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FCSA Sale to Rabobank: Selling What? On Whose Authority? And For Whose Benefit?

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Rabobank's proposed buyout of Farm Credit Services of America (FCSA) would not, on its face, seem to be a radical event. Buyouts, mergers, and consolidations are certainly not an uncommon event in the US economy. Aren't buyouts nothing more than one of the methods firms use to adjust to changes in market conditions? Absent any egregious anticompetitive side effects, they usually occur with a minimum of fanfare beyond the press releases of the parties involved.

But in the case of FCSA, there were strong and sometimes strident outcries from a number of quite varied sources. Challenges were coming not only from some of the current FCSA members, but also from former directors and members, other farm credit institutions, and even some US congressmen and senators. Just what made the proposed FCSA deal so different from all of the others?

At least some of the differences observed in the Rabobank-FCSA case are related to the ambiguities created by (a) the FCSA charter and its intent; (b) the relationships of FCSA to the rest of the Farm Credit System (FCS); (c) the historical background of the FCSA entity; (d) the fact that FCSA is organized as a cooperative rather than an investor-oriented corporation (IOC); and (e) the FCSA pattern of retaining its earnings as unallocated equity rather than allocating it to borrowers. These factors not only create a larger set of stakeholders than would typically be the case for an IOC, but they also create a much different set of claims and expectations.

The Charter

The charter for the FCS banks or Agricultural Credit Associations differ from typical commercial bank charters in a couple of important ways. The vast majority of corporate charters, including those for commercial banking corporations, are issued by the states. In addition, the charter is required to enter the banking business. These banking charters are issued and regulated by either state banking authorities, or the Office of the Comptroller of the Currency (OCC) in the case of national banks, and usually permit the holder to take deposits from the public. The charters issued to the Farm Credit System banks do not permit depository rights and are issued by the federal government in accordance with farm credit legislation passed by Congress. But, there is another key difference. FCS charters are issued in a way that guarantees that there is an FCS bank serving the producers in all geographic areas of the United States. Thus, the charters are issued as a means of meeting a legislative mandate rather than simply enabling the establishment of a commercial entity. At a minimum this complicates the question of selling an FCS Bank or Ag Credit Association such as FCSA to a non-FCS entity.

After such a sale, the legislative mandate still exists for the FCS to serve the geographic area. However, the operational means to accomplish the mandate has been sold to a noneligible entity that is beyond the reach of the FCS regulators. There is always the option to charter a new FCS entity and start over. However, it could take years before the new entity could develop significant market share, become well capitalized, and effectively serve the market. The "new start-up" solution also ignores the question of whether there is a genuine need for an additional player in the market. Just how the intended uniform access to the FCS would be achieved remains an issue in this kind of transaction.

Whether the current shareholders of an FCS chartered Agricultural Credit Association or a FCS bank have the unilateral authority to liquidate the capital built up while it was operating under that FCS charter is also an open question. In addition to the unique responsibilities mandated by the charter, there are also unique advantages. The charter carries some significant tax and funds acquisition advantages for building equity and reserves that would generally not be available to other non-FCS institutions.

As long as the FCS-chartered entity continues to perform its legislative mandate, these advantages are more easily defended. But when a group of stockholders attempt to sell the Agricultural Credit Association or bank and distribute its accumulated unallocated surplus and reserves, the special treatment may be less defensible. The action would not only leave the FCS entity in a poor position to perform on its legislative mandate, it would also create a more favorable treatment for the current set of FCS Agricultural Credit Association stockholders than the treatment accorded similar sets of stockholders in other non-FCS lenders.

The Other Banks in the Farm Credit System

Other banks in the system were clearly not supportive of the sale, and some raised vocal opposition to their members, regulators, and the press. It would appear that the stockholders of FCSA would have the undisputed authority to sell or dissolve without any obligation to the other parts of the FCS. All of the Farm Credit System banks and associations (including CoBank, AgroBank, etc.) are independent business entities with separate balance sheets governed by separate boards of directors and owned by distinct sets of stockholders. Why should other FCS banks and Agricultural Credit Associations care if FCSA dissolves itself?

