sup> or the quality of goods sold,<sup>146</sup> topics that are not relevant to the issue of member bankruptcy discussed in this Article.

#### *d. Whether Purchase and Sale Contracts Can Be Rejected*

In most bankruptcy cases involving cooperative members, the executory contract analysis will focus on marketing and supply contracts. As noted earlier, marketing contracts are generally more important than supply contracts. Under a marketing contract, it is very likely that unperformed obligations will remain on both the part of the member and the cooperative at the time of the bankruptcy filing. The member may

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<sup>142</sup> See, e.g., KAN. STAT. ANN. § 17-1616 (1988). For the courts' interpretation of this provision, see *Kansas Wheat Growers' Ass'n v. Schulte*, 113 Kan. 672, 216 P. 311 (1923).

<sup>143</sup> See, e.g., *Watertown Milk Producers' Coop. Ass'n v. Van Camp Packing Co.*, 199 Wis. 379, 225 N.W. 209, *reh'g denied*, 199 Wis. 394, 226 N.W. 378 (1929).

<sup>144</sup> See, e.g., CAL. FOOD & AGRIC. CODE § 54264 (West 1986).

<sup>145</sup> See, e.g., *Clarke County Coop. v. Read*, 243 Miss. 879, 139 So. 2d 639 (1962).

<sup>146</sup> These cases will generally fall under Article 2 of the Uniform Commercial Code, which deals specifically with the sale of goods.

be obligated to deliver commodities to the cooperative, and the cooperative will be obligated to market these commodities. Under a section 365 analysis, such mutual obligations constitute an executory contract.

At least two bankruptcy court decisions support the finding of an executory contract in the cooperative setting. In the case of *In re Public Service Company of New Hampshire*,<sup>147</sup> the First Circuit Court of Appeals considered a bankruptcy case involving a contract between the public service company and an electric cooperative. According to the terms of the contract, the cooperative was entitled to a share of the electricity generated by the public service company's Seabrook nuclear power plant when and if the plant became operational. A side agreement obligated the public service company to buy back any power that the cooperative did not need. At issue in the case was whether the cooperative, which also owed money to the public service company, could setoff its obligation against a breach of contract claim against the public service company. This breach of contract claim apparently was based on the public service company's failure to bring the Seabrook plant into operation. In response to the cooperative's attempted setoff, the court held that "because performance remained due on both sides," the contract between the public service company and the cooperative was "a classic example" of an executory contract under section 365.<sup>148</sup> As such, the trustee had all of the rights available under that section to assume, assign, or reject the contract. Because no such action had yet been taken,<sup>149</sup> the contract continued in effect, and a breach of contract claim was premature.

Similarly, in the case of *In re Herschell*,<sup>150</sup> a Wisconsin bankruptcy court acknowledged the existence of an executory contract between a member-debtor and a cooperative. The contract at issue in this case was a dairy marketing contract. The cooperative brought an action against the debtor for breach of the patronage agreement. Because the bankruptcy case was closed, the court dismissed the cooperative's action. The court explicitly acknowledged, however, that the dairy marketing contract had been an executory contract.<sup>151</sup>

As has already been discussed, cooperatives, particularly marketing cooperatives, must be able to rely on the performance of their members'

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<sup>147</sup> 884 F.2d 11 (1st Cir. 1989).

<sup>148</sup> *Id.* at 14.

<sup>149</sup> Because this case involved a chapter 11 bankruptcy, the debtor in possession held the § 365 rights.

<sup>150</sup> *In re Herschell*, 43 Bankr. 680 (Bankr. E.D. Wis. 1984).

<sup>151</sup> *Id.* at 682.

contractual obligations. Outside of bankruptcy, cooperatives generally have been afforded broad remedies in breach of contract actions against their members. It appears that these remedies may not be available from the bankruptcy courts.

For example, in *In re Herschell*, after finding that the dairy marketing contract was executory, the court went on to state that the rights in the contract had passed to the estate. Because the trustee failed to act within the sixty-day time period, the contract was deemed rejected. This rejection constituted a breach of contract deemed to have occurred immediately before the filing of the petition.<sup>152</sup> Similarly, in *In re Public Service*, the court clearly acknowledged that the public service company had a right to reject the contract at issue. The public service company had just not chosen to do so yet.<sup>153</sup>

Marketing cooperatives may find this analysis disturbing, especially in light of the favorable treatment they usually receive from the courts outside of bankruptcy. Nevertheless, this result is consistent with the bankruptcy courts' countervailing support for debtors. For those representing cooperatives in this precarious situation, a helpful analysis is the discussion of the California courts in *In re Aslan* and *In re Chinichian*.<sup>154</sup> In these cases, the courts urged a balancing test between the benefit of contract rejection to the debtor and the harm of rejection to the creditor. Taking a similar approach, a Vermont bankruptcy court outlined several factors that must be considered before approving contract rejection.<sup>155</sup> One factor was the economic impact of contract acceptance or rejection. In that case, rejection of the contract at issue would have put the nondebtor contracting party out of business. For this reason, the court declined the trustee's application for rejection.

