



# NATIONAL COUNCIL OF FARMER COOPERATIVES SAMPLE BYLAWS PROJECT

## VOLUME I

Overview of Cooperative Articles of Incorporation  
Sample Bylaws Commentary

This publication is the product of a special Working Group of the Legal, Tax and Accounting (LTA) Committee of the National Council of Farmer Cooperatives (NCFC).

The Working Group solicits comments and additional input on the publication from readers by contacting NCFC at [mcarson@ncfc.org](mailto:mcarson@ncfc.org) or 202-626-8700.

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## ACKNOWLEDGMENT

This publication is a product of the National Council of Farmer Cooperatives (NCFC), a trade association established in 1929 to represent the interests of America's farmer-owned cooperatives. Farmer-owned cooperatives are central to America's abundant, safe, and affordable food, feed, fiber, and fuel supply. Through cooperatives, farmers can better manage risk, strengthen bargaining power, and improve their income from the marketplace, allowing individual producers to compete globally in a way that would be impossible as individual producers.

Cooperatives share the financial value they create with their farmer-owners. They also create and sustain quality jobs, businesses, and consumer spending in their local communities. The majority of our nation's more than two million farmers and ranchers belong to one or more farmer cooperatives. NCFC members also include twenty-one state and regional councils of cooperatives.

This publication is a product of NCFC's Legal, Tax and Accounting (LTA) Committee. The all-volunteer committee is made up of professionals who work with or for NCFC's member cooperatives. LTA Committee members graciously donate their time and expertise to many NCFC efforts, including legal, regulatory, and legislative endeavors. NCFC is grateful for LTA Committee members' generous contributions.

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The names and responsibilities of the members of the Sample Bylaws Working Group are set out below. Additional information about the background and contact information for the Sample Bylaws Working Group members is included as an Attachment at the end of Volume II.

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# NCFC SAMPLE BYLAWS PROJECT BACKGROUND

The articles (or certificate) of incorporation and bylaws (collectively, the “Organizational Documents”) that underpin any farmer cooperative are critical to defining the structure of the organization and the legal relationships among the cooperative and its members and indirectly also affect the cooperative’s relationship with third parties and government actors. Having properly drafted provisions in Organizational Documents may profoundly impact outcomes on many important issues, such as (1) the cooperative’s ability to claim limited immunity from the antitrust laws under the Capper-Volstead Act, (2) the tax treatment of the cooperative’s earnings under the Internal Revenue Code (the “Code”) and applicable state tax law, (3) the property rights of members (and their voluntary and involuntary assignees), and (4) the internal governance of the cooperative.

Despite their importance, many cooperatives, large and small, have failed to give adequate attention to their Organizational Documents. Some cooperatives appear to have merely adapted their Organizational Documents from standard corporate forms, without giving careful thought to the special antitrust, tax, securities, governance and other issues which make the cooperative form of business entity so unique.

At the 2014 Annual Meeting of the National Council of Farmer Cooperatives (the “NCFC”), members of NCFC’s Legal, Tax and Accounting Committee (the “LTA Committee”) observed that cooperatives and their advisors would benefit greatly from a resource that identifies key issues to be considered when drafting or amending the Organizational Documents of a cooperative and that suggests language addressing those aspects of cooperative corporations that make them unique from other business entities. Such sample language could then be adapted by cooperatives and their advisors for the particular needs of the cooperative and implement the law of the state in which the cooperative was to be organized. The LTA Committee determined that such a resource would also be helpful to organizers of new cooperatives, who often lack relationships with attorneys, tax professionals and accountants familiar with the cooperative form of business. To respond to this perceived need, the LTA Committee authorized the formation of a special Working Group (the “Sample Bylaws Working Group”) of experienced LTA Committee members to define and develop such a resource.

The Organizational Documents of any cooperative are highly dependent on the state of incorporation, the specific operations of the cooperative and the numerous choices and compromises made by cooperative organizers for the individual cooperative. Because of the wide variety of cooperatives and the multiple differences within and among state cooperative incorporation laws, the Sample Bylaws Working Group determined that it would be difficult to provide a model set of Organizational Documents that would be useful to practitioners without being confusingly long, dense and unreadable. Instead, the Sample Bylaws Working Group opted for simplicity and determined to develop an Overview of Cooperative Articles of Incorporation (the “Articles Overview”) explaining the various issues to be addressed in state-specific charter documents and a sample set of Bylaws (the “Sample Bylaws Text”) which included the typical provisions found in cooperative bylaws. Using such sample documents, the Sample Bylaws Working Group developed a more detailed commentary on the Sample Bylaws Text (the “Sample Bylaws Commentary”) to address and explain the drafting considerations associated with both articles of incorporation and bylaw documents. The Articles Overview and Sample Bylaws Commentary is included in this work as Volume I and the Sample Bylaws Text as Volume II.

In late December 2017, as this Sample Bylaws Commentary and Text was being finalized for printing and distribution, the U.S. Congress and President Trump enacted the Tax Cuts and Jobs Act of 2017 into law. This new law will have an immediate effect on farmer cooperatives by repealing Code §199 (the deduction for domestic production activities income), effective as of December 31, 2017, and replacing it (effective as of January 1, 2018) with a new Section 199A to provide certain other deductions for farmer cooperatives and their members. Such change in law may have significant impact on the operations of cooperatives which are not wholly foreseeable at this time and some of which may make certain changes to a cooperative's Bylaws advisable to reflect the further guidance on Section 199A that may become available to cooperatives through the issuance of Regulations, IRS pronouncements and judicial decisions. Subsequent updates of this Sample Bylaws Commentary and Text, if any, may include revised provisions to implement such additional direction.

## TIPS FOR USE OF THE SAMPLE BYLAWS PROJECT VOLUMES

The Articles Overview, Sample Bylaws Text and Sample Bylaws Commentary are intended only to identify and help agricultural cooperative leaders and their advisors understand the key considerations in developing Organizational Documents for their own cooperatives. All cooperatives are formed under the cooperative incorporation or other law of a state (each such law, a "Charter Statute"), and the resources developed by the Working Group are not tailored to the laws of any particular state. Moreover, the Articles Overview, Sample Bylaws Commentary and Sample Bylaws Text do not address all legal, tax and other issues and considerations that are relevant to forming, structuring and operating a farmer cooperative. The Articles Overview, Sample Bylaws Commentary and Sample Bylaws Text are for informational purposes only, and are not intended as legal or accounting advice. Users are urged to consult with their own legal and tax advisors, and to consider the particular requirements of state, federal and other applicable law in drafting and revising their own Organizational Documents. Additional materials on cooperative organization and governance, including a state-by-state summary comparison of cooperative incorporation statutes, are available at no-cost or minimal-cost through the U.S. Department of Agriculture website, <https://www.rd.usda.gov/publications/publications-cooperatives>.

Cooperatives may be formed in for many purposes, including marketing, supply, and service, and may be formed in many different industries. Further, most Charter Statutes provide that a cooperative may be formed with capital stock or on a non-stock membership basis. The Working Group has chosen to draft the Articles Overview and Sample Bylaws Text for a stock agricultural marketing cooperative and specifically address the organizational, governance, tax, antitrust and other issues that are of particular concern to a stock agricultural cooperative marketing cooperative. However, the concepts and issues discussed are also applicable to supply, service and other forms of cooperatives.

As an example, for a cooperative formed on a non-stock (membership) basis, a number of provisions in the Articles Overview and Sample Bylaws Text would require adaptation for use, although many of the same or similar concepts would apply; Sample Bylaws Commentary Chapter III *Authorized Capital Stock and Equity* identifies and discusses a number of such considerations for organizers of a membership cooperative using these materials. Similarly, although the Articles Overview and Sample Bylaws Text may not apply directly for cooperatives organized in industries other than agriculture or for purposes other than marketing, similar cooperative principles would likely be applicable and should be considered by the drafter.

## **SAMPLE BYLAWS PROJECT – VOLUME I**

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The Working Group has attempted to provide substantive tools to assist cooperative participants in customizing the sample language of the Articles Overview and the Sample Bylaws Text to the applicable cooperative use. Through specific language in the Articles Overview and in the individual Chapters of the Sample Bylaws Commentary and by liberal inclusion of Drafting Notes and brackets around alternative language in the Sample Bylaws Text, the Working Group highlights applicable principles, outlines the specific issues and provides potential solutions to be considered in developing Organizational Documents for cooperatives of any type in any industry.

Throughout the Articles Overview, the Sample Bylaws Commentary and Drafting Notes in the Sample Bylaws Text, the term “cooperative” has been used in all lower case when referring to cooperatives generally and capitalized (i.e., the Cooperative) when referring specifically to the Cooperative governed by the Articles Overview or the Sample Bylaws Text.





# **OVERVIEW OF COOPERATIVE ARTICLES OF INCORPORATION**

# OVERVIEW OF COOPERATIVE ARTICLES OF INCORPORATION\*

A cooperative is legally formed when its Articles of Incorporation are filed in the particular state of incorporation. The required content of Articles of Incorporation varies from state to state. The precise state of incorporation may be obvious (e.g., the cooperative will be located within a single state and will only do business with patrons located within such state) or may require comparison of multiple state incorporation laws to determine the most advantageous state of incorporation (e.g., the cooperative will have facilities and offices in multiple states, will have patrons from multiple states and will conduct its business across state, and even national boundaries). Just selecting the most appropriate state of incorporation may itself require substantial review and discussion with cooperative organizers to elicit and evaluate all relevant considerations for the choice of incorporation jurisdiction.

Most cooperatives presumably choose an incorporation statute within the state in which the cooperative's headquarters will be located or where a significant portion of the cooperative's facilities or members will be located. However, if the laws of one of such usual states somehow inhibit the cooperative from operating as desired, it may be advantageous to use the cooperative incorporation statute of another state outside of such contacts or possibly (although not usually) even in a state where the cooperative has no facilities or business contacts. More unusually, a cooperative could even choose to incorporate under a state's general business incorporation statute but operate on a cooperative basis. However, if a cooperative maintains a presence in a state other than the state in which it is incorporated (either because the cooperative has chosen to incorporate in a state other than in which the cooperative's headquarters will be located, or the cooperative conducts business in multiple states), the cooperative will also have to qualify as a foreign corporation in order to lawfully do business in such other state or states.

The state statute under which the cooperative chooses to become incorporated obviously determines in large part the content of the Articles of Incorporation. The specific state requirements could range from "post card" Articles of Incorporation containing only the most basic requirements to a much more detailed Articles of Incorporation with extensive statutorily-required provisions regulating the cooperative and how it will operate (some of which might more logically be included in Bylaws or other agreements but for the statutory provision). Cooperative advisors should be familiar themselves, or should consult with local advisors who are familiar, with the actual practice of the relevant state incorporation offices, since inclusion of non-statutorily-required information or unexpected provisions in Articles of Incorporation may create problems with the incorporation process due to rigidity, lack of familiarity or confusion of government officials when dealing with cooperative law and practice. The U.S. Department of Agriculture, with the assistance of local cooperative practitioners, is currently developing a state-by-state survey of state cooperative laws in all 50 states which will provide summary comparisons of cooperative statutory provisions. As of the date of publication of this Sample Bylaws Project, the current version of the survey can be accessed on the National Cooperative Business Association website at <http://ncba.coop/our-work/cooperative-statute>. Further information on the initiative as it develops should be available from [www.usda.gov](http://www.usda.gov).

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\* Primary drafter – Dan C. Mott, JD; reviewers – Teree Castanias, CPA, Todd R. Eskelsen, JD and Ronald C. Peterson, JD.

Many cooperative statutes allow cooperative governing provisions to be included in either the Articles of Incorporation or Bylaws. This Sample Bylaws Project assumes that virtually all of the key cooperative governance provisions will be included in the Bylaws. However, the reader should note that even under flexible cooperative statutes with enlightened and up-to-date state administrators, some provisions may be required to be set-out in the Articles of Incorporation rather than the Bylaws. For example, some state laws require that explicit statements of such things as principal place of business, duration of existence, membership qualifications, preemptive rights, and special voting rules (or limitation thereof), etc. be included in the Articles of Incorporation. Additionally, members may negotiate for the inclusion of certain provisions in the Articles of Incorporation so as to be of public record or to be harder (or easier) to amend than Bylaw provisions. Careful consideration should be given to the requirements of the applicable statute and whether or not some of the provisions that appear in the Sample Bylaws should (or must) be moved to the Articles of Incorporation.

The Sample Bylaws Working Group chose not to provide model Articles of Incorporation for a cooperative because of the need for Articles of Incorporation to contain the necessary provisions under the laws of the specific state of incorporation, the multiple variables presented by different types of available cooperative incorporation statutes and the potential idiosyncrasies which inevitably result from individual cooperative operations and negotiated compromises among members.\* That said, there are several things worth noting and considering in drafting Articles of Incorporation. They are:

### I. **Types of Cooperative Statutes.**

a. Traditional Cooperative Statutes. Cooperatives are typically organized under one of three types of cooperative statutes. The first is a traditional cooperative statute that reflects the fundamental principles of “operating on a cooperative basis” under Internal Revenue Code (the “Code”), antitrust or other law. Some states have modernized their traditional cooperative statutes, but other states have somewhat antiquated statutes. Some traditional cooperative statutes are also fairly specific in terms of requirements for cooperatives, while other statutes are much more general and may incorporate the general corporate statutes by reference.

b. Hybrid Cooperative Statutes. Some states have recently adopted new, hybrid cooperative statutes that reflect a combination of the traditional cooperative statute and a limited liability company statute. These statutes typically provide a cooperative with more flexibility in terms of capitalization and governance as compared to the traditional cooperative statutes. In addition, the hybrid statutes often allow a cooperative to be taxed under either Code Subchapter T (as a cooperative) or Subchapter K (as a partnership). This Sample Bylaws Project focuses on those cooperatives that will be structured and taxed as a cooperative under Subchapter T, whether using a traditional or hybrid cooperative statute. Careful consideration must be given in structuring a hybrid cooperative to ensure that the provisions are consistent with the intended basis upon which it will be taxed.

c. General Corporate Statutes. In some states (e.g., Delaware, which has a separate

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\* Some states (e.g., California) do not permit filing Articles of Incorporation containing material other than that mandated by statute, meaning that any other non-statutorily required governance provisions must be set out in bylaws, a membership agreement or other document.

## ARTICLES OF INCORPORATION

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cooperative statute), a “cooperative” might also be organized under a general corporate statute. In this case, the cooperative would comply with the requirements of the corporate statute, but would include provisions in the bylaws providing for operation on a cooperative basis. Corporate statutes typically do not include many of the technical requirements in traditional cooperative statutes, which may provide an advantage for some organizations. It should be noted that a cooperative organized under a general corporate statute will also “inherit” many of the unique statutory requirements of corporations which may not otherwise be applicable or desirable for cooperatives. It should further be noted that a cooperative organized under a corporate statute may be prevented from using the word “cooperative” in its name.

In addition to selecting the type of organizational statute to be used, the cooperative organizers must also select which state law will apply. All of the various statutory options may or may not be available in a particular state. Furthermore, statutes vary significantly from state to state in terms of the requirements of the various types of statutes. Cooperative organizers should consult with knowledgeable cooperative practitioners regarding the various state statutory options that are available, and the pros and cons of using one type of statute or the other. The pitfalls resulting from the wrong choice can be significant.

**II. Cooperative Purpose.** Many statutes under which cooperatives are formed require that the Articles of Incorporation include a statement of the cooperative’s intended purpose. Some statutes limit the purpose for which cooperatives may be organized. Accordingly, the cooperative’s purpose must be verified for consistency with the requirements of the statute. In addition, there are two schools of thought with regard to the statement of purpose. The first approach is to include a specific statement of purpose, thereby defining the nature of the cooperative and its intended business activities. The other school of thought is to state a more general purpose, allowing the cooperative to conduct any business activities consistent with the cooperative statute. While there are pros and cons to each approach, it is important to note that the use of a specific purpose will act as a limitation on the cooperative’s authorized activities and may require an amendment to the Articles of Incorporation should the cooperative wish to expand its business beyond its initial limited purpose.

**III. Incorporators.** All incorporation statutes require one or more incorporators who are responsible for signing and filing the Articles of Incorporation. The number of incorporators, their residency requirements, and other qualifications vary from state to state. Although it is typically most convenient to include the minimum number of incorporators, some cooperatives place great emphasis on the selection of incorporators due to the desire to preserve their names for posterity.

**IV. Directors.** Some statutes require, and most others permit, the naming of the initial board of directors in the Articles of Incorporation. Some statutes may also require establishing some of the requirements associated with the composition and operation of the board of directors (such as terms of office) in the Articles of Incorporation. The Sample Bylaws prepared as part of this Sample Bylaws Project includes all of the detailed requirements related to the board of directors. Depending upon the statute used, some of those provisions may need to be included in the Articles of Incorporation (e.g., elections by district, staggered terms of office, limitations on liability, etc.).

**V. Limitation of Director Liability.** Many cooperative statutes allow the cooperative to limit the liability of directors and officers arising in connection with the performance of their duties with the cooperative. Typically, these liability limitation provisions are required to be included in the Articles of

Incorporation in order to be effective. Further, the detailed nature of the limitation and the required language varies from state to state and statute to statute. The organizers should assure that these provisions are thoroughly considered and included in the Articles of Incorporation where appropriate.

**VI. Capital.** Cooperatives may be organized as a non-stock cooperative or as a stock cooperative. Non-stock cooperatives simply define the eligibility for membership and admit prospective members in accordance with an established process. They may or may not issue membership certificates. Equity in a non-stock cooperative is typically in the form of some sort of equity credit that is issued to reflect the allocated but unpaid portion of a member's patronage distributions. Stock cooperatives are organized in a similar manner and typically issue one (1) share of common stock as evidence of membership. A stock cooperative may also authorize one or more classes of equity stock. The Articles of Incorporation would typically state whether or not the cooperative is to be operated on a stock or non-stock basis. If the cooperative will be operated on a stock basis, the Articles of Incorporation must designate the various classes of stock and the rights and preferences associated with each class in detail (e.g., voting, dividends, liquidation priority, redemption, conversion, etc.), either by setting out rights in the Articles of Incorporation, referencing another document in which such rights are set out (e.g., the Bylaws) or, if allowed by applicable law, granting authority to the Board of Directors to set such rights. These classes of stock might be used for the issuance of patronage distributions, but could also be used for various types of investments in the cooperative. Depending upon the particular statute under which it is organized, a cooperative will have more or less flexibility in designating its capital structure and who is eligible to own equity. Organizers should take care to match the desired capital structure with a cooperative statute that will accommodate that structure. See Commentary chapter 3 and Sample Bylaws Article III for a more extensive discussion of capital concepts.

**VII. Dissolution.** The Sample Bylaws include dissolution provisions for a cooperative. However, some statutes may require that the dissolution provisions be included in the Articles of Incorporation. Alternatively, some statutes (e.g., California) may require provisions governing the property rights and interests of members, which would include rights and interests upon dissolution. To the extent that such a statute is used for organization of the cooperative, the relevant provisions in the Bylaws may need to be included in the Articles of Incorporation. See the Sample Bylaws for a discussion on dissolution considerations.

**VIII. Amendment Process.** Virtually all statutes governing the organization of cooperatives require that amendments to the Articles of Incorporation be approved by the members of the cooperative. Some state statutes allow the board of directors to amend the Bylaws without approval of the members in limited instances when the board of directors is delegated such authority by the members. Such a provision obviously provides the board of directors with greater flexibility in making changes in the governance of the cooperative. However, members may or may not wish to empower the board of directors with the authority to change the Bylaws without a member vote. In structuring the cooperative, care should be taken to determine the options available for amending the Articles of Incorporation and Bylaws under the applicable state statute. In addition, the process for amending the Articles of Incorporation and Bylaws may require the inclusion of specific language in the Articles of Incorporation to establish the desired amendment process.

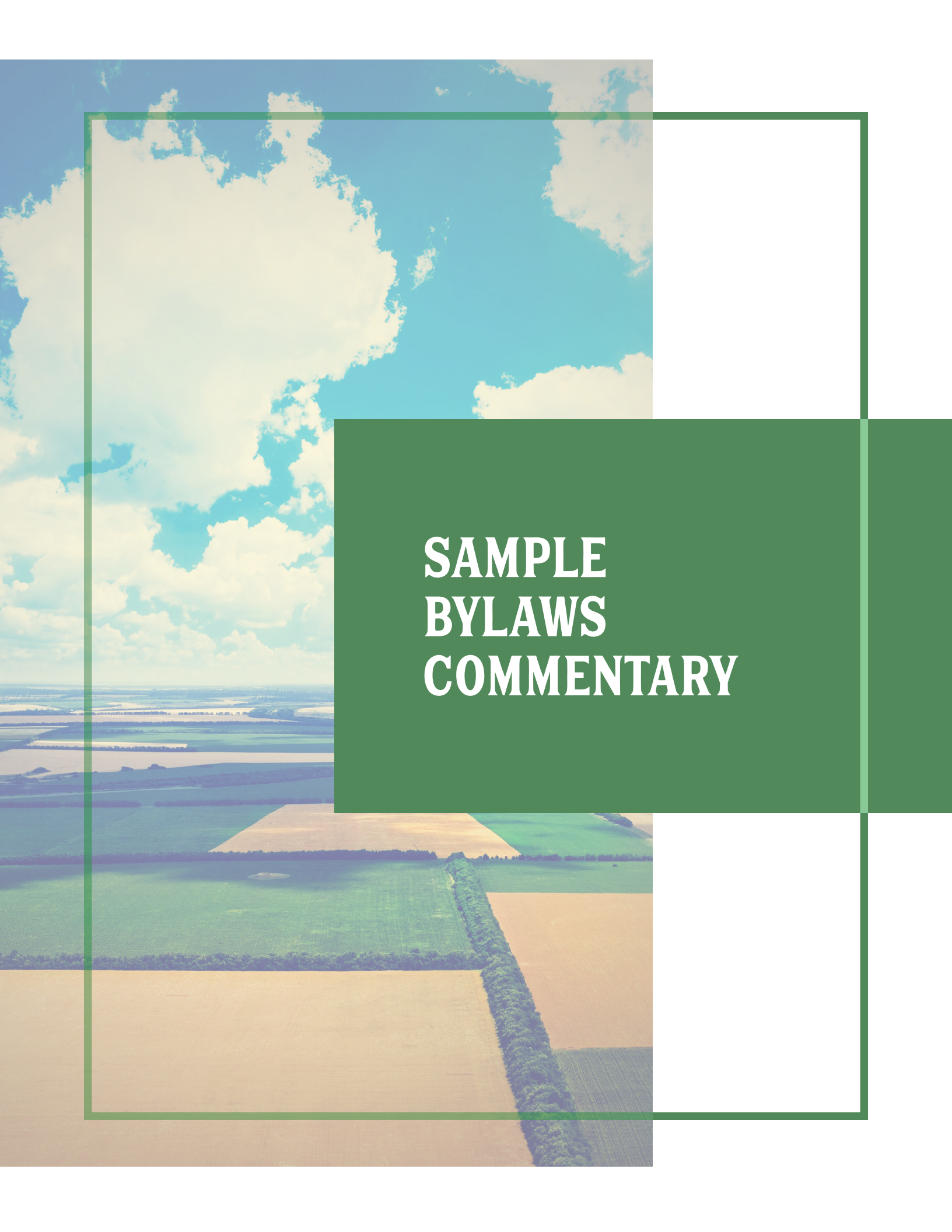
**IX. Special Considerations.** Some state statutes provide specific provisions that are applicable only if included in the Articles of Incorporation. Once a state statute is selected, careful consideration

## ARTICLES OF INCORPORATION

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should be given to the unique provisions of that statute. For example, the Wisconsin statute allows for changes in the voting requirements for approval of mergers, consolidations and other significant corporate actions. However, in order for the optional rules to apply, language must be included in the Articles of Incorporation electing to take advantage of these special provisions. Failing to address these issues at the time of formation of the cooperative could have a significant impact down the road.

**X. Conclusion.** The importance of selecting an appropriate cooperative organizational statute cannot be over-emphasized. Each cooperative is different, and there is no “right” answer when it comes to selecting a statute under which the cooperative will be organized. While the Sample Bylaws and Sample bylaws Commentary developed as part of this Sample Bylaws Project address most of the issues important for cooperatives and how they operate, there are important state by state, and statute by statute, differences that go beyond the scope of the Sample Bylaws Project. The organizers of the cooperative should seek competent professional advice in order to assure that these issues are properly addressed and considered at the time the cooperative is formed.

An aerial photograph of a rural landscape featuring various agricultural fields in shades of green, brown, and tan. A prominent tree-lined path runs through the center. The sky is bright blue with scattered white clouds. A large, semi-transparent green rectangular box is overlaid on the right side of the image, containing the title text in white, bold, serif font.