Despite the autonomy of each FCS bank or entity in most visible respects, they have some less obvious interdependencies and shared responsibilities. When FCS bonds are sold into the financial markets, they are sold for the entire FCS as a whole rather than individual FCS chartered banks or associations. This means that exit of an FCS entity with significant loan volume has the potential impact of reducing the size of issues. Likewise, exit of an FCS entity serving a specific region may marginally reduce the geographic and commodity diversity of the portfolio behind the issue. Perhaps even more significantly, all of the banks and associations in the system are "jointly and severally liable" for the bonds issued. Stated differently, in the event that an FCS entity fails and cannot meet its obligations to bondholders, a formal set of loss-sharing procedures defined among the remaining FCS entities is triggered.

Thus, a portion of the equity in all FCS banks or Agricultural Credit Associations serves as the first line of defense when a system entity cannot meet its obligation to FCS bondholders. This procedure was last triggered in the mid-1980s during the farm debt crisis, when capital from all parts of the Farm Credit System was used to prevent default when some of the banks began to fail. Subsequently, even this measure proved inadequate. Assistance from the US government was required to partially recapitalize many of the entities in the Farm Credit System to avoid a default on bonds that had been issued.

When it became apparent that US government assistance would be required to avoid default, the FCS banks and Agricultural Credit Associations did not approach the government individually. Instead, the Farm Credit System as a whole made a unified request. When the money provided by the government to avoid default was repaid in the 1990s, it was done through the system. FCSA benefited from these system-wide activities at a critical point in its history.

Although the individual Farm Credit System entities operate autonomously with respect to managing and capitalizing their activities, the authority for an entity to unilaterally decide to sell or liquidate itself remains unclear. The agreements for joint and several liability and the established patterns of joint behavior in times of great crisis for FCSA creates some ambiguity about the true extent of this autonomy. At a minimum, there is a serious question about whether any bank that has benefited from loss sharing and government assistance has absolutely no obligation to the rest of the system and is free to behave in a way that diminishes the stature and effectiveness of the system.

Organization as a Cooperative Versus an IOC

Firms organized as cooperatives share many characteristics with firms organized as investor-oriented corporations. Both are state-chartered corporate entities controlled by elected directors with a fiduciary responsibility to shareholders who have invested equity capital. Both are subject to market forces and may fail unless explicit intervention by government prevents it. To the general public, there are few visible differences as the firms go about their day-to-day business.

There are, however, a number of important differences between the two. Capitalization is one key difference. In a cooperative, the people using the products and services of the firm usually provide the equity capital required by the firm. In virtually all cases, some level of capitalization is required if the user is to share in the profits generated from the firm's operation. Some cooperatives require capital to be provided not only as a condition for sharing in the profits generated by the cooperative, but also as a prior condition for gaining access to the products and services the cooperative produces. Farm Credit System banks impose this requirement on their borrowers.

In contrast, the investment activity in an IOC and the access to the firm's services are completely decoupled. A consumer of the IOC's goods and services may or may not choose to be an investor and an investor in the IOC may or may not choose to use the firm's products and services. Any melding of the role of investor and consumer is strictly voluntary and occurs entirely at the pleasure of the party involved.

Distribution of net margins or profits is another important difference between cooperatives and IOC's. Net profit margins generated by IOC's are distributed to stockholders based on the amount of equity provided. If the net margins are retained in the business instead of being distributed to stockholders, the value of the IOC is expected to increase. The presumption is that shareholders will receive more for their shares when they sell them and thereby capture the value.