Absent this type of special circumstance, if rejection is in the best interests of the estate as determined by the business judgment test, the trustee should be entitled to reject the contract with the cooperative under section 365.

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<sup>152</sup> *Id.*

<sup>153</sup> *In re Public Serv. Co.*, 884 F.2d 11 (1st Cir. 1989).

<sup>154</sup> *In re Aslan*, 65 Bankr. 826 (Bankr. C.D. Cal. 1986); *In re Chinichian*, 784 F.2d 1440 (9th Cir. 1986).

<sup>155</sup> *In re Air Vermont, Inc.*, 40 Bankr. 61, 63 (Bankr. D. Vt. 1984).

### D. Avoidance Problems

#### 1. Avoidance of Debtor's Liens

The Bankruptcy Code grants debtors certain avoiding powers to protect their exempt property. A debtor may avoid nonpossessory, nonpurchase money security interests in certain categories of exempt property, including crops and animals that are held for personal consumption, and tools of the trade.<sup>156</sup>

After-acquired property clauses also are jeopardized in bankruptcy proceedings. Article 9 of the Uniform Commercial Code permits debtors to execute security agreements giving creditors liens on after-acquired property. Such security agreements are common as to agricultural collateral, which often consists of livestock and crops.

Section 552(a) of the Bankruptcy Code limits the effects of such after-acquired property clauses. Property of the estate or debtor that is acquired post-petition is not subject to pre-petition liens created by agreement, even though the agreement contains a properly executed and perfected after-acquired property clause. Statutory liens, common law liens, equitable liens, and judicial liens are not affected.<sup>157</sup>

While section 552(a) makes a large number of after-acquired property liens inoperative, section 552(b) provides an important exception for agricultural collateral. Section 552(b) permits creditors to retain secured interests in pre-petition collateral and the proceeds, products, offspring, rents or profits of such collateral.<sup>158</sup> The validity of such liens is subject to the bankruptcy court's discretionary power. Section 552(b) provides for an "equities of the case" exception, which gives the bankruptcy court enormous flexibility and discretion in dealing with security interests and the proceeds, products, offspring, rents and profits of pre-petition collateral.<sup>159</sup>

While the extent of the bankruptcy court's discretion has not been fully developed, the "equities of the case" exception leaves open several avenues by which the debtor may seek to retain after-acquired property. For example, after-acquired property liens are subject to the usual avoidance rules for preferences and fraudulent transfers. Moreover,

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<sup>156</sup> 11 U.S.C. §§ 522(f)(2)(A), (B) (1988). A debtor may also avoid judicial liens on personal or real property. *See id.* § 522(f)(1).

<sup>157</sup> *See generally* Kunkel, Walter & Lander, *The Reach of Prefiling Security Interests in Post Filing Proceeds of Agricultural Collateral — an Analysis of Bankruptcy Code § 552*, J. AGRIC. TAX'N L. 311 (1987).

<sup>158</sup> 11 U.S.C. § 552(b) (1988).

<sup>159</sup> Kunkel, Walter & Lander, *supra* note 157, at 313-14.

under section 506(c), a chapter 11 debtor may recover from the secured parties' pre-petition collateral proceeds "the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claims."<sup>160</sup>

## 2. Trustee's Avoiding Powers

To accumulate as large an estate as possible, the trustee is empowered to recover some of the debtor's property that may have been transferred prior to the filing of a bankruptcy petition. For example, the trustee's avoidance power includes a "strong-arm clause" which gives the trustee power to avoid liens which have not been properly perfected as of the date of the bankruptcy petition.<sup>161</sup> The trustee also can avoid liens that have become effective solely as a result of a statute and upon the happening of a specified event, such as bankruptcy or insolvency.<sup>162</sup> Liens such as those protecting a landlord's interest in a farm lease by creating a lien on crops for rents and advances may be affected. Also subject to avoidance are nonpossessory agricultural statutory liens.<sup>163</sup>

A trustee can also avoid fraudulent conveyances. Fraudulent conveyances are conveyances made with the intent to hinder, delay or defraud creditors. Such conveyances also include transfers in which the debtor received less than a reasonably equivalent value if the debtor was insolvent at the time of the transfer or became insolvent as a result of the transfer.<sup>164</sup>

A trustee also has the power to avoid preferences. Preferences are transfers that favor one creditor over another. The elements of a preference include (1) the transfer of property; (2) for the benefit of a creditor on account of an antecedent debt; (3) made while the debtor was insolvent; (4) made within ninety days of the petition, or within one year as to an insider; and (5) which enabled the creditor to receive more than the creditor would have received had the transfer not been made and the debtor's estate been liquidated under a chapter 7 proceeding.<sup>165</sup>

Finally, the trustee always has the power to avoid post-petition transfers. Post-petition transfers are simply those transfers made after

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<sup>160</sup> 11 U.S.C. § 506(c) (1988).