# **SAMPLE BYLAWS COMMENTARY**

**SAMPLE BYLAWS COMMENTARY  
TABLE OF CONTENTS**

**CHAPTER I MEMBERS ..... 1**

- Section 1.1 Eligibility for Membership ..... 1
- Section 1.2 Common Stock..... 2
- Section 1.3 Representative Membership..... 2
- Section 1.4 Membership Agreement; Enforceability ..... 2
- Section 1.5 Nontransferability of Membership and Common Stock..... 3
- Section 1.6 Termination of Membership..... 3
- Section 1.7 Members’ Rights Upon Termination of Membership ..... 3
- Section 1.8 Voting Power..... 4

**CHAPTER II MEMBERS’ MEETINGS ..... 5**

- Section 2.1 Annual Meeting..... 5
- Section 2.2 Special Meetings..... 5
- Section 2.3 Notice..... 5
- Section 2.4 Participation in Meetings ..... 6
- Section 2.5 Quorum ..... 6
- Section 2.6 Proxy or Cumulative Voting ..... 6

**CHAPTER III AUTHORIZED CAPITAL STOCK AND EQUITY ..... 8**

- Section 3.1 Common Stock Authorization and Terms..... 9
- Section 3.2 Preferred Stock Authorization and Terms ..... 11
- Section 3.3 Transfer or Sale of Shares ..... 12
- Section 3.4 No Dissenter’s Rights ..... 14
- Section 3.5 Other Equity Interests..... 14
- Section 3.6 Record of Stockholders..... 14
- Section 3.7 Stock Uncertificated ..... 14

**CHAPTER IV OPERATION ON A COOPERATIVE BASIS .....15**

- Section 4.1 Cooperative Operation..... 16
- Section 4.2 Definitions..... 17
- Section 4.3 Establishment of Pools or Allocation Units..... 17
- Section 4.4 Determination of Net Proceeds..... 17



Section 4.5	Allocation of Net Proceeds .....	18
Section 4.6	Treatment of Patronage Losses .....	19
Section 4.7	Distribution of Net Proceeds .....	19
Section 4.8	Capital Reserve .....	20
Section 4.9	Allocation and Distribution of Nonpatronage-Sourced Income and Loss.....	21
Section 4.10	Base Capital Plan .....	21
<b>CHAPTER V CONSENT .....</b>		<b>22</b>
Section 5.1	Member Consent.....	23
Section 5.2	Consent Notification to Members and Prospective Members .....	24
Section 5.3	Consent of Nonmember Patrons.....	24
<b>CHAPTER VI FIRST LIEN; RIGHT OF SET-OFF .....</b>		<b>25</b>
Section 6.1	First Lien.....	25
Section 6.2	Right of Set-off.....	26
<b>CHAPTER VII BOARD OF DIRECTORS.....</b>		<b>27</b>
Section 7.1	Board of Directors.....	27
Section 7.2	Vacancy.....	28
Section 7.3	Meetings .....	28
Section 7.4	Quorum .....	28
Section 7.5	Compensation.....	28
Section 7.6	Board Committees .....	28
Section 7.7	Audit Committee; Audit.....	29
<b>CHAPTER VIII OFFICERS.....</b>		<b>30</b>
<b>CHAPTER IX INDEMNIFICATION AND INSURANCE.....</b>		<b>31</b>
Section 9.1	Right of Indemnity .....	31
Section 9.2	Insurance .....	32
<b>CHAPTER X DISSOLUTION.....</b>		<b>33</b>
Section 10.1	Distribution of Assets. ....	33
Section 10.2	Treatment of Members' Rights in the Event of a Merger, Reorganization or Consolidation.....	33
<b>CHAPTER XI ARBITRATION.....</b>		<b>35</b>
Section 11.1	Arbitration of Disputes.....	35

**SAMPLE BYLAWS COMMENTARY**

---

Section 11.2 Selection of Arbitrators..... 36

Section 11.3 Arbitration Procedures..... 36

Section 11.4 Costs..... 37

Section 11.5 Continued Performance ..... 37

Section 11.6 Binding Effect ..... 37

**CHAPTER XII FISCAL YEAR; MISCELLANEOUS ..... 38**

Section 12.1 Fiscal Year..... 38

Section 12.2 Registered Office; Other Offices ..... 39

Section 12.3 Books and Records..... 39

Section 12.4 Corporate Seal ..... 39

**CHAPTER XIII AMENDMENTS ..... 40**

Section 13.1 Amendments..... 40

**CHAPTER XIV UNCLAIMED PROPERTY ..... 41**

## CHAPTER I\* MEMBERS

**Introductory Comments:** Members of an agricultural marketing cooperative have two relationships to the Cooperative. They are both suppliers of their farm products for marketing by the Cooperative and owners of and investors in their cooperative. Accordingly, a cooperative is not only an economic enterprise, but also a membership organization, so membership concepts are central to the cooperative model. The cooperative's organizational documents must fully and clearly set out the qualifications, rights and duties of members, whether the cooperative is organized on a stock model (as contemplated by the Sample Bylaws) or on a membership model. Under the Sample Bylaws (which are intended for a stock model), there is significant coordination between Article I Members and Article II Capital Stock and Equity, although the concepts of "membership" and "stock" are not completely interchangeable. Article I sets out the eligibility requirements and admission process for membership, defines the actual rights and duties of members once admitted (either directly or by reference to a Membership Agreement authorized under this Article I) and establishes the process and consequences of membership termination, while Article III focuses on the economic aspects of the relationships through the issuance and holding of stock. In a non-stock membership cooperative, both membership and economic terms typically would be included in the same bylaws Article.

Generally, the relationship between a cooperative and its members will be governed not only by state law governing the formation and operation of cooperatives, but also by contract law generally, as courts have consistently held that the cooperative articles of incorporation, bylaws, membership agreement and other organizational documents form a contract between the cooperative and its members. State law governing cooperatives most frequently will be found in specific cooperative statutory provisions, but in some states cooperative statutes incorporate by reference the provisions of general corporation law to be applicable to cooperatives.

**Section 1.1 Eligibility for Membership.** This Sample Bylaws Section is important because of a variety of legal implications. First, the law of the Cooperative's state of incorporation may dictate who may be members of the Cooperative. This eligibility Section may be revised as necessary to reflect the requirements and membership eligibility of the Cooperative.

Second, although membership in a cooperative has at times been described as a privilege, the arbitrary exclusion of some applicants for membership and not others may give rise to possible legal consequences under state and federal antitrust or other laws as membership in a cooperative may create economic benefits that are not otherwise available to nonmembers. Such standards might include, for example, being a producer of a particular type of agricultural product. In this regard, establishing uniform standards for membership administered by the Cooperative's Board of Directors is advisable.

Third, the Cooperative will want to define and limit members' qualifications for other purposes such as compliance with the U.S. federal Capper-Volstead Act, 42 Stat. 388, 7 U.S.C. §§291-292, qualification under securities laws or eligibility under government programs. Professionals who are engaged in the formation of cooperatives must be particularly sensitive to antitrust and restraint of trade immunity provided for

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\* Primary drafter – Ronald C. Peterson, JD; primary reviewers – Todd R. Eskelsen, JD and Charles J. Sullivan, JD.

## SAMPLE BYLAWS COMMENTARY

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under both federal and state laws that limit membership to producers of farm products who are subject to farming risks (for example, lessors of farm land in sharecropper and not fixed rent lease arrangements).

Finally, membership should be conditioned upon the applicant entering into a uniform Membership Agreement (or other applicable agreement used by the Cooperative) in the form prescribed by the Cooperative (see Commentary to Sample Bylaws § 1.4, below).

**Section 1.2 Common Stock.** Membership in a stock cooperative is evidenced by ownership of a share of common stock, while membership in a non-stock cooperative is typically evidenced by simply entering into a membership agreement. It is not necessary to issue a physical stock certificate or membership certificate.

The brevity of this Sample Bylaws Section is consistent with the stock cooperative model which has a more complete presentation of Capital Stock and Equity in Article III.

**Section 1.3 Representative Membership.** This Sample Bylaws Section is useful for the purpose of identifying who, in the case of entity members, may represent and exercise the membership rights of an entity member. It is also useful in identifying who may be eligible to serve on the Board of Directors of the Cooperative where Board of Directors' eligibility is limited either completely or partially to individual members or individual representatives of entity members. The law of certain states provides that cooperatives may permit or require entity members to designate in writing one individual with authority to represent the member in all matters involving the Cooperative, including executing agreements and casting ballots.

**Section 1.4 Membership Agreement; Enforceability.** As noted in the Introductory Comments, the relationship between the Cooperative and its members is contractual in nature and set out in the Articles of Incorporation, Bylaws and other contracts of the Cooperative such as a Membership Agreement. This Sample Bylaws Section, in providing for the commitment of all members to enter into a Membership Agreement, establishes that the event constituting commencement of membership to be the executing of the Membership Agreement. Generally, if a Membership Agreement is used, changes in the Membership Agreement require the re-execution by each member of the Membership Agreement containing the changed provisions in order to be binding on such member. This Sample Bylaws Section, however, contemplates the agreement of all members to be bound by all changes to the Articles of Incorporation, Bylaws and rules and regulations promulgated from time to time by the Cooperative. Although these future changes are made unilaterally by the Cooperative as one party to the Membership Agreement, because of the implicit member consent provided pursuant to this Sample Bylaws Section, such changes are arguably enforceable generally as a matter of contract law so long as the changes are reasonable. This Sample Bylaws Section also makes it clear that various actions taken by the Cooperative with respect to any particular member or members in enforcing the Membership Agreement does not create a basis or precedent for other members to avoid compliance with such other members' obligations under their Membership Agreements.

This Sample Bylaws Section further contemplates that the Cooperative may change the form of its Membership Agreement from time to time. Some cooperatives may prefer to incorporate the terms applicable to membership into the bylaws. This has the advantage of allowing the terms applicable to membership to be changed by the amendment of the bylaws rather than requiring the cooperative to obtain a new membership agreement from all members some of whom may be reluctant to sign a new agreement.

**Section 1.5 Nontransferability of Membership and Common Stock.** This Sample Bylaws Section makes clear that memberships, whether or not evidenced by common stock, are not transferable as transferability might otherwise circumvent the membership application process and/or result in such instruments being characterized as securities. It should be noted that the blanket restriction on transferability would also (a) limit transfers between related persons and entities for estate planning purposes, (b) prevent the use of the membership interest as collateral for financing purposes, and (c) aid in guarding against an involuntary transfer or transfer by operation of law (such as to a trustee in bankruptcy or a receiver). See also the discussion on transferability of stock under Commentary to Sample Bylaws § 3.3 below.

**Section 1.6 Termination of Membership.** Although the “for cause” circumstances that trigger the termination of membership can also be stated in the Membership Agreement, it would seem advisable to state them in the Bylaws as universally applicable to all members. Although not included in the Sample Bylaws, it might also be advisable to establish some due process procedures with respect to such terminations which are not necessarily objectively verifiable. A Membership Agreement will normally provide for a right of a member to withdraw from membership (and may provide a corresponding right of the Cooperative to terminate a membership) from time to time (for example, annually). More importantly, such a Bylaw Section will provide for automatic termination where a member becomes ineligible for membership under state law or ceases to be a “producer” under the federal Capper-Volstead Act which could cause the loss of limited antitrust or restraint of trade immunity under state and federal law. The importance of this Sample Bylaws provision cannot be overstated because of court decisions which cause the loss of Capper-Volstead Act antitrust immunity for the Cooperative even if only one member is determined not to be a “producer.” With respect to subsection (e), although the termination of a Membership Agreement may cause the termination of contractual rights and obligations under the agreement, this provision provides for expulsion from membership and the associated voting right to eliminate any questions in this regard, particularly with regard to the status of a member as a “producer” or other qualifying status under state law. In any event, the treatment of a member’s interests on termination should conform to the Cooperative’s equity and/or equity redemption plans (whether such plans are provided in the Bylaws or elsewhere).

**Section 1.7 Members’ Rights Upon Termination of Membership.** The rights of members upon termination is in the first instance determined by applicable state law. However, state law often provides flexibility that can allow cooperatives to tailor such rights to the individual circumstances of the cooperative, consistent with such state laws. Cooperative advisors can and should carefully review relevant state cooperative law and consult with cooperative organizers to craft appropriate provisions documenting a member’s rights upon termination of membership in such areas as the form and timing of payment of allocated but unpaid patronage, discounts for early redemption of equity upon different types of termination, conditions to receipt of partial-year patronage if terminated prior to completion of an annual period, etc.

Cooperative members normally have very limited property rights to realize and obtain the value of an individual member’s interest in the assets of the Cooperative until such time as the Cooperative is dissolved or is involved in a merger, reorganization or consolidation. This is particularly true as to unrealized gain in various intangible assets (e.g., intellectual property, trademarks, appreciated property, etc.). Subsection (a) makes it clear that no additional property rights are created upon termination of membership. Subsection (b), however, makes it equally clear that upon termination (i) the member’s membership stock will be redeemed by the Cooperative, (ii) the terminated member will continue to receive outstanding allocated

## SAMPLE BYLAWS COMMENTARY

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patronage (i.e., crop payments) and payments in redemption of allocated but unpaid equity as if the membership had not been terminated, and (iii) the terminated member is entitled to all other payments due from the Cooperative. However, the Bylaws provision provides the Board of Directors with reasonable discretion in the payment of all such amounts, consistent with the financial resources of the Cooperative.

**Section 1.8 Voting Power.** Voting power of members in cooperatives may be made equal irrespective of the volume of business or patronage by the member with the cooperative. However, to a limited extent and only up to an explicit maximum voting percentage (e.g., no more than five percent (5.0%)), voting power may also be weighted in proportion to the members' patronage, unless precluded by the law of the Cooperative's state of incorporation. If weighted, professionals engaged in the formation of cooperatives should be cautioned that state and federal laws (including possible tax laws) may be implicated (including the Capper-Volstead Act which provides as one alternative basis to qualify for limited antitrust immunity that each member have only one (1) vote).

## CHAPTER II\*

### MEMBERS' MEETINGS

**Section 2.1 Annual Meeting.** The Cooperative's Bylaws typically will provide that an annual meeting of members will occur, and will set forth the time and place of the annual meeting. The laws of the state in which the Cooperative is organized will dictate whether an annual meeting is required, and may further set the time period within which it will be held. The laws of certain states may impose penalties upon cooperatives for failing to hold annual meetings, including making such failure grounds for forfeiture or dissolution of the cooperative. Some state statutes give members the right to petition a court to direct that an annual meeting be held. As to when the annual meeting should occur, it can be either a number of days after the fiscal year, a specific month or months, a specific date or as determined by the Board of Directors from year to year. The location is usually the principal office, but the Bylaws should provide the Board of Directors with the authority to select the location for the meeting (which may expressly provide that the meeting may occur at a location outside of the Cooperative's service area).

As for the conduct of business at any annual or special meeting, the Cooperative should adopt rules of order, either in the Bylaws, or by resolution. Many cooperatives choose to adopt Robert's Rules of Order for member meetings.

Depending upon the laws of the state in which a cooperative is organized, and the governance structure chosen by a particular cooperative, a cooperative's annual meeting actually may be comprised of a series of meetings that occur in different geographic regions that are served by the cooperative, followed by an annual meeting of delegates. Under such regional membership structures, delegates selected at each of such regional meetings or from such regions will serve in a representative voting capacity at the annual meeting of members. If this procedure is to be used, it should be provided for in the Bylaws.

**Section 2.2 Special Meetings.** The Cooperative's Bylaws should follow the laws of the state in which it is organized with regard to who can call a special meeting. The laws of most states provide that special meetings may be called by the Board of Directors as well as a stated percentage of the members acting by written petition. If members have this right, the Bylaws must conform to state law requirements regarding the minimum percentage of members that will be required to call a special meeting. If permitted by state law, the Bylaws may also provide that the president or Board chairman have the authority to call a special meeting of members. If state law is silent regarding the threshold percentage of members who must act to call a special meeting, the Cooperative will need to consider whether a lower percentage would be favorable to make it easier to call a special meeting, or whether a lower percentage would lead to unnecessary special meetings being called and held. Special meetings could be disruptive and expensive and the Cooperative may want to limit the authority to call such a meeting, subject to the requirements of state law. As discussed below, the purpose(s) of any special meeting should be stated in the notice of such meeting. It is normal practice that the business to be conducted at any special meeting will be limited to the purposes stated in the notice.

**Section 2.3 Notice.** The time, date and location of any annual or special meeting should be stated in a notice of such meeting. The purpose or purposes of any annual or special meeting (which may include

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\* Primary drafter – Ronald C. Peterson, JD; primary reviewers – Todd R. Eskelsen, JD and Charles J. Sullivan, JD.

## SAMPLE BYLAWS COMMENTARY

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specific actions, such as electing directors, or general agenda items, such as any other business as may be properly brought before the meeting) should be set forth in the notice. State law should be reviewed to determine the number of days' notice which is required to be given to members, as well as the manner in which notices are given. The Bylaws should conform to the requirements of state law regarding notice of meetings in all respects, including the manner in which the notice may be delivered. Electronic notices may be permitted and, if so, the Cooperative will need to decide if notices should be sent electronically. State law also may permit notice by publication. State law should be considered to address how notice can be waived, either by a signed waiver or by attending the meeting, unless attendance at the meeting is to contest notice. While it may not necessarily be set forth in the Bylaws, the Cooperative should consider having the secretary execute a certificate setting forth a correct copy of the notice and the date of mailing of the notice.

State law may impose different notice periods depending on the purpose of the meeting. For example, notices for mergers, consolidations, share exchanges, dissolutions or the sale, lease or exchange of substantially all of the assets, may require a different notice period.

The Bylaws may establish a mechanism for determining record dates in all or specified instances, or the Board of Directors can set the record date consistent with the requirements of state law.

**Section 2.4 Participation in Meetings.** If voting by mail ballot or electronic means is permitted by the laws of the state of the Cooperative's incorporation, such an option may significantly benefit the Cooperative in obtaining necessary member approval. Cooperatives frequently struggle to achieve good attendance at member meetings. Therefore, members may be more likely to vote by mail ballot or electronic means than to attend a meeting and vote. Because of the potential confusion possible between voting by mail ballot or electronic means and voting by proxy (which may be prohibited by state cooperative statutes), the safe course for voting by mail ballot or electronic means may be to physically hold a meeting attended by at least the presiding member and a few members at which votes cast by mail ballot or electronic means are counted.

Additionally, the Cooperative may wish to provide, if permitted by state law, that any member may attend any annual or special meeting by using a conference telephone, video conference or other interactive technology

**Section 2.5 Quorum.** State law should be reviewed for quorum requirements, and whether and what flexibility the Cooperative may have in setting a quorum for member meetings in its Articles of Incorporation or Bylaws. A lower quorum requirement may be useful, particularly if the Cooperative has experienced or expects to experience poor attendance at member meetings. However, the Cooperative should consider the potential consequences of a minority of members approving matters with a low quorum requirement.

**Section 2.6 Proxy or Cumulative Voting.** State law should be reviewed to determine if voting by proxy is permitted, and if so, the requirements for proxy voting (including, for example, the term of the proxy). In addition, state law should be reviewed as to the manner in which proxies can be solicited. Voting by proxy will assist in obtaining the required votes for certain actions, such as mergers or amendments to the Articles of Incorporation. State law should be reviewed to determine whether cumulative voting exists automatically or whether the Cooperative must take steps to remove cumulative voting and, if so what those steps involve. The Articles of Incorporation should be reviewed as well to determine if cumulative



voting is addressed therein. The advantage of cumulative voting is to permit a minority of members to elect a director. The Cooperative must decide if it wants a minority of the members to have this right.

## **CHAPTER III\***

### **AUTHORIZED CAPITAL STOCK AND EQUITY**

**Introductory Comments:** As noted in the General Introductory Comments, the Sample Bylaws are based on an agricultural marketing cooperative model which uses corporate concepts of authorized and issued capital stock to represent interests in the Cooperative. A stock cooperative is a familiar model generally understood by members, suppliers, customers and financial institutions in which separate classes of common and preferred stock are used to represent and define equity and quasi-equity relationships between a cooperative and its members. Stock cooperatives often issue a single share of common stock having a single vote as the foundational membership instrument and use other common and preferred stock for patronage distributions, written notices of allocation, per-unit retains, base capital credits and other strands of the membership relationship. Capital equity and debt instruments represented by stock are also sometimes used by cooperatives to represent and define investment relationships distinct from the commercial and equity relationships with members and patrons. Certain instruments that have investment characteristics (e.g., delivery rights in a closed cooperative) may also be represented by capital stock with clearly detailed rights and obligations.

A stock cooperative model is not the only allowed structure for cooperatives. Founders could also organize a non-stock cooperative in which the various strands of the cooperative/patron or cooperative/investor relationships are expressed through contractual language rather than through the issuance of capital stock. Although not reflected in the Sample Bylaws, non-stock membership cooperatives are not uncommon and may fit the individual circumstances better. Check state statutes to determine whether the Cooperative can be organized with capital stock and whether state law allows organization of cooperatives on either stock or non-stock bases. Certain state cooperative organizational statutes have membership and stock concepts interspersed (at times confusingly so), which may cause some confusion and result in unexpected results if not deftly handled.

Care should be taken in drafting to avoid unanticipated consequences. Drafters should always clearly and accurately identify and describe the various relationships represented by capital stock (or by non-stock contractual language) in order to avoid confusion that might arise either as a result of a poorly phrased description of rights or through the application of state corporate law or membership law precedents implementing certain treatment to capital stock instruments or memberships that may differ from the results desired from the Cooperative's perspectives. For example, because state laws often grant voting rights to equity holders in fundamental corporate transactions (e.g., mergers, sale of all or substantially all assets, etc.), the use of a stock instrument to represent a commercial or investment relationship (e.g., patronage distributions, written notices of allocation, per-unit retains, delivery rights, lenders, etc.) could result in members or other commercial or investment participants obtaining voting rights in instances where no such rights were intended.

If a non-stock cooperative model is to be used, Article III of the Sample Bylaws should not be used and the provisions of Article I should be expanded to allow for issuance by the Cooperative of additional equity instruments contemplated by Sample Bylaws § 3.5 and the issuance of selected investment instruments, as necessary. References to "stock" in the Sample Bylaws should also be replaced by specific descriptions

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\* Primary drafter – Todd R. Eskelsen, JD; primary reviewers – Teree Castanias, CPA and David P. Swanson, JD.

of the relevant relationship or non-stock instrument used to represent such relationships. Both stock and non-stock cooperatives currently exist and flourish. Further, many cooperatives include both stock and non-stock concepts, using stock to represent membership status and voting rights and non-stock equity to represent patronage capital allocations. The key for drafters is to make sure that the equity, commercial and investment rights of the various constituencies in the Cooperative are clearly delineated and defined so that the Cooperative is not caught in a no-man's land of conflicting rights and obligations as a result of sloppy or poorly-analyzed stock or non-stock provisions that are neither fish nor fowl.

The concepts of this Article III must be coordinated with the other provisions of the Cooperative's Articles of Incorporation and other articles of the Bylaws affecting capital stock or non-stock membership and equity concepts and related ideas. For example, Sample Bylaws § 1.2 references a minimum stock purchase amount (one share of common stock), Sample Bylaws §1.7 establishes the right and obligation of the Cooperative to repurchase a terminated member's common stock at par value and Sample Bylaws §1.8 refers to voting rights of members, each of which is a capital stock concept. To avoid confusion and possible inconsistency, best practice would be to have the specific description and definition of relevant rights be conclusively expressed only once somewhere in either the Articles of Incorporation or the Bylaws, with all other applications, uses or citations referencing back to such single definitional description (either by express citation of the relevant provision or implicitly through use of similar terms, especially defined terms).

**Section 3.1 Common Stock Authorization and Terms.** The capital structure of the Cooperative (number, type and specific rights and obligations of each class and series of capital stock and other capital instruments of the Cooperative) must initially be set out in the Articles of Incorporation and/or Bylaws of the Cooperative, as required by relevant state law. Usually state law requires that many of the provisions describing stock must be set out in the publicly-available Articles of Incorporation, but, if allowed, such provisions may also be set out or specifically referenced in the Cooperative's Bylaws. Provisions describing non-stock patronage and other equity provisions should have equal prominence, although many state laws may allow such provisions to be set out in Bylaws. However, if amendment of the Bylaws requires a member vote, it may provide the Cooperative with more flexibility to put in statutorily-required minimum provisions in the Articles of Incorporation (which almost always require a membership vote to amend), but place other provisions in the Bylaws where they may be more easily changed as required by Cooperative operations.

Basic default rights of capital stock (number of authorized shares, voting, distributions, meetings and access to information and transfer) are usually defined in applicable state law. If additional rights and obligations beyond such basic rights are to be defined or when multiple classes and series of stock are to be used by the Cooperative, state law often requires that the Articles of Incorporation and Bylaws must include provisions defining the classes (common, preferred, etc.) and series of stock and describing the respective rights and obligations of each class and series, such as provisions allowing, expanding or restricting voting, dividends, transferability, priorities, dissolution, cumulative voting, dissenters rights, etc. Some state cooperative laws permit the Board of Directors "blank check" authority to establish the terms of stock by resolution (see the further discussion of "blank check" authority below and in Section 1.2 below). Best practice would be to use a separate section for each class of stock (common, preferred, other), with separate subsections for each sub-class or series (Class A, Class B, etc. or Class A Series 1, Class A Series 2, etc.) and separate sub-subsections detailing the specific rights and obligations of each division of stock.

## SAMPLE BYLAWS COMMENTARY

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Common stock usually carries no dividends. However, cooperatives organized under state laws that permit dividends on common stock may provide for dividends on some classes of stock, often classes representing all or part of non-cash patronage allocations. Such dividends are often discretionary and paid only if declared by the Board of Directors for a fiscal year; undeclared dividends may or may not cumulate if not declared.

Typically, state law requires the Cooperative's constituent documents to set forth a statement of the specific number of authorized shares of each class, the par (or no par) value of such stock and a description of the relative rights inherent in such stock. States may require some or all of such rights and duties to be specifically set out in the Articles of Incorporation or may grant the Board of Directors "blank check" authority to set out such rights by separate Board resolution. Check the relevant state law to determine the relevant requirements and limitations for the specific state of incorporation. Any resolution adopted by the Board of Directors setting out the rights and obligations of stockholders would be a fundamental document of the Cooperative and therefore must be kept as part of the permanent records of the Cooperative; some state laws granting "blank check" authority require such board resolutions or a "certificate of designation" to be filed with the secretary of state.