Cooperatives generally distribute net margins based on the level of business that a member shareholder has done with the cooperative rather than the level of investment the member shareholder has made in the cooperative. The idea is to operate on an "at-cost" basis by returning any excess net margins above actual cost to those who were charged more than actual cost when they purchased products and services from the co-op. It is also common for cooperatives to distribute at least a portion of the net margins as equity rather than cash. This creates a pool of equity that has been retained to meet the need for additional equity. However, unlike the retained earnings in the IOC, these earnings have been identified with individual stockholder names, and there is an expectation that it will be redeemed in cash at some future date. It should be noted that most cooperatives hold some of the net margins as unallocated surplus reserves. It permits some level of operating loss to be absorbed without canceling some of the equity that has been allocated in prior years. (However, it is not at all common for a cooperative to retain virtually all of the earnings as unallocated equity, as FCSA did.)

Because members who do more business with the cooperative receive a proportionately greater percentage of the earnings, they also contribute a proportionately greater percentage of the allocated equity under this arrangement. Stated differently, their ownership of the cooperative is kept in rough proportion to their use. As long as the stockholder's equity contribution is roughly proportional to the level of business done with the cooperative, there is little quantitative difference between what the stockholder would have received had the net margins been distributed based on the amount of equity he or she held.

This raises the question: If there is little or no difference, then why not just organize as an IOC and pay out the net margins based on profits? The answer lies in the motivation the founders have for forming the organization. If the motivation is simply to maximize return on capital invested, then the IOC is the superior choice. Once formed, the IOC is free to seek out maximum return to shareholder capital as its singular goal and pursue any legal opportunity to do so.

However, if the motivation is to address some sort of market failure (such as providing a product or service that is underprovided by the market or providing increased competition in the marketplace), the cooperative may be a better choice. In that case, the founders want to limit the activity of the firm to those markets they use and wish to influence. Although it is still important to generate a return on shareholder investment, maximizing return on investment is not the singular goal. A dual goal of correcting market failure and generating an acceptable return on invested capital is pursued. An additional consequence of the dual goal is a more complex board of director's fiduciary responsibility to shareholders.

A third important difference between cooperatives and IOC's is the way that owners exit the business. In the typical publicly traded IOC (and some that are not publicly traded), the IOC assumes no responsibility to redeem its stock in cash. The stockholder must sell the shares to a third party in order to receive the value of his or her interest in the company. Potential buyers of the stock are presumed to capitalize any undistributed net earnings into the share price; thus, the sale of stock incorporates the value of any undistributed net margins due the shareholder into the share price.

In contrast to the IOC, cooperatives typically redeem purchased shares of stock at the same face value it had at the time of purchase. Net margins that have been issued as equity for later redemption are handled in a similar fashion. This creates no problem as long as the cooperative allocates all of the net margins to individually identified users of the cooperative. When a member exits, he or she has explicit rights to both the purchased share and the allocated net margins received while actively using the cooperative.

However, if net margins have been retained as unallocated surplus (without an identified user's name attached), a serious problem arises in reflecting the increased value of the firm when the stockholder no longer needs the co-op and wishes to exit. The share price is fixed and will be redeemed at the same value it had when it was purchased. If the net margins have been held in unallocated form instead of allocated, the shareholder has no explicit rights to them. Absent any explicit claims, cooperative members receive the value of the unallocated surplus only upon sale or dissolution—an extreme measure.

Because few (if any) FCSA earnings had been allocated since the mid-1980s, this was precisely the situation confronting FCSA shareholders in 2004. Following the farm debt crisis of the mid-1980s and the passage of the Agricultural Credit Act of 1987, FCSA and its predecessor banks had dutifully repaid government assistance given, capitalized an insurance fund, and steadily rebuilt reserves by withholding earnings as unallocated surplus reserves.

Under the leadership of the board of directors (and most likely at the behest of regulators), members borrowing from the bank during this period agreed to forgo receiving allocated patronage refunds in order to rebuild adequate reserves to provide the bank with enough reserves to withstand another period of disastrous losses without assistance from the government. Apparently, most borrowers felt that ensuring the existence of a viable Farm Credit System bank dedicated to providing a consistent source of competitively priced long- and intermediate-term credit to agriculture was worthy of the sacrifice.

