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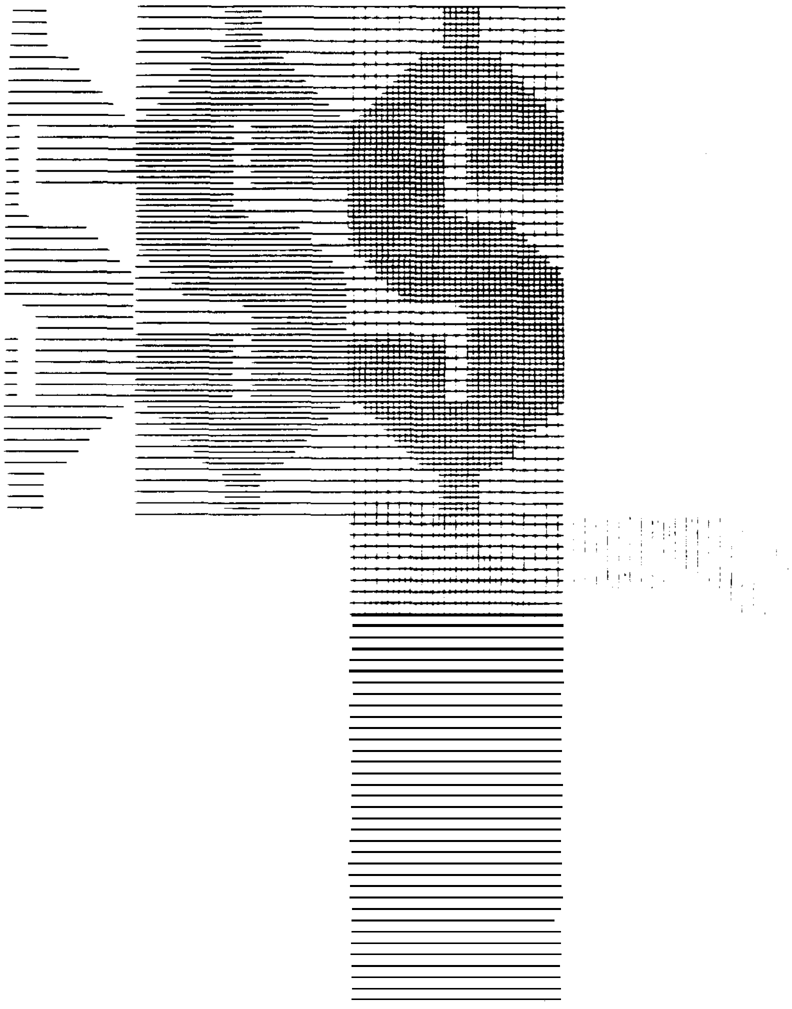
Equity Redemption Guide



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Equity Redemption Guide

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A cooperative is supposed to serve its member-owners, right?

Who owns your cooperative?

Heirs of Bill Jones who died 10 years ago?

Sam White who moved out of State 5 years ago?

Ted Brown who retired last year?

Director Ned Smith who has done 100 percent of his business with the co- op for 25 years?

Or young Johnny Green who started trading at the cooperative last month?

Do these types of member-owners have the same interests and goals? Hardly.

Bill Jones' heirs have been pressing the board to redeem his equity; further, they're upset because they don't have voting rights to affect equity redemption policies.

Ned Smith believes the cooperative needs a million-dollar feed mill.

Johnny Green and some of his young farmer friends are threatening to quit the cooperative unless it pays a larger portion of the patronage return in cash.

How can your cooperative serve such diverse interests and yet survive?

Perhaps it can't . . . without adopting solid financial planning that includes a carefully developed and conscientiously followed equity redemption program.

Redeeming equity is an ownership transfer process to keep the cooperative financed, owned, and controlled by current member-users. Such a process should result in a membership whose reasons for using the cooperative are more similar. And similarity of member interests greatly simplifies a cooperative's business strategy and future direction.

Pressures are intensifying to bring about improved programs for retiring member and patron equities.

Former members or their heirs are voicing increasing frustration over their inability to get cooperatives to redeem equities allocated many years ago. That frustration occasionally has been brought before State legislatures and to Congress. A continuation of equity redemption problems could result in a legislated mandatory program that could be devastating to many cooperatives and would greatly reduce cooperatives' financial flexibility.