All stock cooperatives use Common Stock for memberships. Many such cooperatives may also use other series of Common Stock or separate series of Preferred Stock to evidence other relationships of the cooperative with its members, former members, nonmember patrons, investors and lenders. Cooperative law requires democratic control by members, which is often reflected in the issuance of a single share of Common Stock having a single vote. However, cooperative precedent also allows votes to be allocated to members on a patronage or equity basis. Often, such voting is restricted to prevent a small number of producers from obtaining effective control of the Cooperative to the exclusion of other members. For example, cooperatives currently exist (and are regularly audited by the IRS without challenge to the voting structure) which allow one vote for each share of membership common stock held (whether received from the Cooperative as a membership instrument or as a written notice of allocation of non-cash patronage distributions), but restrict the total allowable voting by a single member to a maximum of five percent (5.0%) of the total outstanding common stock.

The Common Stock or a specific class or series of Common Stock should be designated as the membership stock for purposes of evidencing voting rights in the Cooperative, the right to receive patronage distributions, and the potential to participate in distribution of excess proceeds on liquidation after payment of all other Cooperative obligations (as specified in the dissolution bylaws). Such residual Common Stock would generally be viewed (by the Internal Revenue Service, U.S. Department of Agriculture, courts and others) as the "membership stock" and usually defines membership for other purposes (e.g., Capper-Volstead Act determination of whether a specific person involved with a cooperative is a "member"). Care must be taken in drafting to ensure that such residual Common Stock satisfies all requirements of state and federal law, while not unintentionally creating unexpected difficulties for the Cooperative (e.g., granting or continuing membership to non-producers or ineligible persons through ownership of residual Common Stock; interfering with requirements of operating on a cooperative basis through restrictions of democratic voting; triggering application of federal and state securities laws by introducing transferability and the possibility of investment returns, etc.).

Various classes and series of Common Stock (and/or Preferred Stock, if desired) can be useful in evidencing relationships of the Cooperative with other equity participants in the Cooperative. For example, different

classes of Common Stock could be issued to define different classes of producer or supply customer members or to classify members geographically or by business type into voting districts in voting for a classified Board of Directors. The Cooperative could also issue multiple classes and series of Common Stock (and/or Preferred Stock) to a single entity or person to evidence the multiple different relationships of such entity or person with the Cooperative. For example, a series of Common Stock separate from membership Common Stock may be used by the Cooperative to evidence a patronage distribution distributed in the form of a written notice of allocation or to evidence required capital contributed to the Cooperative in satisfaction of the Cooperative's base capital plan. Capital stock (Common and/or Preferred) can also flexibly be used to represent the Cooperative's relationship with its members, former members, nonmember patrons, investors and lenders, and can be structured so as to allow flexible transition of members and others in their relationships with the Cooperative (e.g., transition of active producers to passive producers or to non-member patron) or to define the rights and responsibilities of retired members while they wait to receive eventual redemption of prior non-cash patronage distributions. In all such uses of capital stock, care must be taken to ensure that each such class or series of Common and/or Preferred Stock are clearly and fully defined to implement the desired relationships without creating other unintended results.

**Section 3.2 Preferred Stock Authorization and Terms.** Similar consideration as detailed above for Common Stock also would apply to Preferred Stock. Cooperatives often use Common Stock to reflect the mandatory requirements of membership and the voting, patronage and residual rights relationship between the Cooperative and its members, while using Preferred Stock to represent other investment relationships with members or non-member investors. As such, Preferred Stock can therefore be especially useful to separate out the various strands of the relationship between the Cooperative and the member or other person and make sure that the characteristics of the specific series of stock evidence the appropriate relationship facets without inadvertently including other strands. For example, agricultural processing cooperatives sometimes utilize capital stock to evidence the right and obligation of member producers to deliver the agricultural product for processing, often referred to as delivery rights. It would be possible to include such delivery rights as one strand in membership Common Stock, but it may be more advantageous to separate out such delivery right in a separate preferred stock and require that as a condition to membership, preferred stock evidencing the producer's delivery rights must also be purchased and held throughout the membership in order to patronize the Cooperative. By so separating out the delivery rights strand of membership into a separate class or series of Preferred Stock, the Cooperative could ensure that the Common Stock would be recognized as evidence of the membership and commercial relationship rather than being found to be a security subject to SEC and state securities registration and periodic reporting regulation. Such separate series of stock evidencing delivery rights would also focus compliance with relevant securities laws and exemptions for the specific series of Preferred Stock.

Preferred Stock can also be used to evidence differing capital investment required of members under a base capital plan; as an instrument for distribution of a non-cash patronage distribution in the form of written notices of allocation or per-unit retains; and the means to implement different access to Cooperative resources or a priority or unequal distribution of returns resulting from targeted additional investment by members in specific assets. The Sample Bylaws include a generic provision for authorized Preferred Stock and grant the Board of Directors "blank check" authority to set the terms and conditions of the Preferred Stock; the alternative to such "blank check" authority would be to designate the terms of preferred stock in these Bylaws. If "blank check" authority is provided to the Board of Directors, then Board of Directors' resolutions fixing preferred stock rights would be the governing documents and should be maintained

## SAMPLE BYLAWS COMMENTARY

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in a manner similar to the Articles of Incorporation, Bylaws and other organizational documents of the Cooperative. More complicated Preferred Stock provisions can generally be derived from typical corporate Preferred Stock provisions so long as such provisions are carefully analyzed with a view toward the unique impacts of the Cooperative's capital structure on such provisions.

One area of specific sensitivity for agricultural cooperatives arises in connection with the rate of dividend payable on capital stock, especially Preferred Stock. Under the Capper-Volstead Act, the Agricultural Marketing Act of 1929, the Farm Credit Act and other regulations affecting agricultural cooperatives, the amount of dividends that can be paid by cooperatives on capital stock is limited (in most cases to eight percent (8%) per annum) as a specific direct requirement of the applicable statute (e.g., IRC §521) or as one of two alternative requirements necessary to obtain the benefits of the statute (e.g., the Capper-Volstead Act). Certain state laws also restrict the rate of return that may be paid by a cooperative on capital stock. Drafters should carefully check relevant federal and state law to ensure compliance with such limitations on dividends.

Preferred Stock sold to members or to non-member investors to raise capital almost always do not have voting rights, except with respect to changes in Articles and Bylaws that impair the rights and preferences of the Preferred Stock. These investment shares are almost universally entitled to a liquidation preference over common stock and patronage allocated as equity. Dividends on preferred shares are often cumulative, meaning that if the dividend is not declared and paid, the cooperative continues to have the dividend obligation to the share owner that must be paid at a later time (usually without interest). Non-member investors can be expected to demand cumulative payment of dividends, but member-investors in preferred stock may not. Often, preferred shares are also protected by a "dividend stopper" covenant, which means if cumulated dividends are outstanding, the cooperative may be limited in making discretionary cash payments to members for current year patronage allocations or for retirement of patronage equity or common stock, until the cumulative dividend is paid (usually without interest). "Blank check" authorization in the Articles and Bylaws adds flexibility to the Board of Directors to establish Preferred Stock terms that will be acceptable to members and non-member investors consistent with the Cooperative's needs and resources.

Preferred stock dividends will have a different tax treatment for federal income tax purposes. As such, Sample Bylaws Section 4.9 specifically provides for the payment of such dividends out of the cooperative's current and accumulated "Earnings and Profits" as computed under Subchapter C of the Internal Revenue Code. The drafter should take care to ensure that such dividend provision is included in the Bylaws to achieve the proper tax result.

**Section 3.3 Transfer or Sale of Shares.** Typically, capital stock is not transferable without consent from the Cooperative's Board of Directors. In particular, membership Common Stock is most often nontransferable to prevent unqualified entities from inadvertently obtaining membership which could have drastic consequences on the Cooperative (e.g., loss of Capper-Volstead Act immunity because of the presence of even one non-producer member) and to avoid application of federal and state securities laws on the Cooperative. Transfer restrictions allow the Cooperative to review the characteristics of prospective transferees to ensure compliance with membership qualifications or other requirements, ensure that the transactions do not violate applicable securities law and protect the Cooperative and its members from transfers to unacceptable holders. Antitrust issues can arise if the Board of Directors acts unreasonably or in a self-serving manner to control or limit transfers of stock. However, since successful cooperatives

require a significant amount of voluntary cooperation and coordination, appropriate Board of Directors input and control on membership and equity holders are advisable.

To the extent that transferability of the Cooperative's equity instruments may be advisable (e.g., closed Cooperative delivery rights which regulate member access to processing facilities or Preferred Stock sold to members or non-members), the Cooperative should consider appropriate ways to balance the interests of the Cooperative and its members as an on-going business while also protecting the interests of the holders of such instruments. Including transfer restrictions in the Articles of Incorporation or Bylaws makes it more difficult to amend such transfer restrictions, thereby giving holders assurances against change, but also makes it more difficult for the Cooperative to react to changed circumstances which could render such restrictions onerous. Granting authority to the Board of Directors to make revisions to such transfer restrictions provides the Cooperative with flexibility to react to changed circumstances or unintended consequences, but at the cost of less control by members. A grant of authority in the Articles of Incorporation or Bylaws allowing the Board of Directors to establish and amend detailed written transfer guidelines addressing sale, lease, grant of security interests in or other such transfers could be a reasonable way to provide the necessary balance of holder protection and Cooperative flexibility, especially if a supermajority Board of Directors' vote is required to adopt and amend such transfer guidelines.

Allowing transferability of Cooperative stock should be approached carefully since the ability to transfer (or negotiate) an instrument is one of the indicia of being a "security" under U.S. Supreme Court rulings. Other indicia of being a "security" are the right to receive dividends; voting rights in proportion to share ownership; the ability to be pledged or hypothecated; and the ability to appreciate in value. If an instrument is found to have sufficient indicia of being a "security," then compliance with federal and state securities laws is required, unless relevant exemptions from such compliance are available. Such compliance may include the Cooperative being subject to SEC and state securities registration and/or periodic reporting requirements and the Cooperative being subject to disclosure requirements in connection with transactions involving the instrument. Cooperative "insiders" such as Board of Directors members, officers, employees and large holders may also have reporting requirements and potential liability if they trade in the instrument without providing adequate disclosure of non-public information about the Cooperative and its prospects which might have been obtained through such persons' involvement with the Cooperative or if they don't make adequate disclosure of their trades. Further, the Cooperative could be considered to be a "dealer" in securities, with accompanying registration and reporting requirements, if it does anything more than passively sponsor a "bulletin board" type listing of buyers and sellers seeking to transact transfers of such security.

Under applicable state law, it may also be necessary for the Cooperative to give notice of restrictions on transferability of stock, either by including a restrictive legend on the applicable stock certificate or providing other notice of restrictions on transfer in the Articles of Incorporation or other Cooperative publications available to participants in transfer transactions.

Restrictions on transferability may also require the Board of Directors to carefully examine certain policy alternatives, since the term "transfer" is usually read broadly. For example, the usual definition of "transfer" would likely include pledges by the holder of the Cooperative instrument as collateral for commercial loans and thereby may impede the ability of members to obtain necessary financing. Transfer may also include transfers to heirs on death. The Cooperative's Board of Directors should make policy decisions about whether such pledges are allowed and if so, under what circumstances. If use of the instrument

## SAMPLE BYLAWS COMMENTARY

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as collateral for a loan is allowed, the Board of Directors should develop a process by which a lender can reasonably foreclose and obtain the value of such collateral in the event of default by the member without adversely affecting the Cooperative and its members. The Board of Directors must understand how transfer restrictions could practically affect the holders of instruments subject to such restrictions, consider how best to protect the Cooperative and its members and advance their reasonable objectives and then develop a process to provide commercially reasonable protections.

Because of the complexity of federal and state securities laws, the potential for disruption of reasonable expectations from unreasonable transfer restrictions and the potentially onerous consequences on the Cooperative and its members from a misstep, even if inadvertent, the provisions relating to transferability of Cooperative securities should be developed with the involvement of experienced cooperative securities counsel.

**Section 3.4 No Dissenter's Rights.** Both state corporate and cooperative law should be reviewed to determine the applicability of any dissenter's rights, cumulative voting, voting by class, limitations on proxy voting and other similar provisions that may exist under state law and be applied if no other provision is drafted. Drafters must ensure appropriate drafting of relevant provisions to implement the desires of the Cooperative's organizers and the requirements of state law.

**Section 3.5 Other Equity Interests.** In connection with operating on a cooperative basis under Subchapter T of the Internal Revenue Code, a cooperative may from time to time issue equity or debt instruments for use as allocated equities, written notices of allocation, per-unit retains, certificates of indebtedness, etc. As noted in the Introductory Comments above, it is possible to represent such instruments either by using stock or other instruments specifically authorized and described in the Cooperative's governing documents or to use contractual instruments that are either specifically detailed in such governing documents or developed as needed and memorialized in contractual language adopted by the Board of Directors. Cooperative advisors must develop and implement a comprehensive and integrated capital structure for the Cooperative in order to avoid chaos resulting from opportunistic use of ill-defined disparate instruments. However, even within a well-drafted, integrated capital structures in which all instruments are clearly included and defined, it may nonetheless be advisable to provide the Board of Directors with some general and flexible authority to develop limited instruments for unique circumstances, such as the flexibility in raising equity capital that may be available with a "blank check" Preferred Stock provision. Because the cavalier use of such authority could be dangerous, such general provision should be carefully considered and limited.

**Section 3.6 Record of Stockholders.** Cooperatives, like corporations, are required under state law to maintain a record of all holders of stock and other instruments and their holdings as part of the Cooperative's books and records. The information included in such record of holders is necessary for the Cooperative to be able to comply with the corporate formalities of annual and special meetings, notice of meetings, quorums, voting by ballot and proxy (if allowed), action by consent without a meeting, etc.

**Section 3.7 Stock Uncertificated.** Applicable state law may have default provisions which detail requirements for certificates evidencing ownership of stock, including the form of such certificates, required signatures and the inclusion on the certificate of an obvious and notable statement of any restrictions on the transferability of stock. A decision by the Cooperative not to issue certificates to evidence stock ownership may require the inclusion of relevant language in the Cooperative's organizational documents.



## CHAPTER IV\*

# OPERATION ON A COOPERATIVE BASIS

**Introductory Comments:** As noted in the General Introductory Comments, the Sample Bylaws are based on a stock agricultural marketing cooperative model. In the interest of completeness, the Sample Bylaws allow nonmembers to participate on a patronage basis and recognize that there may be business done with members and nonmembers on a nonpatronage basis. Non-member participation in patronage business is not required and is completely at the discretion of the Cooperative, but the decision of the Cooperative with respect to participation of non-members should be clearly set forth in the Bylaws one way or another. The Sample Bylaws also provide for the use of Qualified and Nonqualified Written Notices of Allocation to be used for the non-cash portion of the patronage distribution or for per-unit retention of Net Proceeds.

An excellent discussion on the financial and patronage provisions of cooperative bylaws can be found in Kimball J. Devoy, *Patronage Bylaws for the 21st Century*, The Cooperative Accountant, Vo. LII Number 4, Winter 1999. The focus of the article is the financial or patronage provisions of cooperative bylaws from the perspective of a tax lawyer. As pointed out in the article, there had been significant changes in the structuring, financing, operations and taxation of cooperatives since Subchapter T was originally drafted in 1962. As such, the article found that many cooperative bylaws did not adequately handle these evolving changes. It has been over 15 years since the article was published, and a number of significant developments have occurred during that time, and these make it easy to make a similar observation now. For example, a significant development has been the implementation of the Manufacturing Deduction under Internal Revenue Code § 199's special rules for cooperatives, with related rulings for cooperatives discussing which payments to members can be added back for that purpose. Now with the passage in late December 2017 of the Tax Cuts and Jobs Act of 2017 which repealed Section 199 and replaced it with new Section 199A, there may be additional changes that cooperatives should consider.

All of these developments should cause tax attorneys and accountants to reconsider the definitions used in the “operating on a cooperative basis” provisions of cooperative bylaws to bring more clarity to the calculation and handling of patronage distributions and other payments to members. The term “operating on a cooperative basis” is a federal income tax concept under Subchapter T that has evolved and developed as a body of law over the past 100 years, and is not easily defined. Tax attorneys and accountants must become familiar with this body of law in their work with cooperatives. Many cooperative bylaws do not make clear that all payments from patronage-sourced income made to member/patrons are payments under Internal Revenue Code §1382, whether in the form of an advance at the time of delivery, progress payments, payment for the product (e.g. milk check, beet check or grain check) or patronage distributions. Cooperative bylaws usually specifically address the final payment (i.e. patronage distribution, patronage dividend or refund), but often do not even discuss the cash payments made for the product whether they are called delivery or progress payments or are a payment for the product, such as the milk check or grain check), which may lead to differences between actual practice and the written bylaws and confusion on the part of cooperative staff in calculating patronage distributions. Hence, the Sample Bylaws include the concept of “Net Proceeds” to encompass all of the Internal Revenue Code §1382 payments. While the

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## SAMPLE BYLAWS COMMENTARY

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term “Net Proceeds” (or Net Savings or Net Margins) are not often seen in financial statements, the term is important in the legal and tax construct of cooperatives.

It is important to note here that the purpose of this Article IV of the Sample Bylaws is to provide the basis for the computation of the patronage income. It is not mandated for such calculation to be based on federal tax income or generally accepted accounting principles, although most cooperatives will chose one or the other as the base for the computation to keep things easier. It is also possible to make changes to the basic method of calculation when the facts and circumstances suggest a different calculation method would be more fair and equitable to the patrons. These Sample Bylaws show a number of ways in which this can be done and provide that the computation and distribution of patronage and related issues, such as handling of losses and reserves, can and should allow for flexibility for the Board of Directors and Cooperative management to do what is proper for the Cooperative at the time.

The financial provisions of cooperative bylaws provide the significant components of the contract with the members which, in turn, provide the necessary framework supporting the calculation, payment and deduction of the patronage distribution and per-unit retain allocations. It is this contract with the members that provides the essential “pre-existing legal obligation” that is required for the deduction of the patronage distribution.

The Sample Bylaws attempt to strike a middle ground between too sparse and too detailed provisions in order to give the Board of Directors reasonable guidance in handling issues that arise without being too strict. Where possible, the Sample Bylaws language provides suggested alternatives to certain major cooperative operating policies. For example, this Sample Bylaws Article IV assumes that patronage distributions will be paid to both members and non-member patrons, assumes that a revolving capital plan (instead of a base capital plan) will be used and anticipates the calculation of patronage and patronage distributions on a book basis (rather than a tax basis). In each of these instances, suggested alternative provisions and drafting tips are also provided. Because of the statutory requirement that the Cooperative have a pre-existing legal obligation to pay patronage distributions to its members (see, Commentary to Sample Bylaws Chapter V Consent for more information), the decisions related to such alternatives must be decided in advance and clearly set out in the Bylaws in order to be effective.

The Working Group does not subscribe to the view that the Bylaws should be vague in order to provide the Board of Directors and management with ultimate flexibility. Based on our experience, such lack of specificity and direction has caused more negative issues with the tax authorities and Cooperative membership than were avoided by maximum flexibility. Instead, as set out in these Sample Bylaws, the Working Group advocates that a Cooperative’s Bylaws provide substantial direction to the Board of Directors and management, but also include directed flexibility where necessary and advisable to deal with extraordinary circumstances in specific instances.

**Section 4.1 Cooperative Operation.** This Sample Bylaws Section discusses how the Cooperative will operate with respect to the patronage business it does with patrons. The last sentence of subsection (a) discusses income that will be taken into account in determining patronage-sourced income, and includes any unincorporated entity in which the Cooperative has an equity interest, patronage distributions from other cooperatives, and the undistributed income or loss of any entity in which the Cooperative has an equity interest. The Cooperative should specify how earnings from wholly- or partially-owned subsidiaries will be handled. Sample Bylaws Section 4.3 discusses the various methods of computing the patronage

income, and related issues.

**Section 4.2 Definitions.** This is a useful Sample Bylaws Section that can be expanded as needed by the drafter to better explain terms used in the document. As discussed above in the opening remarks, the term “Net Proceeds” should be included here to cover all payments to patrons, but the terminology for each of the specific advances and payments by the Cooperative should also be separately broken out and defined as a component of “Net Proceeds” to fully explain the concept for the particular cooperative involved. A cooperative that has both marketing and supply functions may want to define the patronage-sourced income from the two functions separately and may want to set out the method of calculation and the defined component steps.

The Sample Bylaws use the term “Net Proceeds” and “Net Income”, and it is important to be clear what those terms mean. If necessary, both can be defined in the Bylaws. These Sample Bylaws only define the term “Net Proceeds” since that term is the least understood. As used in these Sample Bylaws, “Net Proceeds” is a cooperative concept and means the revenue earned from the patronage business done with or for members/patrons less the expenses directly and indirectly related to that patronage business done with or for the members/patrons *before* any payments to those members/patrons. Such usage differs from the concept of “Net Income from Patronage Business” which would be the same revenue and expenses but would also include *all* payments to the members/patrons, including the Per-Unit Retain Paid in Money or Certificates and the Patronage Dividend but before income taxes. “Net Income” for the entire cooperative business includes both patronage and nonpatronage business, but is an after-tax amount generally. In these Sample Bylaws, the term “Net Income” is generally related to the overall income of the cooperative or to an entity in which the cooperative is invested.

There are several “drafting notes” included in the Sample Bylaws text volume to provide alternative language as advisable.

**Section 4.3 Establishment of Pools or Allocation Units.** This Sample Bylaws Section provides the Board of Directors with the authorization and flexibility to establish pools or allocation units in any number of ways in order to reasonably and equitably allocate the profits to the members.

**Section 4.4 Determination of Net Proceeds.** This Sample Bylaws Section describes how Net Proceeds is computed and should be carefully written, with appropriately defined terms, to reflect the actual practice by the Cooperative. The Sample Bylaws are particularly directed at an agricultural marketing cooperative where the members are paid the net amount remaining after all other patronage expenses have been deducted from the patronage-sourced revenue. Payments to members for their commodity are specifically excluded from those expenses. Those payments to members are part of the “Net Proceeds.”

Generally, cooperatives use either the federal income tax basis (“tax” basis) or the generally accepted accounting principles (GAAP or “book” basis) for paying patronage distributions. In recent years, some cooperatives have felt that pure GAAP or pure tax basis do not equitably compute the profit that should be distributed to the members for that year. The “mark to market” adjustment for hedge accounting is one example of this. In these cases, the cooperative will prospectively determine a modified book or modified tax method for allocating patronage distributions in order to more equitably allocate Net Proceeds to members.

## SAMPLE BYLAWS COMMENTARY

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Some examples of things that cooperatives, and their Boards of Directors and management should consider in adopting either of these methods, and perhaps carving out certain items that are most problematic for their cooperative, include:

- a) Changes of accounting method – how they are to be handled in the current year patronage computation despite their “book” or “tax” treatment;
- b) Hedge accounting;
- c) In mergers, appropriate adjustments to reflect equitable treatment of members for assets “booked up” in merger; and
- d) If on “tax” method, do you include the former Section 199 or new Section 199A deduction in determining “tax” income?

In the past, many cooperative bylaws were very vague regarding the method that was to be used for making the patronage distributions. While it could be argued that such vagueness would give the Cooperative more flexibility, it is more often the case that it creates confusion. In the most extreme circumstances, the lack of clarity could result in a loss of the Cooperative’s patronage distribution deduction for failure to have a pre-existing legal obligation to distribute patronage distributions. It is generally best to spell out the method to be used and to provide adequate means for the Board of Directors to make adjustments as situations arise.

**Section 4.5 Allocation of Net Proceeds.** As discussed earlier, the Treasury Regulations require that there be a “pre-existing legal obligation” for the Cooperative to pay patronage distributions to its participating patrons and that such legal obligation be evidenced in a valid enforceable written obligation that may originate in state law, the Articles of Incorporation, the Bylaws or other written contracts. This section of the Sample Bylaws provides the critical pre-existing legal obligation language when it states that the Net Proceeds from the patronage-sourced business **shall** be allocated to the patrons on a patronage basis.

In some cases, the Cooperative may have taxable income for alternative minimum tax (AMT) purposes that substantially exceeds their regular taxable income. The Cooperative may wish to pass the excess AMT income through to the patrons, rather than paying the AMT at the Cooperative level. It is generally very difficult for a cooperative to generate enough regular tax in future years to recoup the AMT credit. By allocating the AMT to the patrons, the Cooperative spreads the larger amount across their many members. This can lower the overall AMT paid, and it may be easier for the member to generate regular tax in excess of AMT in future years. Care must be taken if this approach is considered to ensure that a sufficient cash patronage distribution is paid to satisfy the AMT patronage distribution amount (i.e. at least 20% cash must be paid on the higher AMT patronage distribution amount).

One issue that arises periodically in cooperatives is what to do with unusual or extraordinary income or loss. By including a provision in the Bylaws regarding this issue, the Board of Directors will have the needed guidance on how best to handle a transaction such as the sale of a major asset, or the receipt or payment of a major settlement on a lawsuit. The IRS takes the position that such items should be allocated to the members who participated in the years in which the asset was used (to the extent practical) or to which the lawsuit related. The allocation of an unusual or extraordinary gain or loss can become a membership issue as well, and having this type of provision in the Bylaws can be a great help to the Board of Directors, and avoid potential member suits against the Cooperative.