Some would argue that FCSA had gone past the level of reserves required for prudence and could have begun allocating equity long before it did in late 2004. Indeed, a large number of the sister Agricultural Credit Associations and FCS banks in the Farm Credit System (including CoBank) had done so. Perhaps this was due to an incomplete understanding about the differences between cooperatives and IOC's and the inability of cooperative stockholders to access unallocated reserves. Or, perhaps the turmoil experienced in the 1980s caused the management and board of FCSA to act with an abundance of caution and to continue to build unallocated reserves. One can only speculate about the motives, but the fact that Federal Land Bank sourced earnings could be placed into surplus without taxation almost certainly played at least some role. It enabled these earnings to be placed into surplus without a tax consequence. Had these earnings been allocated to members, either the member who received the allocation or the co-op would have had to pay income tax on them.

The Offer From Rabobank

By early 2004, FCSA found itself holding a very large pool of unallocated equity with no visible way (short of sale or liquidation) for members to access it. This made it an ideal target for an outside offer to purchase. Sale of the FCSA would result in an inflow of cash; the cash could then be distributed to current stockholders who had purchased shares of stock at a modest cost as a condition for joining. The payout would be multiples of the relatively modest price of the shares they had purchased. This creates an enormous incentive to sell the cooperative, perhaps even at a bargain price.

The payout to current shareholders would be very lucrative even if the sale price of FCSA were significantly less than its value as a going concern or its fair market value. Division of only half the fair market value (as estimated by some analysts) among the relatively small number of current stockholders would still yield a significant sum. Some large-volume borrowers would receive sums in five or six figures. All of this presumes that the current members of FCSA hold the only legal claims to the unallocated surplus reserves and can legitimately divide the proceeds among themselves. But are the current stockholders of FCSA really the exclusive and rightful owners of the unallocated surplus?

The answer for an investor-owned corporation (which pays its stockholders based on the amount of equity they hold) is straightforward. It belongs to the current stockholders. Those who have sold their stock and are not currently shareholders have no claims. Presumably, the value of retained earnings was capitalized into the stock price when they sold their shares. Thus, all prior stockholders received fair market value at the specific time of the sale, and all of the value of the unallocated retained earnings would be due to current stockholders.

In the case of FCSA (which is a cooperative), the answer is not so simple. Several key differences between cooperatives and ordinary investor-oriented corporations complicate things. (a) Unlike the ordinary corporation, earnings in the cooperative are issued to stockholders based on their use of the cooperative rather than on the amount of capital provided, and in nearly all cases the equity cannot be publicly traded. (b) The decision to invest was not solely based on generating a return on investment. For FCSA borrowers it was also coupled with the right to use the cooperative. The FCSA borrower *had* to be a stockholder in order to use the cooperative. (c) The equity in FCSA is purchased and redeemed at face value. Those who redeemed their stock after paying off their loan received only face value. This is radically different than what happens in an IOC. For the IOC, the level of unallocated retained earnings is usually reflected in the share value at the time it is purchased and at the time the share is sold.

When the current shareholders of FCSA bought their shares in the cooperative, the price they paid for the share did not reflect the capitalized value of the unallocated retained earnings. But if they sold or liquidated FCSA, they stood to divide the surplus and receive many times what they paid for their share.

So Who Owns the Capital Surplus?

The ambiguities that arise from the FCSA charter, its relationship to the other FCS banks, FCSA's own history, and its cooperative structure raise serious questions about who has legitimate (if not strictly legal) claims to the unallocated surplus reserves. A case could be made that several different groups and institutions could lay claim to at least a portion of the reserves. At least five such potential claimants could be identified:

- the current stockholders;
- the past stockholders who contributed to building the surplus;
- the successor FCS Ag Credit Association chartered to replace FCSA;
- the other Farm Credit System banks that provided assistance; and
- the government who provided the initial risk capital, special tax treatment, and recapitalized it in the 1980s.