<sup>161</sup> *Id.* § 544(a).

<sup>162</sup> *Id.* § 545.

<sup>163</sup> *See In re Loretto Winery Ltd.*, 81 Bankr. 573 (9th Cir. 1987).

<sup>164</sup> 11 U.S.C. §§ 544(b), 548 (1988).

<sup>165</sup> *Id.* § 547(b).

commencement of the bankruptcy case.<sup>166</sup>

The relationship between the cooperative and its members makes the cooperative particularly vulnerable to the trustee's avoiding powers. The member-cooperative relationship necessarily entails fiduciary duties. Also, the business relationship of the parties means that the cooperative may be more familiar with the member's debts than the member's other creditors. As a result, any pre-bankruptcy transfers by the member to the cooperative will be closely scrutinized. The cooperative that takes additional collateral from a member or that takes control of a member's accounts receivable may create a voidable preference. Such action enables the cooperative to collect a greater percentage of the member's debt than other creditors of the same class are able to collect.

A cooperative may even become a party to a fraudulent transfer made by a debtor. A transfer made within one year of the filing of the bankruptcy petition may be invalidated if the transfer was made or the obligation was incurred without fair consideration and (1) the transferor was insolvent at the time, or was rendered insolvent by the transfer; (2) after the transfer, the transferor continued the business without a reasonable amount of capital to do so; or (3) the transferor intended to incur or believed that it would incur debts beyond its ability to pay as the debts matured.<sup>167</sup> A critical consideration as to fraudulent transfers is whether the transfer was conducted in good faith. A transaction is not conducted in good faith if it is not an arm's length transaction.

At a minimum, a cooperative may find its claims subordinated to the claims of other creditors. Section 570(c) of the Bankruptcy Code gives bankruptcy courts broad equitable powers to adjust the status of claims. If a creditor engages in inequitable conduct and the misconduct injures other creditors or puts them at an unfair advantage, the claims of the offending creditor may be subordinated to the other creditors' claims.<sup>168</sup>

#### *E. Expulsion of Members Who Have Filed for Bankruptcy*

As previously discussed, cooperative members are subject to expulsion for a variety of reasons, including insolvency and breach of contractual relationships. Certainly, the expulsion of a cooperative member must be carefully handled in a pre-bankruptcy setting, as the cooperative must comply with due process requirements. Even greater care must be taken if the expulsion is attempted after the member files for

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<sup>166</sup> *Id.* § 549.

<sup>167</sup> *Id.* § 548.

<sup>168</sup> See *In re American Lumber Co.*, 5 Bankr. 470 (Bankr. D. Minn. 1980); *In re Osborne*, 42 Bankr. 988 (Bankr. W.D. Wis. 1984).

bankruptcy.

Initially, the cooperative must deal with the automatic stay order. Section 362 of the Bankruptcy Code provides for an automatic stay of all post-petition collection efforts. Given the breadth of the automatic stay provision, any attempt to expel the member from the cooperative could be seen as an act adversely affecting the debtor's rights. This interpretation is especially likely if the debtor intended to continue in farming and filed a chapter 11, 12 or 13 proceeding. Cooperative membership is a valuable right and may be critical to the economic existence of some members.

There is also the unanswered question of whether the cooperative may expel a member if the bankruptcy trustee exercises her section 365(c) powers to reject an executory contract. Normally, cooperatives have the authority to expel members for contractual breaches. As previously explained, however, the Bankruptcy Code gives trustees the authority to accept or reject executory contracts, subject to the bankruptcy court's approval. The expulsion of a cooperative member because the trustee obtained court approval to reject an executory contract, whether the contract is a marketing or supply contract, could be difficult to justify.