**Section 4.6 Treatment of Patronage Losses.** The treatment of losses by cooperatives has been the subject of numerous court cases, private letter rulings, technical advice memoranda, and legislation. A number of acceptable methods have emerged, but care should be taken to ensure that state law and the governing documents of the Cooperative allow the use of them. Direct assessment may be the most equitable but it is often precluded by either state law or the governing documents, is the least desirable method from the members' perspective, and is generally not specifically included in the Bylaws. The Sample Bylaws include provisions for the use by the Cooperative (i.e. the Board of Directors) of one or more of the generally accepted methods:

- a) Internal Revenue Code §1388(j) netting (subsection (i)) – A loss incurred by an allocation unit is netted against the income of a profitable allocation unit or units. Internal Revenue Code § 1388(j) requires notification of this to the members.
- b) Accounts receivable (subsection (ii)) – The Cooperative recoups the losses by establishing an account receivable from each patron of the loss year. The receivable can be satisfied with a cash payment or by offsetting allocated non-cash patronage instruments earned by the patron in the future.
- c) Carryforward the loss (subsection (iii)) – This leaves the loss unallocated and carries it over to future years to be applied to reduce patronage-sourced income in the future. This impacts patrons in proportion to their patronage in future profitable years rather than in proportion to patronage in the current loss year. This is the least attractive option from the standpoint of equitable treatment of the members, and from the standpoint of attracting members to do business with the Cooperative.
- d) Charge to capital reserves (subsection (iv)) – A loss is charged to the unallocated capital reserves (retained earnings) of the Cooperative. This is attractive to the members as it reduces their liquidation preference but not their allocated equities. In addition, the Cooperative may be able to get a tax refund to the extent it had paid taxes on patronage-sourced income in the relevant loss carryback period.
- e) Cancel allocated non-cash patronage distributions (subsection (v)) – The Cooperative cancels outstanding non-cash patronage distributions of the loss year patrons. This may be the most advantageous for the patrons from a tax perspective as they can claim an ordinary loss.

The Sample Bylaws do not attempt to direct the Board of Directors to any one method, but rather allow all of the methods except direct assessment to be used. Two alternative approaches are set out in Sample Bylaws § 4.6(d) for the discussion of the Board of Directors' discretion in a loss situation.

**Section 4.7 Distribution of Net Proceeds.** This Sample Bylaws Section discusses what Net Proceeds will be distributed and what form they will have. Some cooperatives, in an effort to provide maximum flexibility to the Board of Directors in making annual patronage distribution decisions, provide the Board of Directors with a general grant of authority to determine the amount and form of any net proceeds distributions, without providing further direction or guidance. Such a general delineation of authority as to distributions, without more, could invalidate the Cooperative's pre-existing legal obligation to allocate net proceeds, thereby risking the Cooperative's ability to utilize the federal patronage deduction. Additionally, such general discretion could result in the Cooperative's Board of Directors having insufficient guidance to implement the members' reasonable expectations and make the process more difficult and divisive. Even worse, in many instances the failure to carefully consider and enunciate principles and processes for patronage distribution results in Bylaws that contain provisions actually restricting the Board from

## SAMPLE BYLAWS COMMENTARY

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implementing patronage distributions in the best interests of the Cooperative. The better practice for the Board of Directors would be to carefully consider, in advance, the operations of the Cooperative and the expectations of the members and then implement Bylaws that set out general principles and processes in sufficient detail and directed flexibility to assist the Board of Directors in consistently approving patronage distributions in amounts and forms consistent with the best interests of the Cooperative and the reasonable expectations of the members.

Within this Sample Bylaws Section, the drafter should also include a summary of all of the different equity instruments that the Cooperative will use. There will be the non-cash portion of the Net Proceeds for the year in the form of either a Per-Unit Retain Certificate or Patronage Distribution Certificate. Many cooperatives have a specific name for these instruments that are part of their history. For clarity, the Bylaws should link what the Cooperative calls them to what they are for tax purposes.

More cooperatives are now providing other investment vehicles for their members. Some offer Preferred Stock or other types of “investment equity.” Dividends are sometimes authorized for these investment equities. If dividends can be paid, it is critical that the Bylaws also provide for where those dividends will be paid from (i.e. from nonpatronage-sourced income, current and accumulated and from unallocated retained earnings). Sample Bylaws § 4.9 provides for the ordering rule, also known as the “dividend allocation rule” which allows the Board of Directors to maximize the patronage-sourced earnings to be paid as a deductible cash patronage distribution. Without this rule in the Bylaws, the dividend will be allocated proportionally across current year patronage- and nonpatronage-sourced income before any Internal Revenue Code §1382 payments are deducted and, since a typical cooperative has a majority of patronage-sourced business, most of the dividend will be paid from patronage-sourced income, thereby reducing the amount of patronage distributions otherwise payable to members for their patronage.

This Sample Bylaws Section also makes clear that no voting rights are conferred with the allocation of equity, that the transfer of the equity is subject to Board of Directors approval, and that revolvment of the equity is completely at the discretion of the Board of Directors. These clarifications should be correlated with the membership provisions of Article I and the Authorized Capital Stock and Equity provisions of Article III.

**Section 4.8 Capital Reserve.** This Sample Bylaws Section specifies the items of income that will go into the “Capital Reserve” (or Retained Earnings). The state law in the incorporation state should be reviewed to determine whether reserves are permitted, required or subject to any limitations. In order to preserve patronage-sourced income for deductible patronage distribution payments, subsections (a) and (b) of the Sample Bylaws provide that nonpatronage-sourced income and *de minimus* amounts of patronage-sourced income are the first two items mandatorily used in setting reserves. Subsection (c) authorizes an additional discretionary reserve from Net Proceeds (which may be nonpatronage-sourced to the extent available, but may also include some patronage-sourced amounts), as determined by the Board of Directors. In many ways, this subsection (c) is a corollary to the pre-existing legal obligation in that such obligation may be negated to the extent the Board of Directors has discretion to divert patronage-sourced income away from the patrons. In some cases where the Board of Directors has the power to divert income away from patronage allocations, even if it is not exercised, there is risk that the patronage distribution deduction will be lost entirely. Sample Bylaws §4.8(c) attempts to put some parameters on the diversion of patronage-sourced income to the Capital Reserve while giving the Board of Directors some needed flexibility. This is an area where the drafter should exercise caution, and understand the Cooperative’s

circumstances.

**Section 4.9 Allocation and Distribution of Nonpatronage-Sourced Income and Loss.** Sample Bylaws § 4.9 deals with two separate and distinct situations. Subsection 4.9(a) covers the situation where the Cooperative is paying a regular corporate dividend on Preferred Stock or other investment equity. This provision states that the dividend will be sourced out of the Cooperative's current and accumulated net income from nonpatronage-sourced business or from unallocated patronage-sourced income. This is the Cooperative's "earnings and profits" and to the extent the dividend is less than this amount, the "dividend allocation rule" of Internal Revenue Code § 61 will not come into effect to reduce the patronage-sourced income before the patronage dividend.

Sample Bylaws § 4.9(b) gives the Board of Directors the authority to allocate to members the Nonpatronage-Sourced Income of the Cooperative. Most cooperatives would typically not want to do this as retained nonpatronage-sourced income could be used as permanent equity for the cooperative. While the members may have liquidation rights to this money, it is not otherwise available to be paid or allocated to them. Thus, the drafter should discuss with the Cooperative inclusion of subsection (b). In addition, care must be taken to ensure that out-of-pocket current taxation of the non-cash portion of an allocation is avoided at the member level.

Sample Bylaws § 4.9(c) provides the Board of Directors with flexibility as to handling a nonpatronage-sourced loss, although it will generally be practically impossible to recover such nonpatronage-sourced losses from nonmember patrons, making it unlikely to handle nonpatronage-sourced losses in any manner other than offset against the Cooperative's reserves. The Cooperative should generally avoid nonpatronage-sourced losses by avoiding any advances on nonpatronage-sourced business until after completion of the year and verification of results.

**Section 4.10 Base Capital Plan.** Cooperatives typically use either a "revolving capital plan" or a "base capital plan" for financing their equity requirements. Sample Bylaws § 4.7 assumes a revolving capital plan is used. Sample Bylaws § 4.10 provides the Cooperative with the option to convert to a base capital plan. If a base capital plan is intended, the drafter may wish to utilize provisions similar to the Alternative Sample Bylaws § 4.10 provided and expand and revise these provisions to fit the needs of the Cooperative.

# CHAPTER V\*

## CONSENT

**Introductory Comments:** As noted in the General Introductory Comments, the Sample Bylaws are based on a stock agricultural marketing cooperative model. In the interest of completeness, the Sample Bylaws allow nonmembers to participate on a patronage basis. This is not required and is completely at the discretion of the Cooperative. The Sample Bylaws also provide for the use of qualified written notices of allocation to be used for the non-cash portion of the patronage distribution or for per-unit retention of Net Proceeds.

Under the Internal Revenue Code, in order for a qualified written notice of allocation to give rise to a valid tax deduction for the Cooperative, there must either be (a) certain redemption rights<sup>1</sup> assigned to the written notice of allocation by the Cooperative when issued (a method that is not commonly used and could result in an equity interest being characterized as debt), or (b) consent by the patron to include the stated dollar amount of the notice in the patron's gross income for tax purposes in the year of receipt. In either case, at least 20 percent of the patronage distribution reported by the written notice must be paid in money or by qualified check.

Patron consent may be satisfied in one of three ways: 1) a written consent agreement<sup>2</sup>; 2) a bylaw provision<sup>3</sup>; or 3) through the patron endorsing and cashing a qualified check<sup>4</sup>. The bylaw consent provision is the most common method of satisfying the Internal Revenue Code requirement (and is used in these Sample Bylaws), but it is only applicable to member/patrons of the cooperative<sup>5</sup>, and has certain timing issues as further discussed below. Nonmember patrons must satisfy the consent provision using the written consent agreement or endorsing and cashing a qualified check. Since the establishment of a valid contract between the patron and the Cooperative is such a critical aspect for tax purposes, the IRS has provided useful sample bylaws language in its Treasury Regulations which provides the practitioner with actual text for the Bylaws. The footnotes in the text provide citations to such specific text.

As detailed in Treasury Regulation 1.1388-1(c)(3)(ii)(a), bylaw consent (as set out in the Sample Bylaws) is effective for current members at the time the provision is adopted and for members who join the Cooperative subsequent to the adoption of the Bylaw consent provision. "Member" means a person who is entitled to participate in the management of the Cooperative organization, usually through the right to vote in the election of the board of directors. However, being a member of the Cooperative with a consent provision in the Bylaws does not, by itself, meet the Internal Revenue Code requirement for bylaw consent. Members must receive a written notification and copy of the Bylaws. The notice must inform members that the bylaw consent provision has been adopted and state its tax significance to the member. Both the notification and a copy of the Bylaws must be given to each member or prospective member. The notice

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<sup>1</sup> Internal Revenue Code §1388(c)(1)(A).

<sup>2</sup> Internal Revenue Code §1388(c)(2)(A) and Treas. Reg. § 1.1388-1(c)(3)(i).

<sup>3</sup> Internal Revenue Code §1388(c)(2)(B) and Treas. Reg. § 1.1388-1(c)(3)(ii).

<sup>4</sup> Internal Revenue Code §1388(c)(2)(C) and Treas. Reg. § 1.1388-1(c)(3)(iii).

<sup>5</sup> Internal Revenue Code §1388(c)(2)(B)(i).



and copy of the Bylaws can be mailed to the last known mailing address.

Patrons may also provide the required consent to include the stated dollar amount of the qualified written notice in gross income for tax purposes in the year of receipt by endorsing and cashing a qualified check on or before 90 days after the close of the payment period for the taxable year to which the patronage distribution is paid.<sup>6</sup>

One issue to keep in mind when considering which type of consent to use is when the consent becomes effective. The consent period is different for written consent, bylaw consent, and qualified check consent. For consent based on a writing or bylaw provision, it is necessary to consider the initial effective date, duration of the consent period, and conditions for revocation.

Written consent is effective for all patronage distribution occurring during the Cooperative's taxable year in which the consent is given, unless it specifically provides to the contrary. Therefore, for example, written consent can apply retroactively to cover patronage-sourced business that occurred from the beginning of the Cooperative's tax year. Once given, such written consent remains in effect for all subsequent tax years of the Cooperative until revoked.

Unlike the written consent, bylaw consent (such as in the Sample Bylaws) cannot be retroactive to the beginning of the Cooperative's tax year. Bylaw consent applies only to patronage-sourced business occurring after a patron has received written notification of the adoption of the Bylaw provision, a copy of the Bylaws, and has attained member status in the Cooperative. Bylaw consent remains in force so long as the patron remains a member of the Cooperative and the Bylaws contain the required consent provision.

Given this difference between the written consent and bylaw consent, the Cooperatives should consider the use of the written consent in the first year that a person joins the Cooperative. If a person becomes a member after the first day of the Cooperative's year but will participate in the full year's Cooperative profits, then he should also sign a written consent for that year.

**Section 5.1 Member Consent.** A consent provision in the Bylaws must provide that membership in the organization constitutes consent and that the recipient agrees to take the distribution into his/her income at its stated dollar amount. The Treasury Regulations provide specific language for an appropriate bylaw consent provision. It states:

Each person who hereafter applies for and is accepted to membership in this cooperative and each member of this cooperative on the effective date of this bylaw who continues as a member after such date shall, by such act alone, consent that the amount of any distributions with respect to his patronage occurring after \_\_\_\_\_, which are made in written notices of allocation (as defined in 26 USC [§]1388) and which are received by him from the cooperative, will be taken into account by him at their stated dollar amounts in the manner provided in 26 USC [§]1385(a) in the taxable year in which such written notices of allocation is received by him.

Treas. Reg. §1.1388-1(c)(3)(ii)(b). This sample provision doesn't name a particular document to serve as

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<sup>6</sup> Internal Revenue Code §1388(c)(2)(C) and §1388(c)(4).

## **SAMPLE BYLAWS COMMENTARY**

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the written notice of allocation. Under this language, any written instrument otherwise conforming to the Internal Revenue Code requirements can suffice. If a bylaw consent provision adopts more specific terminology for the written instrument that is the written notice of allocation, then the instrument issued must conform to the bylaw provision.

**Section 5.2 Consent Notification to Members and Prospective Members.** As discussed in the Introductory Comments, members must receive a written notification and copy of the Bylaws. The notice must BOTH inform members that the Bylaw consent provision has been adopted and state its tax significance to the member. Both the notification and a copy of the Bylaws must be given to each member or prospective member. The notice and copy of the Bylaws can be mailed to the last known mailing address. Presumably now with some of the rulings on use of email and personalized website notifications as approved methods for notifying members, these methods would also be acceptable for this notification. With the personalized website notifications, the Cooperative would have proof of delivery on their system as well.

**Section 5.3 Consent of Nonmember Patrons.** As discussed in the Introductory Comments, the Cooperative may wish to treat nonmembers as patrons and pay patronage distributions to the nonmember patron. However, the Bylaws consent provision only applies if the patron is a member. Therefore, nonmember patrons must satisfy the consent provision using one of the other two methods: the written consent agreement or endorsing and cashing a qualified check. The written consent agreement is more commonly used as there can be issues with the timely endorsing and cashing of the qualified check.

## CHAPTER VI\*

### FIRST LIEN; RIGHT OF SET-OFF

**Introductory Comments:** Sample Bylaw Article VI does two things: first, grants a “first lien” to the Cooperative in stock and other interests issued by the Cooperative (e.g., written notices of allocation) that are held by a member or patron; and second, authorizes the Cooperative to set-off any debts owed by a member against such member’s stock and other interests held by the Cooperative. Cooperative advisors and drafters must carefully think through such provisions and additional actions will likely be required to be taken with respect to both the right of first lien and right of set-off to ensure such provisions actually work as intended.

**Section 6.1 First Lien.** A right of first lien is intended to provide the Cooperative with a priority secured position in specific collateral with respect to indebtedness owed by the member or patron to the Cooperative. Such a lien is often part of a coordinated risk management strategy protecting the Cooperative and its members from commercial loss resulting from an insolvent member. As a starting point, applicable state law (typically the applicable state’s Uniform Commercial Code) requires that a secured party obtain a grant of lien by the debtor in the specific encumbered collateral. In most secured lending, such a grant is usually accomplished through the debtor signing a separate “security agreement” which grants such rights to the creditor. Historically, cooperatives have often included such a lien-granting provision in the bylaws. While a specific Bylaw lien-granting language might persuasively be argued as an effective grant of a lien, the Cooperative should strengthen the Bylaws lien-grant argument by pairing the Sample Bylaws provision with a separate membership application, Membership Agreement or other similar document that is signed by a member whereby the member acknowledges the Bylaws as being an agreement between the Cooperative and its members. Such a signed document, combined with specific Bylaw language granting a lien (or other similar provision whereby the member acknowledges, consents to, grants or waives rights), should satisfy requirements for a written adoption of such provisions.

The actual enforcement of such a lien is governed by the relevant provisions of the U. S. Bankruptcy Code and applicable state law, including most notably such state’s Uniform Commercial Code. Additional actions by the Cooperative are also required in order to obtain first priority secured status in specific collateral that is effective against challenges by other claimants to such collateral. Such additional actions with respect to intangible rights in patronage distributions include complying with Uniform Commercial Code attachment and perfection provisions such as filing a Form-UCC-1 in the applicable state’s Secretary of State’s Office or other appropriate state and/or local office or taking possession of the collateral. Failure to take necessary actions could leave the Cooperative exposed as a general unsecured creditor, even though Cooperative management believed the Cooperative to be in a priority position.

It should be noted that the taking of actions by the Cooperative to ensure secured priority rights in specific collateral will also impact a member’s ability to pledge such assets to other lenders, suppliers and others. The Cooperative should be prepared to address issues of coordination and subordination of liens to effectively protect the Cooperative from member insolvency while also providing its members with adequate financing flexibility to conduct their business. Such coordination and subordination may become particularly challenging as financially-troubled members engage in work-out plans which involve

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\* Primary drafter – Todd R. Eskelsen, JD; primary reviewers – William I. Covey, JD and Ronald C. Peterson, JD.

the acceleration of payments or pledge of collateral to lenders while also expanding participation in the Cooperative's programs in a manner that could increase the Cooperative's exposure to risk of loss from such participation. The participation of members in the Cooperative as an officer, director or other major participant in Cooperative activities can also complicate enforcement of the secured creditor status of the Cooperative. The Cooperative should establish in advance a consistent process whereby its first lien can be subordinated to lenders providing secured operating financing to its members that also provides adequate intercreditor rights and processes and protects the Cooperative's superior position from challenge by the members' other creditors.

**Section 6.2 Right of Set-off.** The right of set-off is intended to provide the Cooperative with enforcement rights to collect member indebtedness to the Cooperative from assets of the member held by the Cooperative. Such common law "set-off" rights are generally established under state law, but federal bankruptcy law also addresses set-off. Because a member is both a commercially contracting party (i.e., a customer) with the Cooperative and an equity holder in the Cooperative, the determination of the respective debts and assets subject to set-off by the Cooperative can be complicated.

The success or failure of a cooperative in using set-off to claim unpaid patronage distributions (whether undeclared or existing as written notices of allocation) depends largely on whether the amounts on both sides of the set-off are classified under state law as debt or as an equity interest of the member in the cooperative. If the member's interest in the cooperative which is the subject of set-off is determined to be debt, then set-off may be possible. If, however, the member's interest is in a form that is not then due and payable by the cooperative upon demand (e.g., member equity or undeclared patronage distributions), then courts have ruled that set-off may not be allowed. The Sample Bylaws authorize the Board of Directors to accelerate equity instruments in certain circumstances.

In considering changes to the Sample Bylaws provision, Cooperative advisors should carefully review federal Bankruptcy Code §553, state statutory law and state common law regarding set-off. Advisors should also anticipate that it is likely that the debtor, bankruptcy trustee or other creditors will raise arguments challenging the Cooperative's right to pursue setoff which may affect the right of set-off.

It is also noteworthy that the Sample Bylaws set-off provision is non-reciprocal – that is, set-off is explicitly allowed for the Cooperative against the member, but explicitly denied to the member against the Cooperative. The debtor, a creditor or the bankruptcy trustee could challenge the right of set-off on fairness grounds and it is possible that by strengthening its explicit rights to set-off against insolvent members in commercial contexts, the Cooperative may thereby strengthen members' arguments seeking reciprocal rights of set-off of members' debts against member equity held by the Cooperative.

Because of the complexity of federal and state bankruptcy and work-out laws and the potentially onerous consequences on the Cooperative and its members from unexpected interference with expected rights, the Cooperative should consult with experienced cooperative bankruptcy and creditors' rights counsel in connection with developing its program of first lien and set-off.

A further discussion of the issues involved in rights of first liens and rights of set-off can also be found in Todd R. Eskelsen, *First Lien and Set-Off Rights in Cooperative Bylaws: Obvious Rights of Uncertain Protection*, *The Cooperative Accountant*, Vol. LXIX Number 3, Fall 2016.

## CHAPTER VII\*

### BOARD OF DIRECTORS

**Introductory Comments:** The provisions in Bylaws concerning the Board of Directors are heavily dependent upon the law of the state in which the Cooperative is organized. Therefore, there may be significant differences from state to state, and drafters should consult the law of the corporation's state of organization when drafting or revising the Cooperative's Bylaws. There are, however, a number of guiding principles that are reflected in the Sample Bylaws and applicable to most cooperatives, as discussed below

**Section 7.1 Board of Directors.** The number and qualifications of directors on the Cooperative's Board of Directors are typically set by the Bylaws, consistent with state law. In certain instances, as reflected in the Sample Bylaws, it may be permissible to set the number of directors pursuant to a Board resolution within a range established in the Bylaws. In any event, it is good practice to have an odd number of directors to mitigate against the risk of deadlock.

Many state statutes define who may be eligible to serve on the Board of Directors, while other state statutes, such as California, impose no limitations on eligibility. Some state cooperative incorporation statutes limit membership on the Board of Directors to those persons who are members of the cooperative or representatives of entity members of the cooperative. On the other hand, the law of many states permits the inclusion of "outside" directors, or persons who have no membership interest in the cooperative. Outside directors typically might be utilized to bring a particular expertise (for example, product marketing skills) to the Board of Directors. In those states where outside directors are permitted, the statute may impose some limitation on the number of such directors who may serve on the Board of Directors. (*See, e.g.*, New York Cooperative Corporations Law at § 61.) Organizers should consider other director qualification requirements (e.g., experience, age, patronage levels, etc.) that may be desirable.

The Commentary to Sample Bylaws §1.3 addresses the issue of designating an individual to represent the interests of entity members of the Cooperative. As noted above, the designated individual is usually the individual who may be eligible to serve on the Board of Directors of the Cooperative where Director eligibility is limited either completely or partially to individual members or individual representatives of entity members. In such case, the Cooperative may wish to require in its Bylaws that only individuals who hold an ownership interest in or are involved in the day-to-day operations of the entity member may serve as its representative, in order to avoid entity members appointing, for example, the member's attorney or accountant to represent the entity member's interest.

Maintaining continuity of experience on the Board of Directors is critical for any organization. Therefore, it is typical for directors to be designated in more than one class (usually three) with so-called "staggered" terms, to ensure that only a fracture of the total number of directors will stand for election in any given year. The statutes in some states authorize the election of directors from districts or other geographic subdivisions within the territory served by the cooperative. Such geographical districts may not be applicable to certain cooperatives, especially smaller cooperatives, but may be useful to the Cooperative by limiting the size of the Board of Directors to a manageable level while also providing representation on the Board of Directors reflecting all sizes, locations and categories of members in the Cooperative. Although

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\* Primary drafter – Charles J. Sullivan, JD; primary reviewers – Teree Castanias, CPA and Ronald C. Peterson, JD.

## SAMPLE BYLAWS COMMENTARY

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directors may be elected from districts to serve on the Board of Directors, such directors, once elected, have fiduciary duties to the entire cooperative and all its members, not just those members who reside in the district from which they are elected. Statutes that permit cooperatives to elect directors from districts may also provide that certain directors are elected at-large.

**Section 7.2 Vacancy.** Subject to state law, vacancies occurring in seats in the Board of Directors (other than upon expiration of a director's term of office) can generally be filled by the remaining members of the Board of Directors and the replacement director generally serves until the next meeting at which an election of directors will occur or until the director whose departure created the vacancy would have next stood for election. The law of the state in which the Cooperative is organized will dictate whether the filling of such vacancies is permissive or mandatory.

**Section 7.3 Meetings.** Bylaw provisions typically provide for regular meetings of the Board of Directors. Meetings can occur monthly, quarterly, or at such other interval as provided in the Bylaws. Meetings can also be held at the discretion of the Board of Directors. It is critical, however, that the Cooperative's Bylaws provide for regular meetings of the Board of Directors, and encourage attendance by all Board members at such meetings. Many cooperatives have established attendance policies which set clear expectations for Board member participation, and establish standards for removal of directors who fail to engage in the business and affairs of the cooperative. Generally, state law does not permit voting by proxy at board meetings.

Most modern bylaws acknowledge that meetings may occur by teleconference, videoconference or similar means. It is important that the Cooperative's Bylaws facilitate such meetings to the maximum extent permitted by the incorporation statute of the state where the Cooperative is organized.

Similarly, the Bylaws should provide authority for the Board of Directors to take action by written consent, where practicable. However, state law often requires Board of Directors action by written consent without a meeting to be unanimous in order to encourage Board discussion and hopefully improve Board decisions.

**Section 7.4 Quorum.** It is typical for the Bylaws to establish a quorum for action by the directors. Usually a majority of those directors serving on the Board of Directors at any point in time constitutes a quorum of the Board of Directors. However, the Bylaws may specify a different quorum, so long as it does not conflict with the provisions of state law.

