Opinion No. 63-149

November 4, 1963

BY: OPINION of EARL E. HARTLEY, Attorney General

TO: Barney Cruz, Jr., Director Corporation Department State Corporation Commission Santa Fe, New Mexico

QUESTION

QUESTIONS

1. May an association allocate to its members the reserves required to be established under § 45-14-12 (c), N.M.S.A., 1953 Compilation?

2. Is the amount of required reserves under Section 45-14-12, supra, for an association which issues capital stock based only upon those shares of capital stock which represent the membership interest in the association?

CONCLUSION

1. Yes.

2. Yes.

OPINION

*{*343}* **ANALYSIS**

Prior to answering in detail the two questions promulgated above, it is necessary to give a brief explanation of the two types of marketing associations authorized under the Cooperative Marketing Association Act, §§ 45-14-1 through 45-14-23, N.M.S.A., 1953 Compilation. Essentially the two types of associations are those whose members comprise a group paying a membership fee, and those whose members comprise a group holding common stock in the association. The first type of association does not issue stock but obtains its capital through membership fees. The second type of association obtains its capital through issuance of capital stock, and its members are the holders of the common stock in the association. Section 45-14-3 (b) provides as follows:

"The term member means in addition to those admitted to membership in an association without capital stock, holders of common stock in associations organized with capital stock."

Section 45-14-4, N.M.S.A., 1953 Compilation, indicates that associations may be organized by five or more natural persons of full age, engaged in the production of agricultural products either as tenants or landowners who are residents of this state, or any other, or two or more cooperative organizations organized under the laws of this state, or any other, and that these persons may form a nonprofit cooperative association with or without capital stock under the provisions of the Act.

It is necessary to realize the distinction between the "fee" associations and the "stock" associations in order to properly analyze the intent of the legislature in promulgating statutory rules to be followed in the operation of each type association.

The particular statute in question is § 45-14-12, N.M.S.A., 1953 Compilation, which deals with "Issuance of Membership Certificates and Stock." Section (a) of this statute relates to the time in which a member of an association may receive his certificate of membership or stock certificate. That time *{*344}* being when his membership fee, or stock subscription, is paid in full. Section (b) prohibits an association from issuing membership certificates or stock until they have been fully paid for, but allows a member to vote as soon as 20% of his membership fee, or stock certificate, has been paid. Section (c) of this statute is presently under question and provides, as follows:

"An association shall limit the interest it pays on membership capital or stock to an amount not greater than eight per cent (8%) per annum. Such apportionment shall not be made until not less than ten per cent (10%) of any undistributed balance accruing since the last apportionment, has been set aside in a surplus or reserve fund unless such surplus or reserve fund equal at least one hundred (100%) per cent of the paid up membership fees or capital stock."

Section (d) relates to distribution of balances in excess of additions to reserves and surplus.

The first question is whether the association may allocate to its patrons the reserves which the statute requires to be established. It is, of course, essential that the reserves remain in the ownership of the cooperative, and the term "allocate" does not mean in this case that the members will receive the funds allocated to them. In this sense, the terms "allocate" and "apportion" mean two different things. The allocation contemplated in this opinion is a bookkeeping transaction by the association to indicate the amount of its unapportioned reserves required by law which represents the patronage of the member in the association. Such allocation may be important to the members even though they do not receive the funds so allocated. For instance, the member would be able to determine for income tax purposes his portion of the earnings of the cooperative for a given year which he has not received due to the statutory reserve requirement. Such allocation might possibly be necessary for the association to maintain a tax exempt status. Further, such allocation would allow a ratable distribution of the reserves in cases of dissolution of the company or where a rotating reserve fund is established.