However, at least one court decision, *Schlossmans, Inc. v. Associated Furniture Dealers of New York*,<sup>169</sup> supports the expulsion of a cooperative member after the filing of a chapter 11 proceeding. In that case, the organization's bylaws explicitly provided for the expulsion of any member who filed a bankruptcy petition, or for whom a receiver was appointed, or who sought to take advantage of any insolvency statute.<sup>170</sup> Following the expulsion, the expelled member sought the revocation of the expulsion and the restoration of full membership privileges. In denying the expelled member's restoration request, the court held that creditors and other persons have the right to take necessary steps to protect themselves from the practical and financial consequences of bankruptcy proceeding.<sup>171</sup>

It is questionable whether the decision in *Schlossmans* is still good law. The case followed a series of decisions under the 1898 Bankruptcy Act upholding contract clauses which *ipso facto* terminated leases and the lessees' contract rights upon the lessees' adjudications as bankrupts.<sup>172</sup>

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<sup>169</sup> 31 Misc. 2d 938, 221 N.Y.S.2d 872 (1961).

<sup>170</sup> *Id.*

<sup>171</sup> *Id.* at 874.

<sup>172</sup> *See, e.g.,* *Urban Properties Corp. v. Benson*, 116 F.2d 321 (9th Cir. 1940) (hold-

Unlike the 1989 Bankruptcy Act, the 1978 Bankruptcy Code specifically addresses *ipso facto* clauses which condition a contract's validity upon a debtor's financial condition, insolvency, or the filing of a bankruptcy petition. The Code gives the trustee the authority to ignore such clauses. Notwithstanding any bankruptcy or *ipso facto* clauses that terminate, forfeit, or modify a debtor's interest in the property, the trustee is permitted to use, sell, or lease the property.<sup>173</sup> The debtor's estate comprises all property in which the debtor has a legal or equitable interest as of the commencement of the case,<sup>174</sup> including a debtor's property interest in contract rights with the cooperative. A debtor-in-possession under a chapter 11 reorganization plan has substantially the same rights and powers as the trustee.<sup>175</sup>

In chapter 11, 12 or 13 proceedings, the trustee or debtor-in-possession could manage the estate in such a manner that the cooperative would not be placed at a financial disadvantage. If the estate's operation does not disadvantage the cooperative, the cooperative has no reason to expel the member. While the reasoning in *Schlossmans* might apply in chapter 7 liquidation proceedings, it is certainly questionable as to the other proceedings. The reasoning might even be questionable in chapter 7 proceedings if the trustee, pending liquidation, chooses to honor the debtor's contracts with the cooperative.<sup>176</sup>

### CONCLUSION

As was demonstrated in the 1980s, unpredictable weather, markets, and agricultural policies combined to make farmers particularly vulnerable to financial distress. Because farmers share a unique financial interdependence with their agricultural cooperatives, cooperatives are subject to the same financial difficulties as their members. The cooperatives' financial difficulties have often been exacerbated by their own poor financial planning.

As stated at the outset of this Article, cooperatives need not be com-

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ing that in chapter 11 case under 1898 Bankruptcy Act, debtor's lessor had option to terminate lease even if lessee was debtor-in-possession of leased properties); *Murray Realty Co. v. Regal Shoe Co.*, 265 N.Y. 332, 193 N.E. 164 (1934) (holding valid lease provision that *ipso facto* terminated lease agreement and lessee's rights under agreement upon adjudication of lessee as bankrupt); *see also* *Schneider v. Springman*, 25 F.2d 255 (6th Cir. 1928).

<sup>173</sup> 11 U.S.C. § 363(b)(1) (1988); *id.* § 541(c)(1)(B).

<sup>174</sup> *Id.* § 541 (a)(1).

<sup>175</sup> *Id.* § 1107(a).

<sup>176</sup> *See* Copeland, *supra* note 81, at 78-79.

pletely vulnerable to their members' financial problems. The protection of the cooperative's financial integrity begins with a clearly established credit policy which sets reasonable credit limits for all members and provides for credit review, adequate collateralization of debt and an aggressive but fair collection process.

The cooperative leadership also must be prepared to deal with those members that no longer function as agricultural producers or who fail to fulfill their contractual obligations to the cooperative. As to such members, expulsion may be required to protect the cooperative's critical tax and antitrust exemptions. A cooperative is ill-served by faint-hearted leaders who are unwilling to aggressively protect the cooperative's financial structure and to make hard decisions as to the expulsion of those members who no longer meet the cooperative's needs and goals.

Inevitably, some cooperative members will seek the protection of the bankruptcy laws. Whenever a cooperative member files for chapter 7, 11, 12 or 13 protection, the cooperative must be prepared to participate in the proceedings and to protect its financial interests. The cooperative's relationship with a member raises some unique issues in bankruptcy as to retained equities, executory contracts, avoiding powers, and the expulsion of a member who files for bankruptcy protection while attempting to retain cooperative membership. The cooperative's leadership must have a clear understanding of such issues to guide the cooperative successfully through the often intricate and confusing bankruptcy process.