**Section 7.5 Compensation.** Cooperative bylaws usually authorize the Board of Directors to fix appropriate levels of compensation payable to directors for their service. In the usual case, the Board policy concerning compensation will be a policy of general application to all directors. Special care should be given, however, when establishing compensation policies because such policies obviously will be subject to scrutiny for unfairness and self-dealing.

**Section 7.6 Board Committees.** Most bylaws, like the Sample Bylaws, grant the Board of Directors broad authority to appoint and empanel such committees as it may deem appropriate from time to time. Bylaws also set forth the existence of an executive committee of the Board of Directors, usually made up of the officers that are identified in the Bylaws. The executive committee's authority will be as set forth in the Bylaws, and may, if allowed by state law, include the full authority to act on behalf of the entire Board of Directors between meetings of the Board of Directors. Special consideration should be given to any

limitations that may be imposed upon the executive committee's authority under state law, and whether ratification of the committee's actions is required at the next regularly scheduled Board meeting. It is common practice for the Board of Directors to adopt committee charters at the time the committee is established. The charter defines the purpose and sets forth the authority and limitations of the committee. Committee charters may also establish the staffing of the committee and define the procedures of the committee.

**Section 7.7 Audit Committee; Audit.** Most cooperatives have an audit committee of the Board of Directors. One of the primary functions of the audit committee is to select and oversee the work of an outside auditor to perform an annual audit of the cooperative and in some states, cooperatives are required by law to undertake an annual audit. Audit committees also may play key roles in such matters as reviewing interested director transactions, overseeing "whistleblower" policies, and implementing risk management policies.

## **CHAPTER VIII\***

### **OFFICERS**

**Introductory Comments:** Bylaw provisions for officers of agricultural cooperatives should not be significantly different, if at all, from provisions used for corporations generally. The statutory law of the state of the Cooperative's incorporation must be complied with, whether that be the general corporation law or the statutory law specifically applicable to cooperatives. As is required by many state laws, the Sample Bylaws provide for a Chairperson (sometimes called a "President"), Secretary and Treasurer (sometimes called a "Chief Financial Officer"). State law may allow any officer other than the Chairperson to be a member of the Board of Directors and may require that the offices of the Chairperson (President) and Secretary not be held by the same person.

The provisions of the Sample Bylaws contemplate that a Chief Executive Officer normally will be a hired executive employee who is not a member of the Board of Directors.

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\* Primary drafter – Ronald C. Peterson, JD; primary reviewers – Marlis L. Carson, JD and Charles J. Sullivan, JD.



## CHAPTER IX\*

# INDEMNIFICATION AND INSURANCE

**Introductory Comments:** The law of most states will permit a cooperative to indemnify its directors, officers, employees and agents from certain types of liability to which such persons may be exposed by reason of the fact that he or she served the cooperative in such capacity. The statutory authority to indemnify is not unique to cooperatives, and is typical among various types of business entities, including cooperatives, business corporations and limited liability companies, among others. However, indemnification rights vary from state to state, and it is important for the bylaw drafter to consult the law of the state in which the cooperative is organized to determine the extent and limits of the cooperative’s authority to extend indemnification.

Indemnification is not mandatory but is generally provided by cooperatives to ensure that the cooperative is able to recruit and retain qualified people to serve the cooperative in various capacities. Without such indemnification rights, the threat of liability could be a significant obstacle to the recruitment and retention of qualified candidates for the various positions within a cooperative. Therefore, most cooperatives feel that it is vital to the strength of the cooperative to provide indemnification to its directors, officers, employees and agents, often using the phrase “to the fullest extent permitted by law” in bylaw provisions. Further, since indemnification often becomes most relevant when the indemnifying entity is facing financial challenges, many cooperatives also purchase director and officer liability insurance (or “D&O Insurance”) to provide additional financial resources to fulfill future indemnification obligations.

As an initial matter, to limit the potential liability for directors, officers, employees and agents (and thus reduce potential exposure to claims requiring indemnification), the Cooperative’s Articles of Incorporation should include any available exculpation or liability limitation provisions that are allowed under the applicable state incorporation law, as referenced in Article V of the Articles Overview. Additionally, the Cooperative’s advisors should carefully review the indemnification provisions of applicable state law to understand who can be indemnified, for what claims and expenses, at what times during a claims proceeding, whether funds can be advanced and upon what terms and how, when and how much of monies that have been advanced under an indemnification process that ultimately results in a determination that indemnification was improper. The law of indemnification is highly developed through multiple court cases in most jurisdictions and D&O insurance policies and underwriting are not standardized. Cooperatives should consult with experienced business law counsel in evaluating and designing their indemnification program and in interacting with insurance professionals.

**Section 9.1 Right of Indemnity.** State law typically permits a cooperative to indemnify any director, officer, employee or agent who is made, or threatened to be made, a party to an action or proceeding (whether civil or criminal), because such person was serving (or had served) the Cooperative or an affiliate of the Cooperative (subsidiary, joint venture, etc.) as a director, officer, employee or agent. State laws typically also permit the cooperative to indemnify a person from a threatened or actual claim made by or in the right of the Cooperative (derivative actions). To the extent adopted by the Cooperative, indemnification, including the advancement of funds before final determination of liability, would typically be permitted, unless it is shown that the person claiming indemnification acted out of gross negligence or willfully

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\* Primary drafter – Charles J. Sullivan, JD; primary reviewers – Todd R. Eskelsen, JD and Ronald C. Peterson, JD.

## SAMPLE BYLAWS COMMENTARY

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caused harm to the cooperative. As discussed above, the drafter must be certain that the indemnification provision conforms to the state law in which the cooperative is organized, which will define the extent of available indemnification and any limits to such indemnification. Indemnification obligations will also likely be broader than D&O insurance coverage (due to deductibles, co-pays, limitations of coverage, etc.), so indemnified persons should carefully review any gaps in coverage to understand their risks.

Indemnification applies not only to recovery from the cooperative of any damage award that is leveled against the director or officer, but also to expenses (including legal fees) incurred by the director in any investigation or defense of the claim (usually referred to as “side A coverage” when covered by D&O insurance; additional insurance coverage for the if it is required to advance indemnification for such expenses can also be obtained for such expenses under “side B coverage” policies.) Indemnification may apply whether or not an action has been commenced, and may include legal fees, costs and expenses incurred costs in connection with a claims that merely are threatened. Additionally, state laws usually allow advancement of funds to potentially indemnified persons even before final determination of liability and rights to indemnification, so long as the recipient provides a satisfactory undertaking to repay such amounts if indemnification is ultimately disallowed; such undertakings are often not conditional on the ability of the financial ability of the person to repay such amounts.

Certain states may provide for indemnification whether or not such indemnification is stated in the cooperative’s bylaws. Additionally, subject to limitations that will be set forth by state law, certain state statutes expressly provide that the cooperative may extend indemnification that goes beyond the basic indemnification provided in the statute. It has become a more common practice in the world of corporate governance for corporations to enter indemnification agreements with their directors and officers, thereby providing a direct contractual right to the protected person. Directors and officers sometimes prefer this approach because an agreement gives them direct privity to enforce against the corporation the indemnification obligation and allows them to negotiate particular terms of indemnification, provided that they are consistent with state law.

To maximize the indemnification benefits, the Cooperative may provide liberal and mandatory indemnification rights to a broad range of persons affiliated with the Cooperative and allow full advancement of funds for legal defense without demonstrated financial ability to repay. However, such a broad and liberal indemnification program could result in unintended consequences, including mandatory indemnification and advancement of funds to numerous people even in instances of clear guilt, and possible even to defend against claims and litigation against such persons. The Cooperative should consult with experienced counsel and with knowledgeable D&O insurance providers to develop the indemnification program appropriate for the risks faced by the Cooperative at an affordable price.

**Section 9.2 Insurance.** A very important corollary to indemnification is D&O liability insurance. Such insurance coverage can be beneficial to both the cooperative and the protected persons. From the cooperative’s point of view, insurance can provide a stable and affordable means of funding the cooperative’s obligation to indemnify the protected person, subject to applicable policy provisions. From the protected person’s point of view, the existence of the policy helps to ensure that there will be funds available from which to satisfy an indemnification claim in the case of, for example, the insolvency of the cooperative. Involvement of an experienced and knowledgeable D&O insurance professional can also assist the Cooperative in evaluating the potential risks and designing an appropriate indemnification program.

## CHAPTER X\*

# DISSOLUTION

**Introductory Comments:** Dissolution provisions usually don't get a lot of attention because liquidation seems remote and is usually associated with financial distress. However, there have been a number of instances where successful cooperatives have sold their assets and liquidated. At that time, the dissolution provisions become very important.

As discussed in the Commentary to Sample Bylaws § 4.5, it can be critical to have language in the Bylaws that provide the Board of Directors with guidance on handling “unusual or extraordinary” patronage-sourced income or loss. With the decision in the *Farmland Industries*' case in 1999,<sup>7</sup> it has become accepted that gains or losses related to the patronage-sourced business are patronage-sourced income. Therefore, it is important to have provisions in the Bylaws that provide for and direct the proper handling of such gains or losses.

**Section 10.1 Distribution of Assets.** After the debts are paid and all equities retired at their stated values, the Bylaws should provide that the residual assets be distributed to current and possibly former members (or if required by state law, patrons) on the basis of historical patronage (to the extent practical). Subject to the requirements of applicable law, the Board of Directors should have at least some discretion to determine the relevant period for measuring historical patronage and whether allocation units should be considered. It may be desirable to establish the look-back period over which residual value will be distributed based on patronage. A pre-established rule will avoid disputes at the time of dissolution and will avoid the need to distribute based on decades of historic patronage to former patrons who are deceased or unidentifiable.

Distributing liquidating proceeds to former members (or patrons, if required by state law) is generally not popular and may not be required under state law. However, in early private letter rulings, the IRS required distribution to all current and former patrons of the liquidating cooperative on the basis of historical patronage as a requirement of the “equitable allocation” requirements of operating on a cooperative basis. More recent IRS private ruling letters have allowed more flexibility where the liquidating cooperative successfully argued that only current members (or patrons, if required) should receive liquidation proceeds and that identifying and locating former members (or patrons, if required) for prior years would be onerous, if not impossible, for the cooperative. In those rulings, the IRS seemed swayed by the fact that the cooperative's membership did not change very much from year-to-year. Therefore, in considering this aspect of the liquidation provisions, the drafter should carefully consider how much the Cooperative's membership changes over a period of time and the ability of the Cooperative to identify and locate former patrons.

**Section 10.2 Treatment of Members' Rights in the Event of a Merger, Reorganization or Consolidation.** Another issue that should be considered when drafting dissolution Bylaws provisions is what could happen in merger, reorganization or consolidation transactions. Some cooperative bylaws

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\* Primary drafter – Teree Castanias, CPA; primary reviewers – Daniel C. Mott, JD and Ronald C. Peterson, JD.

<sup>7</sup> *Farmland Industries v. Commissioner*, 78 T.C.M. 846, 864 (1999), acq., AOD 2001-003

## **SAMPLE BYLAWS COMMENTARY**

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provide that the property rights and interests of members of the cooperative shall be recognized and preserved in an equitable manner which corresponds in general to the property rights and interests of the members recognized on dissolution of the cooperative.

## CHAPTER XI\* ARBITRATION

**Introductory Comments:** Cooperatives may wish to consider inclusion of a provision in their Bylaws under which disputes between the Cooperative and its members will be resolved through arbitration, rather than judicial litigation. Members of the Working Group did not all agree about the advisability of arbitration provisions, with some opposing use of such provisions in cooperative bylaws. However, the Working Group did agree that arbitration provisions should be addressed when thinking about cooperative bylaws and so determined to include Bylaws Article XI in the Sample Bylaws Text, along with this Chapter XI in the Sample Commentary. Inclusion of such provisions is not meant as the Working Group’s recommendation about arbitration provisions, but merely as a discussion of those issues that advisors to cooperatives should consider regarding arbitration.

Arbitration provisions may be particularly relevant in cooperatives that have some form of marketing agreement with their members, where many of the commercial issues must be promptly concluded due to perishability or consequential damages considerations that could result if disputes are not promptly resolved. In those cases, the cooperative could include an arbitration provision in the marketing agreement itself. However, often those “agreements” are informal and not thoroughly documented and so it may be preferable to include an arbitration provision in the Bylaws, which is also part of the “contract” between the cooperative and its members.

There are many different types of arbitration provisions, but there are a number of common considerations that are relevant to any arbitration clause. The arbitration provision included in the Sample Bylaws is intended to offer an example of possible language, but careful consideration should be given as to the appropriateness of the Sample Bylaw provision in a given circumstance.

Case law regarding arbitration provisions in cooperatives largely follows general contract law. Cooperatives are free to provide for arbitration in their bylaws or other contracts. However, an arbitration clause may be challenged in state and federal courts under common law contract defenses of unconscionability, fraud or duress. The most common challenge to arbitration clauses is unconscionability. In order to show that an agreement is unconscionable, a party must demonstrate that the contract is both procedurally and substantively unconscionable. In other words, a party must show that there was unfairness during the contract negotiations in the form of oppression or surprise (procedural unconscionability) and also show that the terms are overly harsh or one-sided (substantive unconscionability). In order to make sure that an arbitration agreement is enforceable, the drafter should take care to make the arbitration provision conspicuous. It is also important that the agreement not appear excessively beneficial to one side at the expense of the other.

**Section 11.1 Arbitration of Disputes.** Section 11.1(a) provides that any dispute between the Cooperative and a member or members will be resolved through binding arbitration. The process is initiated by either party demanding arbitration of a dispute by written notice to the other party. The

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\* Primary drafter – Daniel C. Mott, JD; primary reviewer – Todd R. Eskelsen, JD. This Chapter was initially prepared as the draft 2018 report of the NCFC LTA Subcommittee on Litigation Between Cooperatives and their Members.

## SAMPLE BYLAWS COMMENTARY

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provision also includes a two-year limitation on claims that requires the arbitration of any dispute to be initiated within two years following the date that the alleged claim arose. Note that this two-year period is shorter than the typical six-year statute of limitations that would apply for contract disputes in a litigation setting. The two-year period intended to expedite the resolution of disputes, but could also result in the effective waiver of a claim by one party for failing to initiate the claim within two years. Consideration should be given as to whether or not the two-year period is appropriate.

Section 11.1(b) provides the Cooperative with the right to equitable relief in enforcing contractual obligations of members since in certain limited instances it might still be advisable for the Cooperative to have the right to promptly enforce certain time sensitive or critical contractual rights through the prompt exercise of a court's equitable powers where the potential consequential damage to the Cooperative would be severe or long-lasting. For example, the Cooperative may want the right to seek specific performance of a member's product delivery obligations under a Membership Agreement or Marketing Agreement to ensure receipt of sufficient product for efficient processing or to protect markets and customer relationships that could easily be compromised or lost if the Cooperative is unable to provide a reliable source of supply. Sample Bylaws §11.7 provides such access to equitable remedies if needed at the option of the Cooperative.

Note that the type of font for Section 11.1 is bold. This is intentional to make the provision more conspicuous to address the concern of procedural unconscionability that is described above. It should be noted that the reliance on a Bylaw arbitration provision to control disputes under a separate contract may raise unconscionability issues due to the fact that the clause is not conspicuous in the actual contract between the parties. As a general rule, it would be better to include the arbitration clause in the actual contract (rather than in a separate Bylaw) to strengthen the enforceability of the clause. However, in cases where there is no written contract between the members, or when the terms of those contracts are not consistent, the Bylaw provision provides a workable alternative, albeit with no guaranty of enforceability.

**Section 11.2 Selection of Arbitrators.** Arbitration clauses typically set forth a procedure for selection of the arbitrators. The Sample Bylaws contemplate that the parties will mutually agree on the arbitrator or arbitrators. In the case of smaller disputes (\$250,000 or less), the dispute will be resolved by one arbitrator; larger disputes will be resolved by three arbitrators. In the event the parties are unable to agree on the arbitrators, the provision contemplates that either of the parties may request that the American Arbitration Association select the arbitrators. The American Arbitration Association is a commonly used dispute resolution service that appoints arbitrators and administers the case. There are a number of alternative dispute resolution services that could also be engaged to perform this function. It is worth noting that in the grain industry, disputes are often arbitrated by the National Grain and Feed Association ("NGFA"). While this may be an appropriate alternative for "grain and feed" disputes, it may not be appropriate for other types of dispute. Careful thought should be given to the process by which arbitrators are selected to assure that it is appropriate for the types of disputes that may arise.

**Section 11.3 Arbitration Procedures.** Absent specific provisions in the arbitration "agreement," arbitrators will be generally free to follow the rules of the association with which they are affiliated and/or other rules established by the arbitrator. The Sample Bylaws establish the basic rules for the arbitrators to follow. These include substantive rules of law, the federal rules of evidence, and procedures to provide the parties with a limited period of discovery prior to the actual arbitration proceeding. By specifying some basic procedural rules for the arbitration, the parties can have greater certainty that due process will be followed and that the arbitration procedures will be fair. The sample provisions also require that

the arbitrator prepare findings of fact which are supported by stated reasons. This is important to assure that the decision is well reasoned and demonstrates compliance with applicable law. The Sample Bylaw provisions provide that neither party shall be responsible for punitive or exemplary damages. This means that the arbitrator may only compensate a person for actual damages. Finally, the clause prohibits any sort of “class action” arbitration.

Under the Sample Bylaws procedures, an arbitrator would be free to fashion a decision that he or she determines is appropriate. This provides broad discretion to the arbitrator. Alternatively, arbitration clauses sometimes include a requirement that the two parties each submit their proposed resolution of the dispute and the arbitrator is obligated to select one of the two positions. This approach (sometimes referred to as “baseball arbitration” because it is used in Major League Baseball labor arbitrations) assumes that each party will have an incentive to provide a reasonable proposed resolution to the dispute in order to avoid the risk that the arbitrator will perceive the other party’s position to be more reasonable, and therefore select the alternative proposal. It is argued that this approach narrows the scope of the dispute between the parties and minimizes the risk that the parties will choose extreme positions with the expectation that the arbitrator will somehow split the difference. The drafter should give careful thought to the alternative procedural approaches that are available for arbitration, and should ultimately select a system that is appropriate for the Cooperative and its members.

**Section 11.4 Costs.** Many arbitration organizations charge a fee to file and administer an arbitration dispute. Some arbitration clauses provide that the prevailing party’s fees will be paid by the opposing party, while other provisions provide for a splitting of the fees. The Sample Bylaws provision provides that all costs and expenses of the arbitration, including attorney’s fees, will be paid for by the non-prevailing party in the dispute, but also provides for a division of costs where neither party fully prevails. Careful consideration should be given to whether or not the Sample Bylaws language is appropriate under given circumstances since it places a potentially significant cost on the party that does not prevail, not only for the arbitration costs but also for the attorney’s fees of the prevailing party. This provision certainly provides a disincentive to bring a spurious claim. However, it also exposes the non-prevailing party to a significant financial risk that should be considered when crafting the arbitration provision.

**Section 11.5 Continued Performance.** The Sample Bylaws provision contemplates that both the cooperative and the member will continue to perform under their commercial relationship while the arbitration is pending. This provision is intended to assure that neither party may suspend performance pending resolution of the arbitration. As a general rule, the continued performance clause should provide reasonable protection for both the Cooperative and its members.

**Section 11.6 Binding Effect.** The Sample Bylaws provision confirms that the arbitration is intended to be binding and that the arbitration result can be confirmed in court. The provision also contemplates that the arbitration decision is subject to review by the courts only to the extent that the decision misapplies the law. The language does not provide for judicial review of an arbitration decision where one party questions the arbitrator’s determination of the facts, or simply doesn’t like the result. While the Sample Bylaws provision includes a relatively simple statement of intention with regard to judicial review, the question of judicial review of arbitration decisions is often a question of state law, which may or may not be entirely consistent with the sample bylaw language.

## **CHAPTER XII\***

### **FISCAL YEAR; MISCELLANEOUS**

**Introductory Comments:** Certain miscellaneous bylaw provisions may or may not be required under the state law of incorporation, but discussions of such provisions among cooperative organizers may reveal matters that are significant for the Cooperative and require memorialization. The provisions included in Sample Bylaws Article XI are likely not all statutorily mandated, but they are included in the Sample Bylaws and this Commentary as a reminder for cooperative organizers to carefully review the state incorporation statute and general corporate law to think through whether all necessary and relevant issues have been considered and resolved in connection with the incorporation process.

**Section 12.1 Fiscal Year.** The determination of a fiscal year for the Cooperative is undoubtedly a significant matter to be fully discussed and resolved. Under the Code, every organization, including the Cooperative, is required to have an annual accounting period for keeping records, reporting income and expenses and paying taxes. Possible annual accounting periods are a *calendar year* (12 consecutive months beginning January 1 and ending December 31); or a *fiscal year* (12 consecutive months ending on the last day of any month except December, which would include a tax year that varies from 52 to 53 weeks but does not have to end on the last day of a month). Even if not statutorily required to be specifically addressed in the Bylaws, inclusion of the Cooperative's fiscal year in the Bylaws is usually advisable to ensure adequate consideration of the issues described below and for disclosure to members of an often overlooked attribute of the Cooperative that could have substantial impact on member accounting, tax payment and tax planning.

The choice between a calendar year and fiscal year would depend on the business activities of the Cooperative and should be made by the Cooperative's advisors only after fully understanding such activities and the annual business cycle of the Cooperative's activities. Considerations impacting the appropriate accounting year choice could include crop cycles and harvest schedules, processing and marketing timelines, inventory turnover, sales cycles and other business factors which strongly affect the natural beginnings and endings of the Cooperative's business cycles. Unless the Cooperative has a required tax year under law or regulation (check with the Cooperative's accountant), the Cooperative would adopt a tax year by filing its first income tax return using that tax year. The initial tax year does not have to cover a 12-month period from the date of organization of the Cooperative, but once chosen, a tax year can generally only be changed with the permission of the Internal Revenue Service. The Bylaws Text authorizes the Board of Directors to make any changes in the fiscal year of the Cooperative in the presumably rare circumstance where such a change was necessary without the necessity of amending the Bylaws or otherwise involving the members.

The tax year of the Cooperative will also determine the reporting and payment of patronage distributions to the Cooperative's members. Differences in tax years between the Cooperative and its members may have an effect on the timing of recognition by the members of patronage distributions received from the Cooperative which may afford some tax planning opportunities for members in determining the terms on which to contract with the Cooperative (e.g., when choosing among contracts having future delivery and/or payment dates) and may provide the Cooperative with certain commercial advantages in designing its contracts and programs with its members and patrons.

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\* Primary drafter – Todd R. Eskelsen, JD; primary reviewers – Teree Castanias, CPA and Charles J. Sullivan, JD.



**Section 12.2 Registered Office; Other Offices.** It is usually not necessary to set out the registered office or to allow for additional offices in the Bylaws since such matters are usually explicitly or implicitly allowed under relevant state law, but the geographical residence and physical location of offices of the Cooperative is often a matter that will resonate with members and management of the Cooperative and therefore deserves at least adequate discussion.

**Section 12.3 Books and Records.** Similarly, state law may provide for a required location of the books and records of the Cooperative in the state of incorporation or some other location that allows ready access to such books and records if necessary, especially in the event of government investigation or prosecution. Since many records are now kept electronically and even “in the cloud,” the actual physical location of such records may be difficult to determine. Consideration should be given by Cooperative organizers to such issues to ensure compliance, avoid surprises and allow accurate description of intended practices, even if specific provisions are ultimately not included in the Bylaws.

**Section 12.4 Corporate Seal.** Corporations and cooperatives historically were expected to have corporate seals that were to be affixed to any document signed on behalf of the entity, thereby providing evidence of proper corporate action. Modern practice is to dispense with the use of a corporate seal for ease and simplicity purposes. The Sample Bylaws permit the Board of Directors to determine whether or not to have a corporate seal and if a seal is used, establishes the custodian and manner of authorizing use of such a seal.

# CHAPTER XIII\* AMENDMENTS

**Introductory Comments:** Once adopted, the Cooperative's Bylaws form the policy and procedural superstructure governing the activities of the Cooperative and, together with the Articles of Incorporation, the highest authority for identifying, defining and reconciling rights of stakeholders in the Cooperative. As such, the Bylaws should be given regular attention to ensure that they conform to changes in applicable law and the Cooperative's evolving business, financial, tax and other needs. If changes are necessary, applicable state law should provide a process for such amendment which may allow certain flexibility in the process as set out clearly in the Bylaws. Certain cooperatives have successfully institutionalized this review and, as necessary, amendment process by assigning to a committee of the board the role of periodically reviewing the cooperative's bylaws and recommending changes.

**Section 13.1 Amendments.** The Cooperative's Bylaws should provide a mechanism for their amendment that is consistent with the requirements of the state organizational statute where the cooperative is organized. The key considerations for such a provision include (a) who must approve an amendment to the bylaws, (b) what percentage of the voting body must vote in favor of the amendment in order for it to be given effect, and (c) what prior notice of the proposed amendment (and the associated required vote thereon). Typically, state law vests in members the right to amend bylaws so that bylaw amendments must be approved by a majority of the members at a properly noticed and convened meeting of members. However, many state laws also permit a bylaw amendment to be approved by the board of directors (usually by a supermajority vote of all directors at a properly noticed and convened meeting), subject to the right of members to ratify or veto such changes.