The unallocated surplus in FCSA represents an endowment generated by past members for current (and future members) to use in capitalizing the lending cooperative. It was not generated exclusively by the current stockholders. Nor was the investment cost for current stockholders adjusted to reflect the level of unallocated retained earnings when they entered. Finally, the decision of individual stockholders to buy or sell was based on their need for credit rather than the level of unallocated retained earnings.

So who owns the surplus? Is it those past member stockholders who generated it by forgoing the option to receive a patronage refund on their interest bill? Is it the current member stockholders who now own and use the cooperative and will make the decision of whether or not to liquidate? Or is it possibly the future member stockholders who will want to join a well-capitalized Agricultural Credit Association? Stated differently, should the surplus be taken into the new Agricultural Credit Association that will be chartered to replace FCSA after it has been sold?

One possible answer is it belongs to those who generated the surplus over the past 20 years or so. It could be argued that those who owned and used FCSA during the critical period when FCSA was being recapitalized in the mid-1980s have the most legitimate claims. However, 20 years is a long time, and there are numerous difficulties in looking back that far. More than a few of those members are now deceased and their estates long ago settled.

Another possible answer is that those who have the most legitimate claims are the members who used the cooperative over a more recent (albeit still somewhat arbitrary) period when much of the retained earnings were generated. This has in some cases been formalized in cooperative statutes. Some state statutes (including Iowa, which is part of the FCSA market territory) designate that unallocated retained earnings must be distributed to current and former patrons based on the amount of unredeemed allocated equity they hold.

This kind of provision allows those who did business with the cooperative in the past, and contributed to building the surplus, to share in the distribution—even though some of them may no longer be active members. But in the case of FSCA, virtually all the earnings were put into surplus, and there is no allocated equity to use as a basis for determining how much each patron should receive. It would be necessary to pick some arbitrary period, look back, and calculate what the claims *would have been* if the equity actually had been allocated rather than put into surplus.

A third possible answer is that people who are currently owners and users have the most legitimate claim. They, after all, have undertaken the current fiduciary responsibility for the assets of FCSA, and they are the ones who have the voting rights. But, should the entire endowment be distributed to them simply because they happen to be members at this time? Was it really the intent of prior members (who built the surplus) to create a windfall for the voting members at some future moment in time?

A fourth possible answer is that the surplus is truly an endowment from past and current users for use in capitalizing a user-owned and -controlled cooperative for current and future farm borrowers. Upon sales of liquidation, should at least the majority of the endowment be kept and used toward capitalizing the new FCS Agricultural Credit Association that will have to be chartered and formed to serve the region? Could it be argued that those who built the surplus did it for that purpose rather than for the purpose of distributing it in its entirety as a windfall gain to current members?

Some would argue that the remaining parts of the system should get at least some of the surplus. All parts of the system assume "joint and several liability" for the other parts. If FCSA benefited from this assurance during the period when the surplus was built, does it not have a legitimate claim to at least some of the surplus? To a degree, the exit fee levied by the FCS does this, but questions can be raised about whether the fee is more or less than adequate to accomplish this.

Finally, some might argue that the US taxpayers have a legitimate claim to at least part of the unallocated reserves. The portion of the unallocated surplus that was sourced from land loans was never taxed. Furthermore, the system was conceived and started by the US government, and the majority of the capitalization through the most risky periods of its life came from the government. Some might argue that the taxpayers should have a claim.

Technically, the government assistance was structured as a loan, and it has been repaid in full. But most would agree that at least part of these funds played the role typically played by equity capital rather than the role typically played by debt capital. Is it reasonable that some of the unallocated reserves should be returned to the taxpayers as a return for taking on the role of entrepreneur and venture capitalist during start-up and the most perilous times FCSA has survived? If they are not compensated for playing these roles, should the taxpayers at least be compensated for the untaxed earnings sourced from FCSA's land lending activities?