An additional reason for redeeming equity stems from research indicating a relationship between equity redemption and member commitment. A recent Government study found that 70 percent of farmers surveyed would increase their patronage if their cooperative improved its equity redemption program.

FOUR ALTERNATIVES

Equity formation and redemption can be achieved with four types of plans. Three involve systematic capital formation and redemption as a part of a cooperative's financial budgeting process. The fourth redeems equity according to the member's particular circumstance.

Revolving Fund

Equities are redeemed in the order they're allocated. How soon equities are redeemed is usually left to the discretion of the board of directors and is subject to the cooperative's financial condition.

Tables 1 and 2 illustrate how a revolving fund works.

Table 1 -Revolving fund operation at cooperative level

Year	Beginning equity	Patronage allocations retained	Equity amount redeemed	Equity year (s) redeemed
	- - - - - - - - Dollars	- - - - - - - -		
1	0	500	0	
2	500	500	0	—
3	1,000	500	0	
4	1,500	500	500	1
5	1,500	1,000	1,000	2, 3
6	1,500	500	500	4

Table 2—Revolving fund operation applied to Member A

Year	Beginning equity	Patronage allocations retained	Equity amount redeemed	Equity year (s) redeemed
	- - - - - - - - Dollars	- - - - - - - -		
1	0	50	0	
2	50	100	0	
3	150	150	0	
4	300	200	50	1
5	450	200	250	2, 3
6	400	200	200	4

The cooperative's objective (table 1) is to accumulate allocated equity of $1,500. Retention begins with $500 in Year 1 and reaches the designated level by the end of Year 3. Then, as new equities are retained ($500 in Year 4), old equities ($500 in Year 1) are redeemed.

In Year 5, the cooperative retains $1,000, perhaps because it realized better than expected net margins or it deliberately decided to shorten the revolving period. For whatever reason, by retaining $1,000 in Year 5, it is now able to redeem equities of $500 each from Years 2 and 3.

Member A (table 2) contributes varying amounts of equity each year according to use of the cooperative. Beginning Year 4, A's equity is $300.

In Year 4 when the cooperative decides to redeem equities from Year 1, A would get $50. In Year 5 when the cooperative decided to redeem equities from Years 2 and 3, A would get $250.

Among advantages of this plan:

- It's easy to understand and to administer.

- It provides an easy method for new members to accumulate equity.

- Equity is held more or less in proportion to patronage as long as the revolving period is relatively short.

The basic disadvantage of this plan is the difficulties that may arise if the revolving period becomes too long. An unexpected need for capital or unanticipated low margins would force the cooperative to choose between a cash flow crunch or lengthening the revolving period. The latter might be the only choice. For whatever reasons, as the revolving period lengthens, equity becomes less proportional to use. The eventual result often is conflict among members concerning the cooperative's financing and equity redemption policies.

Percentage-of -All-Equities

The cooperative redeems a percentage of all equities, with members each receiving the same percentage of their equities regardless of when allocated.

Tables 3 and 4 illustrate how the plan works.

In table 3, the cooperative has $2,000 in allocated equity. After the business year is over and net margins are allocated according to established policy, the new total is $2,500. But the board, assessing the coming year, determines only $2,300 is needed. Consequently, $200 in allocated equity could be redeemed to members (10 percent of the cooperative's $2,000 in allocated equity before the most recent year's allocation).

Applying the lo-percent redemption to five members is illustrated by table 4. Note the same percentage is applied regardless of the amount of equity and how long the equity has been held.

Advantages are:

- Equity redemption decisions can accommodate varied operating decisions and growth objectives.

Table 3—Percentage-of-all-equities operation at cooperative level

	Dollars
Allocated equity at beginning of year	2,000
Patronage allocations retained	+500
Equity available at end of year	2,500
Equity required	2,300
Equity redeemable (2,500 minus 2,300)	**200***

* 10 percent of allocated equity at beginning of year.

Table 4—Percentage-of-all-equities operation applied to members

Member	Beginning equity	Percent of equity redeemable	Amount to be redeemed
	Dollars		*Dollars*
A	750	10	75
B	250	10	25
C	250	10	25
D	500	10	50
E	250	10	25
Total	2,000	10	200

- New members participate immediately in equity redemption.