Bylaw amendments should be relatively infrequent as they often favor or disfavor members differently and so can be disruptive. However, once an amendment becomes necessary, Cooperative management (Board of Directors and staff) should re-examine the Bylaws in their entirety to make all necessary and advisable amendments of the Bylaws through the same process for efficiency purposes. Best practice for Bylaw amendments would usually involve a special committee of the Board of Directors, with full input by staff and potentially other members as well, to review the Bylaws, draft proposed amendments and fully vet the potential consequences (intended and unintended) that could result from such amendments. A written summary of the changes and the policies implemented by such changes and a black-lined comparison of the amended Bylaws to the existing Bylaws should be distributed as part of any disclosure. Proponents of the Bylaw amendment should work to develop consensus around the proposed changes. Similar disclosure and consensus-building efforts should also be followed if a member vote is required.

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\* Primary drafter – Charles J. Sullivan, JD; primary reviewers – Todd R. Eskelsen, JD and Marlis L. Carson, JD.

## CHAPTER XIV\*

### UNCLAIMED PROPERTY

**Introductory Comments:** An unclaimed property provision may be an important provision to include in the Cooperative Bylaws. State law should be reviewed to determine whether to include and how to draft this provision as the law regarding unclaimed property, particularly as it applies to agricultural cooperatives, varies from state to state. Distributions and payments by a Cooperative to a member or patron which remain unclaimed or unpaid for a specified statutory period of time may become subject to a state's unclaimed property law requiring payment to the state. Generally applicable state law for unclaimed property issues should be the law of the Cooperative's state of incorporation. However, law other than the unclaimed property law of the Cooperative's state of incorporation may also have application due to the residency of a member or the location of the Cooperative's headquarters and operations outside of the state of incorporation.

The statutory law of some states such as California provide that by compliance with certain notice and requirements, the Cooperative may avoid escheat of the distribution or payment to the state of California and the distribution or payment will become the property of the Cooperative (California Food and Agricultural Code §54041). In other states such as New York, distributions and payments by a Cooperative are made exempt from the operation of the state's unclaimed property law (New York Abandoned Property Law § 1420). In such states, the Cooperative may provide in its Bylaws an enforceable provision which permits the Cooperative to charge off the distribution or payment as a liability on its books and the distribution or payment will become the property of the Cooperative as a matter of contract law.

The unclaimed property provision in the Sample Bylaws reflects a provision that may be used in a state which permits avoidances of escheat by compliance with statutory notice requirements. A similar provision might be used as a contractual provision in states where Cooperative distribution and payments are exempt from the unclaimed property law.

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# NATIONAL COUNCIL OF FARMER COOPERATIVES

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**NATIONAL COUNCIL OF FARMER COOPERATIVES**  
**SAMPLE BYLAWS**  
**PROJECT**

**VOLUME II**  
Sample Bylaws Text

**APPENDIX I**  
Working Group Biographies and Contact Information

This publication is the product of a special Working Group of the Legal, Tax and Accounting (LTA) Committee of the National Council of Farmer Cooperatives (NCFC).

The Working Group solicits comments and additional input on the publication from readers by contacting NCFC at [mcarson@ncfc.org](mailto:mcarson@ncfc.org) or 202-626-8700.

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## TIPS FOR USE OF THE SAMPLE BYLAWS PROJECT VOLUMES

The Articles Overview, Sample Bylaws Text and Sample Bylaws Commentary are intended only to identify and help agricultural cooperative leaders and their advisors understand the key considerations in developing Organizational Documents for their own cooperatives. All cooperatives are formed under the cooperative incorporation or other law of a state (each such law, a “Charter Statute”), and the resources developed by the Working Group are not tailored to the laws of any particular state. Moreover, the Articles Overview, Sample Bylaws Commentary and Sample Bylaws Text do not address all legal, tax and other issues and considerations that are relevant to forming, structuring and operating a farmer cooperative. The Articles Overview, Sample Bylaws Commentary and Sample Bylaws Text are for informational purposes only, and are not intended as legal or accounting advice. Users are urged to consult with their own legal and tax advisors, and to consider the particular requirements of state, federal and other applicable law in drafting and revising their own Organizational Documents. Additional materials on cooperative organization and governance, including a state-by-state summary comparison of cooperative incorporation statutes, are available at no-cost or minimal-cost through the U.S. Department of Agriculture website, <https://www.rd.usda.gov/publications/publications-cooperatives>.

Cooperatives may be formed in for many purposes, including marketing, supply, and service, and may be formed in many different industries. Further, most Charter Statutes provide that a cooperative may be formed with capital stock or on a non-stock membership basis. The Working Group has chosen to draft the Articles Overview and Sample Bylaws Text for a stock agricultural marketing cooperative and specifically address the organizational, governance, tax, antitrust and other issues that are of particular concern to a stock agricultural cooperative marketing cooperative. However, the concepts and issues discussed are also applicable to supply, service and other forms of cooperatives.

As an example, for a cooperative formed on a non-stock (membership) basis, a number of provisions in the Articles Overview and Sample Bylaws Text would require adaptation for use, although many of the same or similar concepts would apply; Sample Bylaws Commentary Chapter III Authorized Capital Stock and Equity identifies and discusses a number of such considerations for organizers of a membership cooperative using these materials. Similarly, although the Articles Overview and Sample Bylaws Text may not apply directly for cooperatives organized in industries other than agriculture or for purposes other than marketing, similar cooperative principles would likely be applicable and should be considered by the drafter.

The Working Group has attempted to provide substantive tools to assist cooperative participants in customizing the sample language of the Articles Overview and the Sample Bylaws Text to the applicable cooperative use. Through specific language in the Articles Overview and in the individual Chapters of the Sample Bylaws Commentary and by liberal inclusion of Drafting Notes and brackets around alternative language in the Sample Bylaws Text, the Working Group highlights applicable principles, outlines the specific issues and provides potential solutions to be considered in developing Organizational Documents for cooperatives of any type in any industry.

Throughout the Articles Overview, the Sample Bylaws Commentary and Drafting Notes in the Sample Bylaws Text, the term “cooperative” has been used in all lower case when referring to cooperatives generally and capitalized (i.e., the Cooperative) when referring specifically to the Cooperative governed by the Articles Overview or the Sample Bylaws Text.



**SAMPLE  
BYLAWS  
TEXT**



**SAMPLE BYLAWS TEXT  
TABLE OF CONTENTS**

**ARTICLE I MEMBERS ..... 2**

Section 1.1 Eligibility for Membership ..... 2

Section 1.2 Membership Stock..... 2

Section 1.3 Representative Membership..... 2

Section 1.4 Membership Agreement, Enforceability ..... 2

Section 1.5 Nontransferability of Membership..... 2

Section 1.6 Termination of Membership; Withdrawal ..... 2

Section 1.7 Members’ Rights Upon Termination of Membership ..... 3

Section 1.8 Voting Power ..... 4

**ARTICLE II MEMBERS’ MEETINGS ..... 4**

Section 2.1 Annual Meeting..... 4

Section 2.2 Special Meetings ..... 4

Section 2.3 Notice ..... 4

Section 2.4 Participation in Meetings ..... 4

Section 2.5 Quorum ..... 5

Section 2.6 Proxy or Cumulative Voting ..... 5

**ARTICLE III AUTHORIZED CAPITAL STOCK AND EQUITY ..... 6**

Section 3.1 Common Stock Authorization and Terms..... 6

Section 3.2 Preferred Stock Authorization and Terms ..... 6

Section 3.3 Transfer or Sale of Shares ..... 7

Section 3.4 No Dissenter’s Rights ..... 7

Section 3.5 Other Equity Interests..... 7

Section 3.6 Record of Stockholders..... 7

Section 3.7 Stock Uncertificated ..... 7

**ARTICLE IV OPERATION ON A COOPERATIVE BASIS ..... 7**

Section 4.1 Cooperative Operation ..... 7

Section 4.2 Definitions..... 8

Section 4.3 Establishment of Pools or Allocation Units..... 9

Section 4.4 Determination of Net Proceeds..... 9

**SAMPLE BYLAWS TEXT**

---

Section 4.5 Allocation of Net Proceeds ..... 10

Section 4.6 Treatment of Patronage Losses ..... 11

Section 4.7 Distribution of Net Proceeds ..... 11

Section 4.8 Capital Reserve ..... 12

Section 4.9 Allocation and Distribution of Nonpatronage Income and Loss..... 13

Section 4.10 Base Capital Plan ..... 13

**ARTICLE V CONSENT .....15**

Section 5.1 Member Consent..... 15

Section 5.2 Consent Notification to Members and Prospective Members ..... 15

Section 5.3 Consent of Nonmember Patrons..... 15

**ARTICLE VI FIRST LIEN; RIGHT OF SET-OFF .....15**

Section 6.1 First Lien..... 15

Section 6.2 Right of Set-Off..... 15

**ARTICLE VII BOARD OF DIRECTORS..... 16**

Section 7.1 Board of Directors..... 16

Section 7.2 Vacancy; Removal ..... 17

Section 7.3 Meetings ..... 17

Section 7.4 Quorum ..... 18

Section 7.5 Compensation..... 18

Section 7.6 Board Committees ..... 18

Section 7.7 Audit Committee; Audit..... 18

**ARTICLE VIII OFFICERS..... 18**

Section 8.1 Election of Officers..... 18

Section 8.2 Chairperson ..... 19

Section 8.3 Vice-Chairperson ..... 19

Section 8.4 Secretary ..... 19

Section 8.5 Treasurer..... 19

Section 8.6 Chief Executive Officer..... 19

**ARTICLE IX INDEMNIFICATION AND INSURANCE..... 19**

Section 9.1 Right of Indemnity ..... 19

Section 9.2 Insurance ..... 19

**ARTICLE X DISSOLUTION..... 19**

**NATIONAL COUNCIL OF FARMER COOPERATIVES**

---

Section 10.1      Distribution of Assets ..... 19

Section 10.2      Treatment of Members’ Rights in the Event of a Merger, Reorganization  
or Consolidation..... 20

**ARTICLE XI ARBITRATION..... 20**

Section 11.1      Arbitration of Disputes..... 20

Section 11.2      Selection of Arbitrators..... 21

Section 11.3      Arbitration Procedures..... 21

Section 11.4      Costs..... 21

Section 11.5      Continued Performance ..... 21

Section 11.6      Binding Effect ..... 21

**ARTICLE XII FISCAL YEAR; MISCELLANEOUS PROVISIONS ..... 21**

Section 12.1      Fiscal Year..... 21

Section 12.2      Registered Office; Other Offices ..... 22

Section 12.3      Books and Records..... 22

Section 12.4      Corporate Seal ..... 22

**ARTICLE XIII AMENDMENTS ..... 22**

Section 13.1      Amendments..... 22

**ARTICLE XIV UNCLAIMED PROPERTY ..... 22**

Section 14.1      Unclaimed Property..... 22

## **BYLAWS OF**

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### **(THE “COOPERATIVE”)**

#### **General Drafting Notes:**

- 1. The Working Group has used blanks (\_\_\_\_\_) and brackets ([ ]) in the Text to indicate required language for the respective Cooperative or alternate language that may be considered to better suit the circumstances of the respective Cooperative. Brackets are also used around language without additional description on time periods, percentages or amounts meant as guidance of reasonable provisions in individual circumstances. Frequently, the specific Commentary on a Text section containing such blanks or bracketed language includes a specific discussion of the issues involved.**
- 2. These Sample Bylaws are not based on any specific state cooperative statute. All provisions must be checked against applicable state law.**
- 3. These Sample Bylaws are based on a stock cooperative structure, with membership in the Cooperative evidenced by ownership of a single share of common stock. Provisions must be modified for a non-stock cooperative.**
- 4. These Sample Bylaws include provisions common for an agricultural marketing cooperative that is intended to be Capper-Volstead Act compliant. Language may need to be modified for supply or other types of cooperatives.**
- 5. These Sample Bylaws make reference in Section 1.4 to a separate Membership Agreement to define specific terms and conditions of membership. Such provisions could also be included in the Bylaws and inclusion in the Bylaws (with specific less-than-unanimous amendment procedures) could make changing the terms and conditions of membership easier than seeking new Membership Agreements from every Member. These Sample Bylaws do not include a sample Membership Agreement.**

## ARTICLE I MEMBERS

**Section 1.1 Eligibility for Membership.** Only persons, partnerships, corporations, limited liability companies, associations, trusts and other entities (including other agricultural cooperative associations) engaged as producers of \_\_\_\_\_ (“Crops”), including lessees and tenants of land used for growing Crops, and lessors receiving as rent all or part of such Crops raised on any leased premises, shall be eligible for membership in the Cooperative. Only such persons and entities engaged in the production of Crops, whose Crops meet the grades and standards and who otherwise meet the qualifications for membership established by the Board of Directors of the Cooperative shall be eligible to become, or qualified to remain, members.

**Section 1.2 Membership Stock.** One (1) share of common stock shall be purchased by and issued to each applicant who has qualified for and been accepted for membership in the Cooperative and shall constitute evidence of such applicant’s membership in the Cooperative and right to vote.

**Section 1.3 Representative Membership.** A member other than a natural person may be represented by a natural person as a duly designated agent for such member under such written authorization as may be prescribed by, and filed with, the Cooperative. Any such person, while so acting in such representative capacity, shall be entitled to have and to exercise all rights, privileges and authority of membership in the Cooperative, including the right to hold office as a director. Such representative person shall be an officer, director, partner, member, associate or manager of such member other than a natural person.

**Section 1.4 Membership Agreement, Enforceability.** Any applicant eligible for membership as provided in these Bylaws shall become a member upon acceptance for membership by the Cooperative and upon execution and delivery of a Membership Agreement in such form as may from time to time be approved and adopted by the Board of Directors. Each member severally shall agree to be bound and abide by all the terms, covenants and conditions of such agreement, by all the terms and provisions of the Bylaws and Articles of Incorporation of the Cooperative as they now exist and may be amended hereafter, and by all the rules, regulations and Board-approved policies as they now exist and may be adopted or amended hereafter.

**Section 1.5 Nontransferability of Membership.** Membership shall not be assigned, transferred, alienated or encumbered in any manner or by any means whatsoever, either voluntarily, by operation of law or otherwise. Any such purported or attempted assignment, transfer, alienation or encumbrance shall be wholly void and confer no rights upon the purported assignee, transferee or claimant. Nothing in this Section 1.5 shall be deemed to preclude assignment of any non-stock equity interests as otherwise provided in these Bylaws.

**Section 1.6 Termination of Membership; Withdrawal.** The membership of a person shall be automatically terminated upon the occurrence of any of the following:

- a) death of an individual member;
- b) effective cessation of business, commencement of bankruptcy proceedings, appointment of a receiver or trustee or dissolution of a member which is a partnership, corporation, limited liability

## SAMPLE BYLAWS TEXT

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company, association, trust or other entity;

- c) cessation of such person being eligible as: (i) a member under the applicable provisions of the law of the State of \_\_\_\_\_, (ii) member pursuant to any provision of the Articles of Incorporation or Bylaws of the Cooperative, or (iii) a “producer” within the meaning of the Capper-Volstead Act;
- d) termination of the Membership Agreement between the Cooperative and the member in accordance with the terms of the Membership Agreement; or
- e) after due notice and an opportunity to be heard, expulsion of the member for failure to comply with the Articles of Incorporation, Bylaws, the terms of the Membership Agreement, the rules and regulations of the Cooperative, or for any other cause which the Board of Directors in its reasonable discretion deems sufficient.

A member may withdraw at such times established by the Board of Directors or, in the absence of a time established by the Board of Directors, upon not less than \_\_\_ days’ prior written notice.

### Section 1.7 Members’ Rights Upon Termination of Membership.

- a) **General Property Rights and Interests Have No Value.** In the event of termination of membership prior to the dissolution or the merger, reorganization or consolidation of the Cooperative or to which the Cooperative is a party, irrespective of how terminated, other than the par value of any membership common stock owned by the member and the cash amount of allocated but unpaid patronage distributions made to such member, the Cooperative shall not be liable for the payment of any amount whatsoever as or for the value of any general property rights and interests in the Cooperative of the member whose membership is terminated. Each member is received into membership upon the express agreement on the part of the member to that effect and upon the express conditions that the value of the property rights and interests of each member in the general property of the Cooperative (prior to dissolution or such merger, reorganization or consolidation) is nothing, and in the event of termination of membership prior to dissolution or such merger, reorganization or consolidation, irrespective of how terminated, such member shall not be entitled to anything as or for the value of such property rights and interests.
- b) **Rights to Redemption of Membership Stock, Allocated Patronage and Other Equity Allocations.** Except as otherwise provided in the Membership Agreement, in the event of termination of membership in the Cooperative, the Cooperative shall (i) redeem such member’s membership common stock at the lesser of par or book value; (ii) pay amounts, if any, due to such member as allocated patronage distributions, crop proceeds and equity allocations, but only on the same basis, at the same time, and in the same manner, as members whose memberships have not terminated; and (iii) pay other amounts, if any, payable to such member. The form and timing of all such payments shall be determined by the Board of Directors, in its reasonable discretion, consistent with the financial resources of the Cooperative.

**Drafting Note:** The specific provisions of the Members’ Rights Upon Termination of Membership should be revised so as to reflect the specific practices of the Cooperative and be consistent with applicable state cooperative law. Some state laws include specific redemption requirements and processes following membership termination.

**Section 1.8 Voting Power.** Each member shall have one, and only one, vote, regardless of the number of shares of common stock owned.[ALTERNATIVE: The voting power of each member shall be as set out in the Articles of Incorporation and these Bylaws.]

**Drafting Note:** Alternative voting structures exist under some state laws. If an alternative voting structure is used, use the bracketed ALTERNATIVE provision and describe the voting power calculation elsewhere in the Articles of Incorporation or these Bylaws. Anything other than one-member, one-vote may have Capper-Volstead Act implications.

## ARTICLE II MEMBERS' MEETINGS

**General Drafting Notes:** State law may have specific or default provisions that dictate or influence Articles of Incorporation and Bylaw provisions and so should be carefully reviewed before relying on the provisions below with respect to members' meetings, including the location and timing of meetings; authority to call meetings; the form, timing and delivery of notice; quorum; voting; actions without a meeting; adjournment and resumption of meetings; proxies, voting by mail ballot; district meetings; etc.

**Section 2.1 Annual Meeting.** The annual meeting of the members of the Cooperative shall be held annually within [one hundred eighty (180)] days following the end of the Cooperative's fiscal year, at the principal place of business of the Cooperative, or at such other place conveniently located within the area served by it, and at such date and hour as may be determined by the Board of Directors and designated in the notice of the meeting.

**Section 2.2 Special Meetings.** Special meetings of the members may be called at any time by a majority vote of the directors or upon the written petition of at least twenty percent (20%) of the members.

**Section 2.3 Notice.** Notice of meetings of the members, both annual and special, shall be mailed to each and every member personally (or, in the case of an entity member, to the secretary or other authorized officer thereof) at said person's last known post office address, not less than [fifteen (15)] days previous to the date of the meeting. Upon the mailing of any notice of any meeting of members, the secretary shall execute a certificate, setting forth a correct copy of the notice and showing the date of the mailing thereof and that the same was mailed within the time and in the manner herein prescribed. Said certificate shall be made a part of the record of the meeting. If permitted by law, notice may be delivered by email or other electronic communication methods as approved by the Board of Directors.

### **Section 2.4 Participation in Meetings.**

- a) Any member who is absent from any meeting of the members may vote by mail ballot on the ballot herein prescribed upon any motion, resolution, or amendment which the Board of Directors may, in its discretion, submit to the members for vote by mail ballot. Such ballot may be in the form prescribed by the Board of Directors and shall contain the exact text of the proposed motion, resolution, or amendment to be acted upon at such meeting and the date of the meeting and spaces opposite the text of motion, resolution, or amendment in which such member may indicate said

## SAMPLE BYLAWS TEXT

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person's affirmative or negative vote thereon. Such member shall express said person's choice by marking an "X" in the appropriate space upon such ballot. Such ballot shall be placed in a plain, sealed enveloped inside another envelope bearing the signature of the member and when received by the Cooperative shall be accepted and counted as the vote of such absent member at such meeting. If permitted by law, the Board of Directors may also authorize voting to be done online or by other electronic voting methods as long as the Board of Directors determines the electronic voting method is secure in verifying the identity of the person voting.

- b) Members may participate in a meeting through use of conference telephone, electronic video screen communication, or other communications equipment. Participation in a meeting pursuant hereto constitutes presence in person at that meeting if all of the following apply:
  - i) Each member participating in the meeting can communicate with all of the other members concurrently.
  - ii) Each member is provided the means of participating in all matters before the members, including the capacity to propose, or to interpose an objection, to a specific action to be taken by the Cooperative.
  - iii) The Cooperative adopts and implements some means of verifying both of the following:
    - i) A person communicating by telephone, electronic video screen, or other communication equipment is a member entitled to participate in the meeting of the members; and
    - ii) All statements, questions, actions, or votes were made by that member and not by another person not permitted to participate as a member.

**Drafting Note:** These Sample Bylaws allow mail ballots to the extent approved by the Board of Directors and utilizing a two envelope balloting system. Applicable state law should be reviewed to determine whether mail ballots are allowed and the decision to authorize mail ballots should be made after careful consideration of the implications of such voting processes.

**Section 2.5 Quorum.** A quorum necessary to the transaction of business at any meeting of the members shall be \_\_ percent (\_\_%) of the total number of members entitled to vote at such meeting [ or \_\_\_\_ (\_\_\_) members, whichever is less]; provided, however, that in determining a quorum on a question submitted to a vote by mail ballot, members present in person or represented by mail ballot votes shall be counted. The quorum shall be established by a registration of the members present at such meeting, which registration shall be verified by the secretary and shall be reported in the minutes of the meeting.

**Section 2.6 Proxy or Cumulative Voting.** No proxy voting shall be allowed at any meeting of the members. [ALTERNATIVE: Voting by proxy shall be allowed on all matters of the Cooperative. In the event proxy voting is utilized, all proxies must be delivered to the Secretary of the Cooperative not less than [\_\_\_\_ (\_\_\_)] days prior to the meeting so that the proxies can be property verified by the time of the meeting.] No cumulative voting shall be allowed.

**Drafting Note:** These Sample Bylaws prohibit proxy voting. Applicable state law should be reviewed to determine whether proxy voting is allowed and the decision to authorize proxy voting should be made after careful consideration of the implications of such voting processes. If the Cooperative adopts proxy voting, the alternative provision should be used.



## ARTICLE III AUTHORIZED CAPITAL STOCK AND EQUITY

**Section 3.1 Common Stock Authorization and Terms.** The aggregate number of shares of common stock the Cooperative has authority to issue shall be \_\_\_\_\_ shares, which shall have voting rights as provided in these Bylaws and shall have a per share par value of \_\_\_\_\_ dollars (\$\_\_\_\_.\_\_\_\_). No dividends or interest shall be paid or payable on or in respect to common stock. Further terms, conditions, rights and features of the common stock shall be as set forth in the Articles of Incorporation or these Bylaws.

**Drafting Note:** The designation of authorized stock is often done in the Articles of Incorporation, but these Sample Bylaws includes it in the Bylaws as well in order to illustrate the equity structure. The drafter must consult applicable state law for equity requirements. The common stock is intended to be membership stock, providing the right to participate as a member in the operations of the Cooperative and granting the right to vote. The terms of the common stock are set out in the Bylaws and may not be amended by the Board of Directors without amending the Bylaws.

### Section 3.2 Preferred Stock Authorization and Terms.

- a) The aggregate number of shares of preferred stock the Cooperative has authority to issue shall be \_\_\_\_\_ shares, which shall have a par value of \_\_\_\_\_ dollars (\$\_\_\_\_.00) per share.
- b) The Board of Directors is authorized from time to time to accept subscriptions for, issue, sell and deliver shares of preferred stock of the Cooperative to any persons, partnerships or other entity at such times and upon such terms and conditions as the Board of Directors shall determine, establishing a price in money or other consideration, or a minimum price, or a general formula or method by which the price will be determined. The Board of Directors shall have the authority to designate different series or classes of shares of preferred stock with such terms, conditions, rights and features of shares of preferred stock as shall be determined and designated by the Board of Directors.
- c) The following apply to shares of preferred stock and preferred shareholders:
  - i) No Voting Rights. The preferred shareholders shall have no voting rights, except as required by law or as specified in the resolution authorizing the preferred stock of any series with respect to matters that would have a material adverse effect on the rights or preferences of the preferred stock.
  - ii) Dividend Limitation. Dividends on shares of preferred stock shall be limited to eight percent (8.0%) per annum.
  - iii) Dissolution Preference Rights. The preferred shareholders shall have preference rights upon dissolution of the Cooperative as set forth in Article X hereof.

**Drafting Note:** The preferred stock in these Sample Bylaws is intended to be “investment” or “delivery rights” stock, the terms of which will be determined by the Board of Directors. This may or may not be acceptable under applicable state law. The 8% dividend limitation is included for purposes of Capper-Volstead compliance. If used, separate classes of preferred stock should be created to denote investment and “delivery rights.” To the extent that preferred stock is used, the Bylaws should be

## SAMPLE BYLAWS TEXT

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carefully examined to ensure integration of such stock with all other applicable terms of the Bylaws (e.g., preferences on distributions or liquidation; voting rights; information rights; participation in select operations; etc.).

**Section 3.3 Transfer or Sale of Shares.** Neither common stock nor preferred stock shall be assigned, transferred, alienated or encumbered in any manner or by any means whatsoever, either voluntarily, by operation of law or otherwise, without the approval of the Board of Directors. Any such purported or attempted assignment, transfer, alienation or encumbrance shall be wholly void and confer no rights upon the purported assignee, transferee or claimant. Nothing in this Section 3.3 shall be deemed to preclude assignment of any equity fund credits as otherwise provided in these Bylaws.

**Section 3.4 No Dissenter's Rights.** A member of the Cooperative shall not have dissenter's rights as otherwise provided under applicable law.