Going Forward from Here

The buyout process was halted before it went to stockholders for a vote. We will never know how it would have played out. It is still interesting and perhaps helpful to consider who would have had the most just or legitimate claim. Would it have been only the narrow legal claims of current stockholders that counted in the end? Would it have simply been decided on the provisions in FCSA articles of incorporation and provisions in the FCSA bylaws along with board resolutions? Or have other stakeholders weighed in through the courts? Or would Congress perhaps have weighed in through legislation? The answers will never be known. It may be useful to consider the other stakeholder claims and evaluate their merit as a measuring rod for future actions. The FCSA experience implies a need for some changes going forward.

Greater effort needs to be made in differentiating the role of the board of directors in a cooperative and from the role of an IOC board. Although there are many similarities, and both IOC and Cooperative boards serve the same general function, the cooperative board has a much more complex task. In many cases, this is not well understood by cooperative boards.

IOC commercial bank boards have a fiduciary responsibility to protect stockholders' investments and maximize return on stockholders' investments. Regulators and insuring agencies such as the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), and the Office of Comptroller of the Currency (OCC) in the Treasury Department place added fiduciary responsibilities on IOC commercial banks to protect customers.

Cooperative boards have a similar responsibility to protect the stockholders' investments and to earn a return on the stockholder's investment. Regulators and insurers, such as Farm Credit Administration and FCS Insurance Corporation, place added fiduciary responsibilities on cooperatively owned Agricultural Credit Associations such as FCSA to protect their borrowers in much the same way that the FDIC and OCC do for IOC commercial banks.

However, the fiduciary responsibility of the cooperative board to its congruent set of owner-users goes beyond that of the IOC board's responsibility to its noncongruent sets of shareholders and customers. The fact that the owners and the users are congruent does not exempt the cooperative board from earning a return on it invested capital. It does, however, place constraints on what the board can do *in pursuit of* returns on invested capital. Although the cooperative board is pursuing return on its capital, it must also ensure that the stockholder's investment is applied in a way that benefits stockholders *as users as well as investors.* Balancing the two is sometimes difficult, and it nearly always forecloses some of the options for generating a return on capital that are readily available to the IOC.

Greater efforts also need to be made to assist cooperative management and boards in understanding the differences in the mechanics that exist between benefit flows from IOCs and benefit flows from cooperatives. Actions that are fair to IOC shareholders will not always be fair for cooperative shareholders. Because cooperative stock and allocated equity is redeemed at face value, the fiduciary responsibility of cooperative directors could extend well beyond the contemporaneous set of voting shareholders in many cases. Simply copying IOC behavior will not always lead to a similar result in a cooperative. It is important for cooperative boards to understand this and communicate it effectively to hired management—especially when the prior experience base of that management has not been in the cooperative sector.

The incentives created by the tax exemption for Federal Land Bank earnings also need to be carefully evaluated. If the exemption applies only when earnings are held as unallocated reserves, it may create future problems similar to the ones encountered at FCSA. One possible solution would be to permit earnings to be allocated as nonqualified patronage distributions by the Agricultural Credit Association with no taxation until the allocation is actually redeemed to the borrower in cash. This would, in essence, leave the Agricultural Credit Association in the same position it currently holds. However, it would identify the member whose business generated the earnings and create an explicit future claim for that member—even if he or she had repaid a loan and exited. By creating a specific property right, this action would eliminate some of the exiting incentive for current stockholders to sell or liquidate as a means of dividing the unallocated surplus.

Finally, there needs to be a clearer specification of what individual system banks and associations have the authority to sell unilaterally. Title to real estate, vehicles, and fixtures are probably not in question. It seems clear that the FCS charter for a regional bank cannot be sold to an entity outside FCS. However, it is less clear whether the loans, customer lists, customer history, and other customer information are the exclusive property of the Agricultural Credit Association or the FCS. The procedures for exiting the system, and the property rights of the stakeholder groups, need to be much more clearly defined before the next sale of an FCS entity is attempted.

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