- The plan works well for cooperatives with stable memberships and little fluctuation in patronage.

Disadvantages are:

- Redemption ignores the length of time equity has been held and the initial patronage basis under which it was supplied.

- Transfer of ownership to current members is slowed and, in fact, never completed without a provision for closing out equity accounts of former members.

Base Capital

Capital needed to run the cooperative is determined annually. Each member's equity contribution is also adjusted annually according to patronage during a base period, usually the past 3 to 10 years.

Underinvested members, those whose equity investments are less than their capital obligations, continue to invest and may be required to pay an interest charge on the amount of their underinvestment. Overinvested members generally are not required to continue investing and may begin to receive at least partial redemption of excess investment.

Table 5 illustrates operation of the base capital plan.

The six-member cooperative operates on a S-year base period and has $18,250 member equity. The board has determined the cooperative needs an additional $250 of equity capital. Each member's capital obligation is determined by patronage over the past 5 years. The member's percentage of the cooperative's total business determines the percentage of the member's new capital obligation. Comparing the new obligation with the member's equity account determines what adjustment, if any, is necessary in the member's capital obligation.

In table 5, Member A needs to contribute $350 more. The amount is determined by dividing A's patronage ($120,208) by the cooperative's total volume ($1,092,796) to determine A's percent (1 1), which determine's A's capital obligation of $2,035 ($18,500 x .11). Because A has only $1,685 in equity, $350 more is needed. In Member C's circumstance, a negative amount of $215 is determined and means that amount could be redeemed.

The burden of redeem ing equity of overinvested members is shared by all members according to their use ofthe cooperative during the base period.

A variable cash patronage return plan is sometimes used with the base capital plan. The percentage of the return that's in cash varies upward from the required 20 percent according to the member's base capital obligation status. An overinvested member would receive a greater percent of the patronage return in cash than would the underinvested member.

Unless underinvested members are required to meet their capital obligations immediately, it is impossible to retire all of the overinvested equities of other members. One gradual approach is to retire a flat percent of each member's overinvestment. Another approach is to retire the equities of the most overinvested members at a faster rate than others.

Table 5—Five-year base capital plan operation

Member	Beginning equity	5-year patronage total	Share of co-op's business	Adjusted capital obligation	Obligation status
	----- Dollars -----		*Percent*	----- *Dollars* -----	
A	1,685	120,208	11	2,035	+350
B	3,345	207,631	19	3,515	+170
C	2,805	152,991	14	2,590	-215
D	5,515	327,839	30	5,550	+35
E	4,550	284,127	26	4,810	+260
F*	350	—	—	—	-350
Total	18,250	1,092,796	100	18,500	+250

*Inactive member.

Advantages of the base capital plan are:

- With equity requirements determined by patronage, it is the most equitable plan.
- Equity requirements can be easily altered to meet changing capital needs.
- Financial planning is easier because equity sources are more predictable.

Disadvantages are:

- Because of its complexity, the plan may be difficult to understand and administer.
- Frequent turnover in membership and changes in patronage directly affect the frequency and degree of adjustments in individual member equity requirements.

Special

Equity is redeemed in one or more of the following situations: (1) estate settlement; (2) certain member age; (3) former members who have quit farming or left the cooperative's trade area; (4) individuals no longer patronizing the cooperative; (5) hardship; and (6) redemption requests on an "on call" basis.

A special plan can be an alternative or supplement to any of the other plans.

Advantages:

- The financial burden on the cooperative is generally small.

- It's easily understood.

- Equity can be redeemed on a priority basis in the absence of another plan, when the other plan is not functioning as intended, or the cooperative is under financial stress.

Disadvantages are:

- Equity is not held in proportion to patronage.

- Financial planning is more difficult because of the unpredictable nature of situations that affect redemption.

FEDERATED PARTICIPATION

Patronage returns from federated cooperatives often comprise a large part of a member cooperative's net margins. Similarly, investments in federated cooperatives, primarily from retained patronage allocations, can account for a large portion of a member cooperative's assets. Because of the magnitude of these interrelationships, cash patronage returns and equity redemption from federated cooperatives can affect the level of cash benefits local cooperatives return to their members.