**Drafting Note:** State law may not permit a waiver of dissenter's rights. Cooperative members may not have dissenter's rights under the law of some states.

**Section 3.5 Other Equity Interests.** The Cooperative may issue such non-stock equity interests as determined by the Board of Directors as provided in Section 4.7 hereof. Such non-stock equity instruments may be transferred only as allowed by the Board of Directors.

**Drafting Note:** Sample Bylaws § 3.5 provides authority for the Cooperative to create (in addition to common stock evidencing Member Equity ownership and preferred stock evidencing Investment Equity in the Cooperative) non-stock equity instruments evidencing commercial or patronage interests in the Cooperative.

**Section 3.6 Record of Stockholders.** A record of all holders of stock issued by the Cooperative shall be kept and maintained by the Cooperative. Lists of stockholders shall be prepared by the Secretary of the Cooperative in connection with any meetings or other action by stockholders as required by law.

**Section 3.7 Stock Uncertificated.** Shares of the Cooperative's stock shall be uncertificated.

## ARTICLE IV OPERATION ON A COOPERATIVE BASIS

### Section 4.1 Cooperative Operation.

- a) The Cooperative shall be operated on a cooperative basis in carrying out its business within the scope of the powers and purposes defined in the Articles of Incorporation. Accordingly, the net income of the Cooperative in excess of amounts credited by the Board of Directors to capital reserves shall be accounted for, allocated and distributed annually as provided in this Article IV. In determining the net income or net loss of the Cooperative or its allocation units, there shall be taken into account (i) the Cooperative's share of the net income or net loss of any unincorporated entity in which it owns an equity interest, (ii) patronage distributions distributed by other cooperatives of which it is a patron and (iii) to the extent determined by the Board of Directors, the Cooperative's share of the undistributed net income or net loss before tax of any corporation

or other entity in which it owns an equity interest.

**Drafting Note:** The Cooperative may wish to specify how earnings from wholly- or partially-owned subsidiaries will be handled. To the extent the subsidiary produces “patronage-sourced income” it would typically be consolidated with the parent cooperative’s patronage-sourced business. Subsidiaries not doing patronage-sourced business would typically be consolidated with the parent cooperative nonpatronage-sourced business. This provision assumes that treatment.

- b) Each transaction between the Cooperative and each Patron shall be subject to and shall include as a part of its terms each provision of the Articles of Incorporation and these Bylaws, whether or not the same be expressly referred to in said transaction. Each Patron for whom the Cooperative markets or procures goods or services shall be entitled to the net proceeds arising out of said transaction as provided in this Article IV unless such Patron and the Cooperative have expressly agreed to conduct said business on a nonpatronage basis. [Nonmembers shall not be entitled to the net proceeds arising out of said transactions as provided in this Article IV unless the Cooperative expressly agrees to conduct said business on a patronage basis.]

**Drafting Note:** These provisions assume that patronage distributions will be paid to both members and patrons. If patronage distributions are to be paid only to members the bracketed sentence should be included and the terminology should be changed to limit patronage distributions to “members”.

**Section 4.2 Definitions.** As used in this Article, the following definitions shall apply:

- a) “Investment Equity” means preferred stock, preferred capital certificates, capital equity certificates, or similar equity interests authorized by the Board of Directors from time to time, having the rights and obligations and subject to the terms and conditions as may be set forth in this Article IV. [As of the date of the adoption of these Bylaws, no forms of Investment Equity have been authorized or are outstanding.]
- b) “Member Equity” means the equity interests of each member in the Cooperative that are determined and fixed in the proportion that the patronage of each member bears to the total patronage of all members and may include common stock, patronage certificates, written notices of allocation, Per-Unit Retain Certificates or other similar equity interests authorized by the Board of Directors from time to time, having the rights and obligations and subject to the terms and conditions as may be set forth in this Article IV.

**Drafting Note:** Sample Bylaws § 4.2(a) and (b) are examples of instruments that may be used to reflect the equity accounts of the members. A description of the terms of each of such instruments should be reflected in Articles III or Article IV of the Bylaws. The names and terms of such instruments should be tailored to fit the Cooperative’s actual operations and use of such instruments.

- c) “Net Proceeds” means the net income or net loss from Patronage Business conducted by the Cooperative, before reduction for payments to members or nonmembers with respect to business conducted on a patronage basis and before reduction for any Per-Unit Retain Certificates.
- d) “Nonpatronage Business” shall refer to business done by the Cooperative that does not constitute “Patronage Business.”

## SAMPLE BYLAWS TEXT

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- e) “Patron” shall refer to any member or nonmember with respect to business conducted with the Cooperative on a patronage basis in accordance with Section 4.1 hereof.

**Drafting Note: If the Cooperative does not want to allocate patronage to nonmembers, subsection (e) should be appropriately adjusted.**

- f) “Patronage Business” shall refer to patronage-sourced business done by the Cooperative with or for Patrons or that is directly related to the Cooperative’s business or actually facilitates the Cooperative’s purposes.
- g) “Patronage Distribution [Refund]” means the final payment to Patrons based on the Net Proceeds of the Cooperative.

**Drafting Note: Nomenclature (as to “patronage distributions,” “patronage dividends” or “patronage refunds”) should be modified to reflect the Cooperative’s actual practice.**

- h) “Per-Unit Retain Certificates” means a portion of the progress payments made by the Cooperative to Patrons for marketing of their commodities that is held back to fund the [revolving fund][base capital] plan or other equity needs of the Cooperative, as described in a written notice of per-unit retain allocation to the Patrons.

**Drafting Note: Nomenclature should be modified to reflect the Cooperative’s actual practice.**

- i) “[PURPIM]” means cash progress payments made to Patrons for marketing of their commodities. The “[PURPIMs]” are the equivalent of the “Per-Unit Retain Paid in Money” under Code Subchapter T of the Internal Revenue Code of 1986 (the “Code”).

**Drafting Note: It may be helpful to insert the Cooperative’s name for payments to members for their product, e.g. Milk Check, Grain Check, Beet Check, Progress Payment, Delivery Payment, and the like. All of these are Per-Unit Retains Paid in Money (PURPIM) under Code Section 1382.**

**Section 4.3 Establishment of Pools or Allocation Units.** Pools or allocation units may be established by the Board of Directors on a reasonable and equitable basis and they may be functional, divisional, departmental, geographic, or otherwise. If pools or allocation units are established, the Board of Directors shall adopt such reasonable and equitable accounting procedures as will, in the Board of Director’s judgment, equitably allocate among such pools or allocation units the Cooperative’s income, gains, expenses and losses and, to the extent provided in Section 4.1 hereof, patronage distributions received by the Cooperative and its share of income, gain, loss and deduction of other entities in which it owns an interest.

**Section 4.4 Determination of Net Proceeds.** The Net Proceeds for each fiscal year shall be the sum of:

- a) The gross revenues directly attributable to goods or services marketed or procured for Patrons, plus
- b) An equitably apportioned share of other items of income or gain attributable to the Cooperative’s Patronage Business, less

- c) An equitably apportioned share of all other expenses and costs of goods or services (other than the [PURPIM]) directly attributable or apportioned to goods or services marketed or procured for Patrons by the Cooperative, less
- d) An equitably apportioned share of all other expenses or losses attributable to the Cooperative's Patronage Business, dividends on preferred stock to the extent that such dividends cannot be fully paid from net income from Nonpatronage Business as provided in Section 4.9(a) hereof, and distributable net income from Patronage Business that is credited to the capital reserve pursuant to Section 4.8(c) hereof.

The foregoing amounts shall be determined in accordance with the accounting treatment used by the Cooperative in calculating its [taxable income for federal income tax purposes][income in accordance with generally accepted accounting principles]; provided however, that the Board of Directors may prospectively adopt a reasonable alternative method. Expenses and cost of goods or services shall include without limitation such amounts of depreciation, cost depletion and amortization as may be appropriate, amounts incurred for the promotion and encouragement of cooperative organization, and taxes other than federal income taxes. Such net income or net loss shall be subject to adjustment as provided in Sections 4.6 and 4.9 hereof relating to losses.

**Drafting Note:** The Cooperative will need to determine if income will be determined on a book, tax, modified book or modified tax basis. In addition, any special considerations or exceptions to the general rule which are utilized by the Cooperative should be specifically provided for in these Bylaws.

### Section 4.5 Allocation of Net Proceeds.

- a) The net income from Patronage Business for each fiscal year shall be allocated among the Patrons in the ratio that the quantity or value of the business done with or for each such Patron during such fiscal year bears to the quantity or value of the business done with or for all Patrons. The Board of Directors will reasonably and equitably determine whether allocations shall be made on the basis of quantity or value, or a combination of the two. The Board of Directors may, in its sole discretion, allocate alternative minimum tax income or preferences among the Patrons.
- b) Upon the occurrence of an event of unusual or extraordinary income or loss (examples include, but are not limited to, the sale of a major asset at a significant gain or loss, or the resolution of a lawsuit with significant receipt or payment of funds), the Board of Directors may create a separate pool for that income or loss, and allocate that pool to a subset of members that in the judgment of the Board of Directors should appropriately share in that income or bear that loss. That allocation may be geographic, by time period, or by any other method deemed equitable in the judgment of the Board of Directors. In making that allocation, the Board of Directors may exclude former Patrons who are no longer Patrons as of the end of a fiscal year, who would have been included in the allocation group if they had remained a Patron. The Board of Directors will provide reasonable notice to the members of any such allocation.

**Drafting Note:** It may be desirable to include language giving the Board of Directors discretion to allocate "material gains or losses" over a period of years in the event of a sale of an asset or otherwise event outside of the ordinary course of business. Subsection (b) is recommended to cover unusual or extraordinary items of income or loss.

## SAMPLE BYLAWS TEXT

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### Section 4.6 Treatment of Patronage Losses.

- a) Methods for Handling Patronage Losses. If there is a net loss in any fiscal year from Patronage Business, the Cooperative may take one or more of the following actions:
  - i) Offset all or part of such net loss against the net income of other pools or allocation units, if any, for such fiscal year to the extent allowed by law;
  - ii) Establish accounts receivable from Patrons that may be satisfied out of any future amounts that may become payable by the Cooperative to each such Patron;
  - iii) Carry all or part of the loss forward to be charged against future net income of the allocation unit that incurs the loss;
  - iv) Offset all or part of such net loss against the capital reserve; and/or
  - v) Cancel outstanding allocated patronage equities in the amount of the loss.
- b) Allocation of Net Loss Among Patrons. Any cancellation of patronage equities and/or establishment of accounts receivable from Patrons pursuant to this Section 4.6 shall be made among the Patrons in a manner consistent with the allocation of net proceeds.
- c) Restoration of Net Loss out of Future Net Proceeds. The future net proceeds of an allocation unit that incurs a net loss may be reduced by part or all of such net loss that was offset against the retained earnings, patronage equities of another allocation unit or against the net proceeds of another allocation unit and may be used to restore the retained earnings, restore such patronage equities or to increase the future net proceeds of such other allocation unit; provided that reasonable notice of the intent to do so is given to the Patrons of the loss unit.
- d) Board Discretion. The provisions of this Section 4.6 shall be implemented by the Board of Directors, having due consideration for all of the circumstances which caused the net loss, in a manner that it determines is both equitable and in the overall best interest of the Cooperative.

#### ALTERNATIVE SECTION 4.6(d)

- d. Board Discretion. The provisions of this Section 4.6 shall be implemented by the Board of Directors having due consideration for all of the circumstances which caused the net loss. The Board of Directors generally shall endeavor to cause the economic burden of a net loss to be borne by Patrons of the allocation unit that incurs the loss. Nevertheless, the provisions that authorize a net loss to be offset against the Capital Reserve or against the net income of other allocation units may be implemented if and to the extent the Board of Directors determines that failure to offset will have a material adverse effect on the competitiveness of the allocation unit that incurs the net loss or on the Cooperative generally, or that such offset is both equitable and in the overall best interest of the Cooperative.
- e. No Assessments Against Members or Patrons. There shall be no right of assessment against members for the purpose of restoring impairments to capital caused by net losses.

### Section 4.7 Distribution of Net Proceeds.

- a) Net Proceeds Payments. The Net Proceeds allocated to a Patron pursuant to Section 4.5 hereof may be distributed annually or more often to such Patron as a [PURPIM], a Per-Unit Retain Certificate

or a Patronage Distribution as defined in Section 4.2 hereof. No distribution need be made of the Patronage Distribution where the amount otherwise to be distributed to a Patron is less than a de minimus amount that may be established from time to time by the Board of Directors.

- b) Form of Net Proceeds Payments. The Net Proceeds shall be distributed in cash and non-cash form as determined by the Board of Directors. Non-cash forms include preferred stock, Per-Unit Retain Certificates, written evidences of equity, book credits, and other securities of the Cooperative and otherwise, or any combination thereof designated by the Board of Directors. Cash payments can be in the form of PURPIMs or the cash portion of the Patronage Distribution. Non-cash distributions can be in the form of Per-Unit Retain Certificates or the non-cash portion of the Patronage Distribution, including, without limitation, the following instruments:
- i) Allocated equities, in one or more than one class or series, in such designations or denominations, and with such relative rights, preferences, privileges and limitations as may be fixed by the Board of Directors, and bearing no interest, dividend or other annual payment. Such equities shall be issued by book entry, without certificates.
  - ii) Certificates of indebtedness, in one or more than one class or series, in such designations or denominations, and with such relative rights, preferences, privileges and limitations as may be fixed by the Board of Directors, and bearing such maturity and rate of interest, if any, as may be fixed by the Board of Directors. Such certificates shall be issued by book entry and shall be callable for payment in cash or other assets at such times as may be determined by the Board of Directors.
  - iii) Nonpatronage Earnings Certificates, in one or more than one class or series, in such designations or denominations, and with such relative rights, preferences, privileges and limitations as may be fixed by the Board of Directors, with no maturity date, and bearing no interest, dividend or other annual payment. Nonpatronage Earnings Certificates may be distributed only to Patrons as part of the allocation and distribution of nonpatronage-sourced income. Such certificates shall be issued by book entry and shall be callable for payment in cash or other assets at such times as may be determined by the Board of Directors.
  - iv) Preferred Capital Certificates in one or more than one class or series, in such designations or denominations, and with such relative rights, preferences, privileges and limitations as may be fixed by the Board of Directors, and bearing no interest, dividend or other annual payment.
  - v) Other Interests, in the form of capital credits in such designations or denominations, and with such relative rights, preferences, privileges and limitations as may be fixed by the Board of Directors, and bearing no interest, dividend or other annual payment.

**Drafting Note:** The terms for all of the Cooperative's equity instruments should be included in the Article III or Definitions Section 4.2 of these Bylaws.

**Section 4.8 Capital Reserve.** The Board of Directors shall cause to be created a capital reserve that is not allocated to Patrons and, except as otherwise provided in Section 4.9 hereof, shall annually add to the capital reserve the sum of the following amounts:

- a) The annual net income of the Cooperative attributable to Nonpatronage Business;
- b) Annual net income from Patrons who are unidentified or to whom the amount otherwise to be

## SAMPLE BYLAWS TEXT

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distributed is less than the de minimus amount provided in Section 4.7(a) hereof; and

- c) An amount not to exceed [twenty percent (20%)] of Net Proceeds, provided that a determination as to a specific amount is determined prior to the first day of any fiscal year, and further that the amount is set at [ten percent (10%)] for any fiscal year for which the Board of Directors does not make a determination prior to the first day of such year. The discretion to credit Net Proceeds to a capital reserve shall be reduced or eliminated with respect to the Net Proceeds of any period following the adoption of a Board of Directors resolution that irrevocably provides for such reduction or elimination with respect to such period.
- d) Amounts carried in the capital reserve and not allocated to the members may be so allocated by the Board of Directors at any time.

**Drafting Note:** the percentages should be determined by the Cooperative based on its circumstances relevant to the Cooperative and could be reset by the Board of Directors within the established range from time to time in advance of the accounting year in which the business is done.

Federal and any state income taxes receivable from the Cooperative shall be charged to the capital reserve.

### Section 4.9 Allocation and Distribution of Nonpatronage Income and Loss.

- a) All dividends paid on preferred stock shall be paid exclusively out of current and accumulated net income from Nonpatronage Business and unallocated income from Patronage Business to the extent such net income is sufficient to satisfy any dividend obligation.
- b) The Board of Directors shall have the discretion to allocate to Patrons those amounts that are remaining after payment of dividends on preferred stock and that would otherwise to be added to the capital reserve pursuant to Section 4.8(a). Amounts so allocated shall be allocated among the Patrons on a patronage basis using such method as the Board of Directors determines to be reasonable and equitable. Amounts so allocated shall be distributed to Patrons thereof in the form of cash, property, other equity interests, or any combination thereof designated by the Board of Directors. The Board of Directors may determine whether and to what extent nonmember Patrons may share in such distributions.

**Drafting Note:** Subsection (b) permits the allocation of nonpatronage-sourced income to members in the current year. The drafter should discuss inclusion of this subsection with the Cooperative to determine if this is desirable. Typically, cooperatives do not actually make this allocation, but rather place the nonpatronage-sourced income into the unallocated reserve. An allocation of this type would typically be taxable to both the Cooperative and the member.

- c) Negative annual nonpatronage losses generally shall be chargeable against the Cooperative's capital reserve, if any, unless and to the extent the Board of Directors, having due consideration for the circumstances giving rise to such a net loss, determines that it is reasonable and equitable to allocate all or part of such a net loss among Patrons of the Cooperative using such method as the Board of Directors determines to be reasonable and equitable.

**Section 4.10 Base Capital Plan.** The Board of Directors may from time to time approve and/or modify reasonable and equitable plans for financing the Cooperative. Such plans may have as their objective



the alignment of member investment with member patronage. Such plans may further provide for the periodic adjustment of Member Equity by the retirement of allocated equity or revolving fund credits, and may contain requirements for new investments, in lieu thereof, the application of Patronage Distributions to additional investment requirements. Any such plan or plans, when approved by the Board of Directors, shall be binding upon all members of the Cooperative.

**Drafting Note:** These Sample Bylaws contemplate primary usage of a “revolving capital plan” for financing the Cooperative. If a base capital plan is to be used, such plan could be set out in the Bylaws. Below is a sample base capital plan provision:

### Alternative Section 4.10 Base Capital Plan.

- a) The Board of Directors may establish a base capital fund for the purposes of providing long-term capital required to operate the specified activity of the Cooperative. Each active member of the Cooperative participating in such specified activity shall commit to contribute capital to the base capital fund in proportion to such member’s volume of business done with the Cooperative with respect to such specified activity.
- b) The Board of Directors shall annually determine each participating member’s proportionate capital commitment to the base capital fund in [as set forth in the Base Capital plan adopted by the Board] [the following manner. First, the Board of Directors shall assess the short- and long-term capital needs of such specified activity and the availability of capital from nonmembers or Nonpatronage Business prior to determining the total requirement for the base capital fund. Second, the Board of Directors shall determine the base period to be used to determine each participating members’ proportion of the total volume of the specified activity. Third, the Board of Directors shall select the appropriate measurement unit or units of the volume of business for such specified activity, which may include adjustments which, in the sole discretion of the Board of Directors, may reflect the different capital requirements associated with the Cooperative’s specific business activities. Fourth, the Board of Directors shall calculate the capital requirement by dividing the amount of the base capital fund by the average number of units marketed annually for participating members during the base period. Fifth, the Board of Directors shall calculate each participating member’s required capital commitment by multiplying the per-unit capital requirement by the average annual number of units marketed by the Cooperative for such member during the base period.]
- c) Annually the Board of Directors may: (i) establish limitations on the amount of capital a member may be required to contribute in any given year; (ii) determine amounts, if any, to be paid by the Cooperative with respect to the amount by which a member’s total capital commitment exceeds the member’s capital contributed; (iii) establish limitation on and procedures for redemption of capital from members whose capital contributions are in excess of their capital commitment; (iv) establish special rules and priorities regarding redemptions from members participating in the specified activity who withdraw from the Cooperative or estates of deceased members; (v) determine priorities for redemptions when the specified activity has insufficient funds available to redeem all capital eligible for redemption; and (vi) establish such other rules as the Board of Directors, in its sole discretion, determines are necessary to ensure fair treatment of its present and past members. Redemption of capital credited to the base capital fund shall be at the capital’s face or par amount or at such lesser amount as may be agreed to by the Cooperative and the holder thereof.

## SAMPLE BYLAWS TEXT

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- d) Annually, the Board of Directors shall determine the method by which members may make any capital contributions required to be made to fulfill their commitment to the base capital plan as determined and limited by the Board of Directors. Such contributions may be comprised of Member Equity, Investment Equity, other equity interests, withholdings of amounts owing to such members or assessments on such members.
- e) All determination and limitations made by the Board of Directors with respect to the base capital fund and rights and obligations related thereto shall apply equally to all similarly situated members of the Cooperative during any one fiscal year.

## ARTICLE V CONSENT

**Section 5.1 Member Consent.** Each person that hereafter applies for and is accepted to membership in the Cooperative, and each member of the Cooperative on the effective date of these Bylaws who continues as a member after such date shall, by such act alone, consent that the amount of any distributions with respect to the member's patronage occurring for fiscal years commencing on or after \_\_\_\_\_, 20\_\_\_\_, which are made in qualified written notices of allocation (as defined in Code §1388(e)) and which are received by the member from the Cooperative, will be taken into account and included in the member's income at their stated dollar amounts in computing gross income in the manner provided in Code §1385(a) in the taxable year in which such written notice of allocation is received by the member.

**Section 5.2 Consent Notification to Members and Prospective Members.** Written notification of the adoption of this Bylaw, a statement of its significance and a copy of the provision will be given separately to each member and prospective member before becoming a member of the Cooperative.

**Section 5.3 Consent of Nonmember Patrons.** The Cooperative shall request that nonmember Patrons each provide written consent to include a qualified written notice of allocation in their gross income for federal income tax purposes if they are to receive or be allocated any such distribution or allocation. The Board of Directors shall have the discretion to require either a "consent in writing" type of consent or a "consent by qualified check" type of consent (as each term is defined by Code §1388(c), as amended).

## ARTICLE VI FIRST LIEN; RIGHT OF SET-OFF

**Section 6.1 First Lien.** Each member hereby grants, and the Cooperative shall have, a first lien on stock and other equity interests standing on its books, for all indebtedness of the respective members and Patrons to the Cooperative. The Cooperative may subordinate this lien to other indebtedness secured by such stock and other equity interests.

**Section 6.2 Right of Set-Off.** The Cooperative shall also have the right, exercisable at the option of the Board of Directors, to set off such indebtedness against the amount of such stock and other equity

interests standing on its books; provided however, that nothing contained herein shall give the holder of such stock or equity interests any right to have such set-off made. The Cooperative may accelerate the redemption of equity interests of holders thereof for purposes of accomplishing the set-off. In the event, the Cooperative exercises its right to set-off such indebtedness, then in the sole discretion of the Board of Directors, any sums so accelerated may be discounted to present value using a discount rate and time period deemed appropriate by the Board of Directors, and the present value as discounted may be set-off against the member's or Patron's debt or liability owing to the Cooperative.

## ARTICLE VII BOARD OF DIRECTORS

**General Drafting Notes:** This Article (i) establishes a fixed number of directors or allows the Board of Directors to establish the number of directors within a range, (ii) contemplates the use of geographic districts (as opposed to “at large” directors) as determined by the Board of Directors and (iii) permits the use of outside directors at the Board of Director’s discretion. Such provisions may or may not be permitted under applicable law and may or may not be desirable from the Cooperative’s perspective. The Article should be revised to reflect terms allowed by law, consistent with the actual practice of the Cooperative. Depending on the choices made, the various subsections below should be should be deleted or revised.

**Section 7.1 Board of Directors.** The number of directors shall be [\_\_\_\_ (\_\_\_\_)][no more than \_\_\_\_ (\_\_\_\_) nor less than \_\_\_\_ (\_\_\_\_), as determined by the Board of Directors from time to time; provided that at all times there shall be at least \_\_\_\_ (\_\_\_\_) directors who are members of the Cooperative]. Each Director shall be an individual member of the Cooperative or a designated representative of an entity member of the Cooperative. Each Director shall serve for a term of three (3) years, which term shall commence at the end of the annual meeting [or District meetings] of the members at such director is elected, and shall be divided into three (3) classes such that approximately one-third (1/3) of the directors shall stand for election each year.

a) District Directors.

- i) The Board of Directors shall determine geographic districts (“Districts”) which shall be geographically described [as designated on the master district map on file in the Cooperative’s main office][as follows: include description].
- ii) The directors to be elected from the geographic districts (“District Directors”). The Board of Directors shall from time to time redistrict the area in which the members live and change said District as the Board of Directors deem appropriate to best serve the interest of the members. The Board of Directors shall call District meetings of the members belonging to a District to be held at least ten (10) days prior to the annual member meeting. The notice of said District meetings shall be given to the members within such District by mail in the same fashion as notice of annual member meeting provided in Section 2.3 hereof. District Directors shall be elected by a majority of members residing in such District and voting at such District meeting. Every member attending the District meeting shall be entitled to cast one (1) vote at such election.

## SAMPLE BYLAWS TEXT

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- b) At-Large Directors. In addition to the District Directors, the Board of Directors may designate that there will be one or more directors-at-large (“Directors-At-Large”). Each Director-At-Large shall be elected by a majority vote of all members voting at the annual meeting of the members or voting by District at the annual District meetings of the members. Every member attending an annual meeting or the District meeting shall be entitled to cast one (1) vote at such election.
- c) Outside Directors. The Board of Directors shall have the power, at its sole discretion to appoint up-to three (3) nonmember outside directors (“Outside Directors”). The Outside Directors shall be [voting][non-voting] and shall be elected by the majority vote of the Board of Directors then in office. The Board of Directors shall have the power to increase or decrease the number of Outside Directors from time to time. The Outside Directors shall serve for a term of one (1) year from the date of their election.