In order to determine whether such allocation would defeat the statutory intent, it is necessary to determine the intent of the legislature in establishing the minimum reserve under § 45-14-12 (c), supra. The statute in question requires that 10% of any undistributed balance accruing since the last apportionment by the association must be set aside in a surplus or reserve fund unless such surplus or reserve fund equals at least 100 percent of the paid-up membership fees or capital stock. It appears that the intent of the legislature in establishing the required reserve for the associations was to assure protection of the association's creditors by establishing an adequate reserve fund, and to establish a means for maintaining capital in the association. It is a well known and fundamental rule in the law dealing with marketing associations that the association can deduct from profits owing to its members on a proportionate basis to establish a reserve fund for emergencies and for working capital. Such fund, of course, may be used in many different ways by the association in its financial operations. See for example, **Burley Tobacco Growers Cooperative Association v. Tipton** (1928), 11 S.W. 2d 116, a leading Kentucky case. From reading the cases and by referring to such encyclopedic works as 43 C.J.S., page 28, it is evident that a typical method of obtaining working capital for most associations is by a deduction from profits owing *{*345}* to the members, whether they be "fee" members or "common stock" members. An allocation of these assessments for reserve account to each member in accordance with his patronage, would not in any way impair the function of the reserve account. It would, however, allow the members to achieve the maximum benefit from the reserve without defeating its purpose. Therefore, it is the opinion of this office that allocations of the reserves required under § 45-14-12 (c), supra, are permissible.

The second question involves an interpretation of the last phrase of § 45-14-12 (c), supra. The phrase reads, as follows:

". . . unless such surplus or reserve fund equal at least one hundred (100%) per cent of the paid up membership fees or capital stock."

The question is whether the reserve fund in a stock cooperative must equal one hundred percent of the common stock or 100% of both the common and preferred stock.

Initially it should be pointed out that the term "capital stock" generally encompasses both common stock and preferred stock. Such interpretation in the present case, however, is not warranted. In the first place, if an association is a fee association, as opposed to a stock association, the statute only requires a reserve fund equaling 100% of the fees. Thus, the minimum capital paid in must equal the amount of the membership fees. In a stock association on the other hand, the holders of common stock are the members of the association. The preferred stockholders, as is usually the case, are not members and do not have a voice in the control of the corporation. Thus, if the statutory section in question is interpreted to mean that the reserve fund for stock associations must include 100% of the paid-in common and preferred stock, the stock associations will be, in effect, required to maintain a greater reserve than the fee associations. Further, since "membership" in the association consists of either a fee or a

share of common stock, it would appear that the term "membership" in the above quoted phrase modifies both fee and capital stock as used in the statute. This interpretation of the statute would mean that the reserve fund for the association would equal at least 100% of the paid-up "membership" **fees,** or 100% of the paid-up "membership" **capital stock.** "Membership capital stock" is common stock. It appears that the intention of the legislature was to include only common stock in the reserve fund requirement for stock associations.

This interpretation becomes more evident when the purpose of the reserve fund requirement is investigated. One purpose of such reserve fund would be to protect creditors of the cooperative, and the second purpose might be to maintain a minimum working capital for the cooperative. A requirement that the reserve fund equal 100% of both common and preferred stock would, in effect, require an establishment of a fund against the paid-in preferred stock. Preferred stockholders are more in the nature of creditors of the corporation than they are owners. In fact, the owners of the association are the holders of the common stock. The common stockholders control the association through their voting power and would be in a position to reduce the size of the reserve fund to an extent less than the paid-in capital represented by the common stock. This, in effect, would damage the financial stature of the cooperative to the detriment of all creditors, including preferred stockholders. On the other hand, there is little danger of the members of the association *{*346}* allowing less than full paid-in preferred stock to exist, since such would amount to their paying interest on the preferred stock when they did not receive the benefit of the capital. Thus, there is an obvious need to limit by statute the extent to which the reserve fund be reduced by the common stockholders, but little need to protect the corporation against the preferred stockholders. The statutory reserve fund appears to be merely a legislative attempt to protect the association by establishing a minimum reserve fund. In view of the fact that a statute contemplates a reserve fund only equal to the paid-in membership fees in a membership association, it appears that the intent on stock associations is to require a reserve fund equal to the "membership capital stock," i.e., the common stock. Therefore, it is our opinion that the reserve fund of the corporation should equal at least 100% of the paid-up common stock of the association.

By: James E. Snead

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