Some federated cooperatives have developed specific participation redemption plans with locals to redeem equities of estates and, in some cases, of retired farmer-members. When the local cooperative redeems the equity of a farmer-member, the federated then redeems a portion of its equity to the local cooperative. As an example: A local has farmer-member equity of $100,000 of which $20,000 is invested in a federated regional cooperative. When the local is faced with redeeming $10,000 held by an individual member's estate, $2,000 would come from the regional.

Many federated cooperatives help their member cooperatives with capital 'budgeting, long-range planning, financial and legal expertise, publications, and training for directors and managers. Some federated cooperatives may have model equity redemption plans and can help locals with implementation.

HOW TO GET A PROGRAM STARTED

Managing the financial affairs of a cooperative is the legal responsibility of the board of directors. Equity redemption is an integral part of that responsibility and requires careful study and planning. These guidelines should help you get a program developed and implemented:

I. Be convinced your cooperative needs an equity redemption program.

You are the key communication link with the membership. Your conviction, whether you realize it, will show through in discussions about the program with the membership. This step alone may determine the failure or success of the capital formation and equity redemption process and, perhaps ultimately, the future of your cooperative.

2. *Know the legal limits of the board's responsibilities and its power to act.*

As a general rule, courts usually defer to the judgment of the board on uses of member equity. In a few cases, a member has used the court to force a board to redeem equity. Usually, the reason stemmed from the board's failure to balance the interests of current and former members or violated a cooperative bylaw, article of incorporation, or State statute.

Courts recognize cooperatives need to engage in long-range planning and that the board must have the responsibility and power to select, adopt, and carry out business strategies. Courts are usually reluctant to interfere in the decisionmaking process of cooperatives and substitute their judgment for that of the board.

Directors are usually expected to act diligently, with skill consistent with other reasonably prudent directors in similar circumstances, in a manner encouraging loyalty to the organization, and in the best interests of the organization yet not favoring one group of members at the expense of another.

The board must balance the interests of members who want service and growth with those who hold large amounts of unredeemed equities. Additionally, the short-term interests of members wanting immediate redemption of equities may conflict with the long-term collective interests of the cooperative. Consequently, decisions on equity redemption must be made by the board instead of individual members.

3. Seek financial and legal advice.

Though equity redemption policies and decisions are recognized as being within the jurisdiction of the board, directors should know when they run the risk of abusing their power. Legal and financial analysis of a particular situation may be complex. Conclusions and decisions should be made only after consulting the State incorporation statute, court cases, and the cooperative's articles of incorporation, bylaws, marketing contracts, and equity certificates.

4. Appoint a committee.

Appoint a committee that represents the board, operating management, and a cross-section of the membership. Give the committee specific objectives and a timetable for examining the cooperative's situation and submitting recommendations. Identify special expertise the committee should consult. The committee should:

- Become familiar with the cooperative's financial operation, sources of capital, and methods of acquiring equity.

- Collect all relevant financial and legal information--including the cooperative's articles of incorporation and bylaws, necessary State statutes, loan agreements, financial statements, and information on equity redemption programs of other cooperatives in which yours has an investment.

- Study your cooperative's long-range financial plans, projected cash flows, and equity allocation records.

- Study alternative plans for equity formation and redemption-evaluating each according to the cooperative's ability to redeem equity and its financial impact on the plans of the cooperative and its members.

- Select a plan of presentation to the board -including any related decisions that need to be made, such as changing the bylaws.

5. Develop a member education plan.

This plan is by far the most important step and usually the most neglected. Initially, member education about capital formation and equity redemption must be overwhelmingly thorough and convincing. Additionally, member education must never cease. Members must be continually informed of the capital formation and equity redemption status of their cooperative. In developing an education plan, the board should:

- Seek public relations and communications advice (just as you should seek financial and legal advice in developing the program).

- Explain the program from the perspective of the member, thus attempting to answer the member's basic question: Why is this program good for me?

- Use multiple approaches—concise brochures, newsletter articles, group and individual presentations by fellow members, directors, operating management and staff, and specialists.

- Consider the need to group members during the presentation stage—long-time members with substantial equity, former members, current members with substantial patronage, young members, and so on.

- Clearly explain why equity redemption is necessary.

- Clearly explain why the selected program was chosen over other alternatives.

- Make a deliberate effort to generate discussion and encourage feedback, either openly or confidentially.

- Set a timetable for implementing the plan, including a target date for member approval.