**Drafting Note:** This provision assumes that outside directors are appointed by the Board of Directors. Outside directors could also be elected by members in a manner similar to At-Large Directors. This provision also assumes that outside directors have all of the rights and responsibilities of elected directors. Some cooperatives opt for the appointment of “advisory directors” in order to avoid state law issues with outside directors.

District Directors and At-Large Directors must remain members of the Cooperative or a designated representatives of entity members of the Cooperative throughout the entire term of the Director’s office. Upon termination of the membership or designation as a representative of an entity member of the Cooperative of any District Director or At-Large Director, whether by withdrawal, expulsion, automatic termination or otherwise, such director’s term of office shall automatically terminate.

### Section 7.2 Vacancy; Removal.

- a) Each vacancy occurring in the Board of Directors, other than by the removal of a director by the members or by the expiration of a term, may be filled until the next meeting of the members by a vote of the remaining directors. In the case of a District Director, the person so selected shall be a resident member of the District in which the vacancy occurs.
- b) Any director may be removed from office with or without cause by vote of not less than a majority of the voting members of the Cooperative (as to At-Large Directors) or of the District (as to District Directors) present at any meeting of members, the notice for which includes such purpose. If a director is removed, the members removing such director may at the same meeting fill the vacancy.

### Section 7.3 Meetings.

- a) Meetings Generally. The Board of Directors shall meet regularly at such times and places as the Board of Directors may determine. Special meetings may be called by the chairperson or a majority of the directors. All meetings shall be held on such notice, if any, as the Board of Directors may prescribe; but any business may be transacted at any meeting without mention of such business in either the call or the notice, if any, of the meeting.
- b) Teleconference Meetings. A conference among directors, or among members of any committee designated by the Board of Directors, by any means of communication through which the participants may simultaneously hear each other during the conference, constitutes a meeting of

the Board of Directors or the committee, if the same notice is given of the conference as would be required for a meeting, and if the number of persons participating in the conference would be sufficient to constitute a quorum at the meeting. Participation in a meeting by such means constitutes personal presence at the meeting.

- c) No Proxy Voting. There shall be no voting by proxy at Board meetings.

**Drafting Note:** State law may have specific or default provisions that dictate or influence Articles of Incorporation and Bylaw provisions and so should be carefully reviewed before relying on the provisions below with respect to directors' meetings, including the location and timing of meetings; authority to call meetings; the form, timing and delivery of notice; quorum; voting; actions without a meeting; adjournment and resumption of meetings; proxies; etc.

**Section 7.4 Quorum.** A quorum shall consist of a majority of the directors. A majority vote of the directors present shall decide all questions except where a greater vote is expressly required by law or these Bylaws.

**Section 7.5 Compensation.** The compensation, if any, of the directors and officers shall be as fixed from time to time by the Board of Directors.

**Drafting Note:** Director compensation may be considered to be an interested transaction for directors. Best practice to avoid potential challenges would be for the Bylaws to provide for specific compensation (either as a specific amount or within a range) or require subsequent ratification by members of any changes in director compensation. Alternatively, the Board of Directors could establish the fairness to the Cooperative of changes to director compensation through a compensation survey or a report from an independent expert as to director compensation of similarly situated entities.

**Section 7.6 Board Committees.** The Board of Directors may, from time to time, appoint such committees as it deems appropriate and prescribe the duties and responsibilities of, and establish the number of members to be appointed to, each committee, either through direct vote or by approval of a charter for such committees. Minutes of the proceedings of such committees shall be kept as part of the books and records of the Cooperative.

**Section 7.7 Audit Committee; Audit.** The Board of Directors shall establish an audit committee (or a committee by another name that performs the functions of the audit committee). The audit committee shall provide for an independent annual audit of the Cooperative's financial statements, with a report to be presented to the members on an annual basis. The Board of Directors may further prescribe the duties and responsibilities of the audit committee.

## ARTICLE VIII OFFICERS

**Section 8.1 Election of Officers.** Promptly following each annual meeting of the members of the Cooperative, the Board of Directors shall elect from among the District Directors and Directors-At-Large, a chairperson and a vice-chairperson, and shall at the same time elect a secretary and a treasurer who may, but need not, be a director. The offices of secretary and treasurer may be held by the same person and,

## SAMPLE BYLAWS TEXT

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when so held, may be termed secretary-treasurer. The Board of Directors shall employ a chief executive officer and may appoint such additional officers with such titles, powers, and duties, and for such terms, as said Board of Directors may determine.

**Section 8.2 Chairperson.** The chairperson shall (a) preside over all meetings of the members and of the Board of Directors; and (b) have all authority ordinarily held by the chairperson of a corporation, but said person need not devote said person's full time to the business of the Cooperative or to actively supervise its ordinary business.

**Section 8.3 Vice-Chairperson.** In the absence or disability of the chairperson, the vice-chairperson shall perform the duties of the chairperson.

**Section 8.4 Secretary.** The secretary shall (a) take or supervise the taking of complete minutes of all meetings of the members and of the Board of Directors; (b) have custody of the Cooperative's minute book and of its corporate seal, if any; (c) give, or cause to be given, all notices as required by law or these Bylaws; and (d) perform such additional duties as may be required of said person by the Board of Directors.

**Section 8.5 Treasurer.** The treasurer shall (a) supervise the safekeeping of all funds and property of the Cooperative; (b) supervise the keeping of complete books and records of all financial transactions of the Cooperative; and (c) perform such additional duties as may be required of said person by the Board of Directors.

**Section 8.6 Chief Executive Officer.** The Board of Directors shall employ a chief executive officer to manage the day-to-day affairs and business of the Cooperative. The chief executive officer shall have the authority to implement the functions, duties and obligations of the Cooperative except as restricted by the Board of Directors.

## ARTICLE IX INDEMNIFICATION AND INSURANCE

**Section 9.1 Right of Indemnity.** The Cooperative shall indemnify and advance expenses [to any person, including] any director, officer, employee or agent of the Cooperative, for such expenses and liabilities, in such manner and under such circumstances, to the fullest extent permitted by applicable law.

**Section 9.2 Insurance.** The Cooperative may purchase and maintain insurance on behalf of [any person, including] any director, officer, employee or agent of the Cooperative against liability asserted against and incurred by such person in such person's official capacity, whether or not the Cooperative would have been required to indemnify such person against such liability under Section 9.1 hereof.

## ARTICLE X DISSOLUTION

**Section 10.1 Distribution of Assets.** Upon dissolution and after all debts and liabilities of the Cooperative shall have been paid or reasonably reserved against, the remaining assets shall be distributed in the order set forth below, as follows:

- a) The par amount of all Investment Equity, together with any accrued but unpaid dividends, shall be paid to the holders thereof in full (or pro rata to the extent of remaining assets if insufficient assets exist to make payment in full); then
- b) All Member Equity furnished through patronage distributions and unit retains, shall be retired without priority as to year to the holders thereof in full (or pro rata to such holders to the extent of remaining assets if insufficient assets exist to make payment in full); then
- c) The par value of members' shares of common stock shall be returned to the holders thereof.

Any amounts remaining after the foregoing payments have been made shall be allocated among the Patrons in such manner as the Board of Directors, having taken into consideration the origin of such amounts, shall determine to be reasonable and equitable. Amounts so allocated shall be paid to current and former Patrons of each such allocation unit in proportion to their patronage of such unit over such period as may be determined to be equitable and practicable by the Board of Directors. Such obligation to distribute shall be construed as a preexisting duty to distribute any patronage-sourced net gain realized in the winding up process to the maximum extent allowable by law.

**Drafting Note:** Some cooperatives specify a patronage time period (e.g., 10 years) for determining the members to whom the cooperative's residual value will be distributed. Other cooperatives provide for distributing the residual only to current patrons. These cooperatives typically have very stable patrons that don't change much from year to year. The dissolution provisions and applicable law should be carefully reviewed, in advance of any dissolution, to determine fair and equitable treatment for the circumstances for each cooperative. Failure to establish in advance fair and equitable provisions has resulted in substantial litigation with unintended consequences for cooperatives and its members.

**Section 10.2 Treatment of Members' Rights in the Event of a Merger, Reorganization or Consolidation.** In the event of a merger, reorganization or consolidation of the Cooperative or to which the Cooperative is a party, the property rights and interests of members of the Cooperative shall be recognized and preserved in an equitable manner which corresponds in general to the property rights and interests of members recognized on dissolution of the Cooperative.

## ARTICLE XI ARBITRATION

### Section 11.1 Arbitration of Disputes.

- a) Any dispute (a "Dispute") between this Cooperative and a member or members with respect to membership in this Cooperative and/or performance under the terms of any contract between this Cooperative and the member shall be resolved through binding arbitration as provided in this Article XI. A party may demand arbitration of a Dispute by written notice to the other party. Any Dispute with respect to which arbitration has not been commenced within two (2) years after the alleged claim or alleged cause of action has accrued, shall be deemed waived.
- b) Equitable Remedies. Notwithstanding anything to the contrary in this Article XI, the mandatory

## SAMPLE BYLAWS TEXT

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arbitration of disputes set out in subsection (a) above shall not preclude the right of the Cooperative to seek judicial enforcement of the contractual obligations of any member or members through injunctive or other equitable relief from a court of competent jurisdiction which is sought in good faith and not otherwise for the purpose of avoiding arbitration under the provisions this Article XI.

**Section 11.2 Selection of Arbitrators.** Within ten (10) days after a written demand to arbitrate a Dispute, the parties shall agree on a single, neutral arbitrator if the Dispute involves \$250,000 or less in damages, restitution or other financial relief; and agree on three neutral arbitrators if the Dispute involves over \$250,000 in damages, restitution or other financial relief. In the event that the parties cannot agree on such arbitrator or arbitrators in that time period, the parties agree that [the American Arbitration Association (“AAA”)] shall select such arbitrator or arbitrators within thirty (30) days after being asked to do so by one of the parties to the Dispute. If the [AAA] selects the arbitrator or arbitrators, the [AAA] will also administer the arbitration.

**Section 11.3 Arbitration Procedures.** The arbitrator or arbitrators shall follow substantive rules of law and the Federal Rules of Evidence; allow for the parties to request discovery pursuant to the rules then in effect under the Federal Rules of Civil Procedure for a period not to exceed sixty (60) days; require the testimony to be transcribed; and issue an award that is accompanied by findings of fact and a statement of reasons for the decision. Neither the Cooperative nor any members shall be liable for any punitive or exemplary damages. Each Dispute shall be determined upon its own facts and circumstances, and no procedure in the nature of a class action, and no joinder or consolidation of one person’s claim with the claim of any other person, shall be permitted in an arbitration.

**Section 11.4 Costs.** All costs and expenses, including attorney’s fees, of all parties incurred in any Dispute which is resolved by arbitration pursuant to this Article shall be borne by the party determined to be liable in respect of such dispute; provided, however, that if complete liability is not assessed against only one party, the parties shall share the total costs in proportion to their respective amounts of liability so assessed.

**Section 11.5 Continued Performance.** Except where clearly prevented by the area in Dispute, both parties agree to continue performing their respective obligations while the Dispute is being resolved.

**Section 11.6 Binding Effect.** The decision and award determined through arbitration shall be final and binding upon the parties; provided that the courts shall have jurisdiction to review alleged errors of law based upon a review of the arbitration record and the evidence. Any arbitration award or decision that does not have errors of law may be confirmed in any appropriate \_\_\_\_\_ state court in the County of \_\_\_\_\_.

## ARTICLE XII FISCAL YEAR; MISCELLANEOUS PROVISIONS

**Section 12.1 Fiscal Year.** The fiscal year of the Cooperative shall be \_\_\_\_\_ through \_\_\_\_\_. If necessary, the fiscal year of the Cooperative may be changed by action of the Board of Directors.



**Section 12.2 Registered Office; Other Offices.** The registered office of the Cooperative in the State of \_\_\_\_\_ shall be located at \_\_\_\_\_. The name and address of the Cooperative's registered agent shall be \_\_\_\_\_. The Cooperative may also have offices in such other places as the Board of Directors may from time to time determine or the business of the Cooperative may require.

**Section 12.3 Books and Records.** Except as otherwise required by statute, the books and records of the Cooperative shall be kept, within or without the State of \_\_\_\_\_, as such office or offices of the Cooperative as the Board of Directors may from time to time designate for such purpose.

**Section 12.4 Corporate Seal.** The Board of Directors may adopt, alter or abandon the use of a corporate seal. If adopted, such seal shall be kept in the custody of the Secretary and shall be fixed by the Secretary or by such other office or person as may from time to time be authorized to do so by the Board of Directors to any instrument for which provision for the affixation of a seal is made.

## ARTICLE XIII AMENDMENTS

**Section 13.1 Amendments.** These Bylaws may be amended at any regular or special meeting at which a quorum is present, in person or by mail ballot and acting throughout, by a majority of the members so present or represented by mail ballot, where the notice of such meeting contains a summary statement of the proposed amendment. These Bylaws may also be amended, at any meeting of the Board of Directors, by a two-thirds vote of all directors then serving. Any amendment of these Bylaws adopted by the Board of Directors must be distributed to the members no later than ten (10) days after the adoption and the notice of the annual meeting of the members must contain a notice and summary of any such amendment to these Bylaws adopted by the Board of Directors. The members shall have the right to re-amend, void, and supersede any amendment of these Bylaws by the Board of Directors to the extent provided under applicable state law.

**Drafting Note:** Sample Bylaws Article XII permits either the members or the Board of Directors (with notice and a right of veto in the members) to amend the Bylaws. This may not be permitted under some state laws.

## ARTICLE XIV UNCLAIMED PROPERTY

### Section 14.1 Unclaimed Property.

- a) A claim for payment to a member or Patron shall be deemed unclaimed within the meaning of this section whenever the Cooperative (i) is ready, able and willing to pay such claims; (ii) has paid or is generally paying claims arising under similar circumstances; (iii) has not paid such amount because the Cooperative does not know the whereabouts or payment address of the person entitled to payment or such person has not claimed or cashed the instrument used by the Cooperative for payment; and (iv) such claim has been outstanding for at least [the period allowed by applicable state unclaimed property laws][\_\_\_ (\_\_) years] after becoming payable.

## SAMPLE BYLAWS TEXT

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- b) If any such claim for payment is unclaimed as hereinabove provided, the Cooperative shall
  - (i) pay such unclaimed property amount to the relevant authority in accordance with applicable state unclaimed property laws applicable to the Cooperative or, (ii) to the extent allowable under applicable state unclaimed property laws, charge off the amount of such claim as a liability on its books and designate the amount of the claim to be the property of the Cooperative and to be used as determined by the Board of Directors; provided that at least sixty (60) days prior thereto the Cooperative shall have (1) sent, by first class or certified mail, a written notice thereof, addressed to the person appearing from the records of the Cooperative to be entitled to payment of such claim at the last known address of such person as shown by such records, and (2) published such notice in a newspaper of general circulation in the county in which such person resides as so shown by the records of the Cooperative.
- c) Upon completion of the actions provided for in subsection (b), any claim for such unclaimed property shall be deemed extinguished and no suit for its collection can be maintained thereon against the Cooperative.



# APPENDIX I

# WORKING GROUP BIOGRAPHIES AND CONTACT INFORMATION

**Teresa Castanias** has a tax consulting practice focused on cooperative issues and other business and individual tax matters. She retired from KPMG in September 2009 where she was the firm's National Director for Technical Tax Services for Cooperatives and was responsible for providing tax consulting, compliance and tax provision services to Consumer and Industrial Markets, and Financial Services clients, including cooperatives and non-cooperative enterprises in food production, manufacturing, distribution and retail, rural electric and telephone, Farm Credit System agricultural lending, banking and financial services. Teree has had a broad range of experience with all types of cooperatives and non-cooperative businesses. Teree has substantial experience leading and coordinating tax engagements, and focuses now on consulting with cooperatives on business and tax issues. She provides subject matter knowledge and guidance on cooperative issues in her business. She also works with several accounting firms providing advice and counsel on cooperative issues to those firms and their clients. Teree has also provided litigation support services from deposition, expert reports to testimony at trial for several clients, including cooperatives. Teree is also serving on the Farm Credit West, A.C.A. Board of Directors. Teree is a graduate of the University of Notre Dame, and has completed graduate course work in accounting and taxation at Seattle University. She can be reached at **Teresa Castanias, CPA, 7401 Pedrick Road, Dixon, CA 95620, (916) 761-8686; tcastanias@aol.com.**

**Marlis L. Carson** is Senior Vice President and General Counsel for the National Council of Farmer Cooperatives, a trade association located in Washington, D.C. Marlis coordinates the activities of NCFC's Legal, Tax and Accounting Committee on federal issues impacting farmer cooperatives. She also manages the association's legal, financial, and tax compliance issues, and serves as its corporate secretary/treasurer. Prior to joining NCFC in 2004, Marlis served as a tax manager in Ernst & Young's National Tax Department in Washington, D.C. She grew up in Kansas and is a graduate of Sterling College (Sterling, Kansas) and of The George Washington University Law School. She is a member of the Virginia State Bar. Marlis can be reached at the **National Council of Farmer Cooperatives, 50 F Street, N.W., Suite 900, Washington, DC 20001, (202) 879-0825; mcarson@ncfc.org.**

**William I. Covey** is the Senior Associate General Counsel for GROWMARK, Inc. He received his Bachelor of Science degree in Accountancy (With Honors) from the University of Illinois in 1980 (Certified Public Accountant) and his Juris Doctorate (Summa Cum Laude) from Southern Illinois University in 1983. He worked for Heyl, Royster, Voelker & Allen for over thirty-two years. He provided legal services as outside counsel to GROWMARK, Inc. and its members from 1999 until joining GROWMARK on January 1, 2016. These services included mergers and acquisitions, contract review and corporate governance. Since joining GROWMARK, he has continued to work on acquisitions, contract review and corporate governance for GROWMARK and its subsidiaries. He can be reached at **GROWMARK, Inc., 1701 Towanda Avenue, Bloomington, IL 61701, (309) 557-6292; bcovey@growmark.com.**

**Todd R. Eskelsen** has been working with cooperatives and other clients for over 30 years in all aspects of their operations, governance and transactions. As a business transactional attorney, Todd regularly acts as an outside general counsel and also regularly advises on specific legal issues involving M&A, joint ventures and financing transactions, exempt securities offerings, antitrust issues and tax exempt organization and compliance matters. He has also led teams of attorneys and other professionals on internal corporate

investigations, acquisitions of U.S. targets by foreign purchasers, litigation, antitrust investigations and government contracting matters. Todd is a graduate of the University of Utah (Salt Lake City, UT) and Georgetown University Law Center (Washington, DC). He can be reached at **Eskelsen Law Group, LLC, 4011 Glenridge Street, Kensington, MD 20895, (240) 460-1115; teskelsen@eskelaw.com.**

**Robert P. Glass** has been employed at Land O'Lakes, Inc. for twenty years and has been their Tax Director for sixteen of those. He holds a degree in Accounting and is a CPA (inactive) licensed in Minnesota. Bob is a past Chair of the Legal, Tax and Accounting committee of the National Council of Farmer Cooperatives and is also very active in the National Society of Accountants for Cooperatives and the Tax Executive Institute. Bob also was an auditor for the Minnesota Department of Revenue for twelve years and a Tax Manager at KPMG for five years prior to landing at Land O'Lakes. He can be reached at **Land O'Lakes, Inc., 4001 Lexington Ave N, Arden Hills, MN 55126, (651) 481-2734; bpglass@landolakes.com.**

**Daniel S. Hall** is Deputy General Counsel for GROWMARK, Inc. He received his undergraduate degree from Western Illinois University in 1981, and his law degree from the University of Illinois in 1984. He became Deputy General Counsel in 2006 after serving as Assistant General Counsel since 1999. Prior to GROWMARK, Hall worked for eleven years at the IAA Office of the General Counsel (1986-1997) and two years with the law firm Heyl, Royster, Voelker & Allen (1997-1999). Hall was also the Compliance Officer for GROWMARK and its subsidiaries from 2003 to 2009. The majority of his responsibilities revolve around large acquisitions and mergers, employment law, grain law and contract review. He can be reached at **GROWMARK, Inc., 1701 Towanda Avenue, Bloomington, IL 61701, (309) 557-6294; dhall@growmark.com.**

**Eric V. Krienert** is a Tax Director with Moss Adams and leads the firm's cooperative tax practice. Eric has worked in public accounting since 1997. He is experienced in tax planning and consulting for large partnerships and corporations in the food and agriculture industries, but his specialty lies in cooperatives. He provides services related to patronage philosophy and formulating patronage allocation programs based on book, tax, and hybrid programs; equity planning; mergers and acquisitions, joint ventures, and other combinations; nonqualified equities; and domestic manufacturing deduction and taxation. Eric is currently the Vice-Chairman of the Tax Committee and a member of the National Board of Directors for the National Society of Accountants for Cooperatives (NSAC). He can be reached at **Moss Adams LLP, 3121 W March Lane, Suite 200, Stockton, CA 95219, (209) 955-6118; eric.krienert@mossadams.com.**

**Daniel C. Mott** is a shareholder in Fredrikson & Byron's Corporate Group and leads the firm's Cooperative and Agribusiness Group. Dan works throughout the country with both large and small cooperatives and other types of businesses. Dan also advises clients on securities, tax and anti-trust issues that are unique to cooperatives and other member-owned organizations. Dan is a frequent speaker on structure and governance issues affecting cooperatives, including new cooperative strategies, joint ventures and the roles and responsibilities of corporate directors. Dan is an experienced "general counsel" and assists his clients in achieving their business objectives in the context of the increasingly complex legal environment in which businesses operate today. Dan counsels his clients by providing practical, business oriented advice that can be utilized by clients to achieve their unique legal and business objectives. Dan is the past Chair of the Legal, Tax and Accounting Committee of the National Council of Farmer Cooperatives and currently chairs the Subcommittee on Litigation Involving Cooperatives and Their Members. Dan is a director and past Chairperson of the United Hospital Foundation in St. Paul and currently serves as the Chair of Innovative Quality Schools, an authorizer of public charter schools. He can be reached at **Fredrikson**

## APPENDIX I

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**Ronald C. Peterson** has been engaged in a general business and transactional practice of law for more than 45 years, specializing in agricultural cooperatives. Ron's practice has involved considerable experience with virtually all aspects of agricultural cooperatives, including general corporate, securities, antitrust and tax matters. He has worked with a wide variety of agricultural cooperatives, including marketing, supply, service and bargaining cooperatives. He has been actively involved with the Legal, Tax and Accounting Committee of the National Council of Farmer Cooperatives since 1975 and is a past chair of the LTA Committee. Ron is a graduate of the University of California at Berkeley where he earned both a Bachelor's degree and MBA and is a graduate of the Stanford Law School. He can be reached at **Hanson Bridgett LLP, 425 Market Street, 26th Floor, San Francisco, CA 94105, (415) 995-5005; rpeterson@hansonbridgett.com.**

**Charles J. Sullivan** is a member of the law firm of Bond, Schoeneck & King, PLLC, and practices primarily from his firm's Syracuse, New York office. Charles chairs his firm's agribusiness practice. Charles is a business attorney who represents cooperatives, agricultural suppliers, agricultural lenders, food processors, other agribusinesses and farmers in a broad array of matters, including: mergers and acquisitions; cooperative formation, governance, finance, taxation, exempt securities offerings and antitrust compliance; secured lending, workouts, financial restructuring and bankruptcy; and business and succession planning. Charles has drafted legislation affecting cooperatives, and is a frequent speaker on a variety of business and agricultural law topics, including the organization and governance of farm cooperatives. He is a graduate of St. Lawrence University (BA), the State University of New York at Buffalo School of Law (JD), and the Graduate Program in Agricultural Law at the University of Arkansas School of Law (LL.M). He was raised on a dairy farm in Malone, New York. He can be reached at **Bond, Schoeneck & King, PLLC, One Lincoln Center, Syracuse, NY 13221, (315) 218-8144; csullivan@bsk.com.**

**David P. Swanson**, an attorney at Dorsey & Whitney LLP (Minneapolis), has been a partner in the corporate practice group since 1998, and co-chair of the Cooperative Law practice group. For over 30 years he has worked primarily with cooperatives, large and small, assisting with legal issues unique to cooperatives, including governance, tax and securities issues. Dave has also assisted clients in connection with organizational issues, project development, financing and transactions. His client base covers many cooperative sectors, including agricultural cooperatives, rural electric cooperatives, consumer cooperatives and purchasing cooperatives, as well as cooperative financial institutions. Dave has also been actively involved in cooperative education, including team teaching a Cooperative Law seminar at the University of Minnesota Law School, and serving as the Chair of the Mergers & Acquisitions and Joint Ventures Subcommittee of the National Council of Farmer Cooperatives, Legal Tax & Accounting Committee. Dave is also on the Board of the National Cooperative Bank, the National Cooperative Business Association, Cooperative Development Services, and the NorthCountry Cooperative Foundation. He is a frequent speaker and author on matters relating to cooperatives. Dave is a 1978 graduate of St. Cloud State University (B.S., chemistry) and a 1981 graduate of Vanderbilt University School of Law. Prior to joining Dorsey & Whitney, he worked for 15 years at Doherty, Rumble & Butler in St. Paul, Minnesota, and two years at Chapman and Cutler in Chicago. He can be reached at **Dorsey & Whitney LLP, 50 South Sixth Street Suite 1500, Minneapolis, MN 55402, (612) 343-8275; swanson.dave@dorsey.com.**

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