RE: Agriculture and Agriculture Related Cooperative Act/Additional General Background/Information n and Industry Content on Cooperatives

TO: Commissioners, National Conference of Commissioners on Uniform State Laws

FROM: Tom Geu, Reporter
Agriculture and Agriculture Related Cooperative Act

DATE: June 11, 2004

A. Purpose of Memorandum

The purpose of this memorandum is to give interested individuals additional general background information on cooperatives in conjunction with the Agriculture and Agricultural Related Cooperative Act Drafting Project. More specific information on the federal law relating to cooperatives and an additional historical perspective are included in the Appendix to this memorandum. The material in the Appendix is graciously provided by Donald A. Frederick, Program Leader, Law, Policy & Governance, USDA/Cooperative Service. Mr. Frederick has attended the drafting meetings and has been very helpful to the Committee. His materials are excellent. Please note the disclaimer on his materials.

The memorandum is organized as follows:

B. Basic and Traditional State Law Structure

There are many similarities between cooperatives and other forms of business. Thus, cooperatives organize under state statutes. Historically these statutes generally tracked the law governing corporations in the various states. Typically, therefore, cooperatives have articles of incorporation, bylaws, and a board of directors elected by its members. Frequently cooperative statutes expressly refer to either the state's general business corporation act or its not-for-profit corporation act to fill statutory gaps that may arise under the cooperative act. Many states have both "stock" and "nonstock" cooperative statutes. *Nonetheless, cooperatives are unique among entities.*

A key distinction between cooperatives and other forms of business organizations is that a cooperative distributes its income to a particular member in accordance with the member's use (patronage) of the cooperative's services. Indeed, one source flatly states: "The primary function of a cooperative is the allocation of economic benefits, either in he form of net savings or net earnings, to the member-patron based on the quantity of business done with the member-patron."[1] This function, "is consistent with the goal of maximizing members' interests and the notion that the cooperative is an

[1] McEowen and Harl, *Taxation of Cooperatives, BNA-Tax Mgmt. Series* at 3.

extension of the members' business operations."[2] The following illustrates this principle in the context of a commodities marketing cooperative:

> To accomplish this objective, a cooperative attempts to market patrons' commodities at the highest possible price and purchase quality inputs at the lowest possible cost. The resulting savings (usually referred to as net income rather than profits) belong to the patrons and are distributed to them at least annually, usually in the form of patronage refunds, though not necessarily all in cash. Typically, at least 20% is paid out as a cash patronage refund and the balance is invested in the users name as a retained patronage refund. The retained portion is redeemed at a later time, usually when the user has stopped using the cooperative.[3]

The focus on patronage as a metric for the allocation of net income limits the amount of income and available to pay for the use of capital and, sometimes, state statutory law limits dividends paid on account of equity contribution (return on capital) to 8 percent (although 8 percent is also important for anti-trust reasons).

The focus on returning income and savings based on patronage is consistent with the historical values of cooperatives. The foundation of the law is the "Rochdale Principles." The "Rochdale Principles" originated with the Rochdale Equitable Pioneers Society in 1844. The Society was an English workers society and it established twelve principles; which seem to have coalesced into four generally accepted principles. These principles are: "(1) business at cost with net returns paid to members based on patronage; (2) democratic control, one person, one vote; (3) limited dividends on invested capital; and (4) ownership (or beneficial membership) limited to patrons."[4] Additionally, most cooperatives have an "open" membership and allow nonmember "patrons" to do business with the cooperative. The Rochdale Society ran a store (consumer cooperative) and it might be safe to assume

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[2] *Id.*

[3] *Id.* at 3-4.

[4] Hanson, "Legal Framework of Cooperative Development," Ch. 5 *Cooperatives and Development* at 1 (in press). There is some slippage as to the number of principles. For example, J. Gary McDavid listed eight principles as the Rochdale Principles in a speech in 2002: (1) Open membership; (2) Democratic control based on one vote per member; (3) fixed low rate of interest on invested capital; (4) Patronage refunds; (5) Cash trading; (6) Good sold at retail, not wholesale, prices; (7) Promotion of education; (8) Political and religious neutrality.

The International Co-operative Alliance defines a cooperative as, "an autonomous association of person united voluntarily to meet their common economic, social, and cultural needs and aspirations through jointly-owned and democratically-controlled enterprise." It has generated a values statement of its own as follows: "Cooperatives are based on the values of self-help, self-responsibility, democracy, equality, equity, and solidarity. In the tradition of their founders, co-operative members believe in the ethical values of honesty, openness, social responsibility and caring for others." Finally the Alliance lists seven co-operative principles similar to those already set forth. Two of the principles, however, are somewhat unique in their emphasis. One of the two is that cooperatives "serve their members most effectively . . . by working together through local, national, regional, and international structures." The other cooperatives "work for the sustainable development of their communities through policies approved by their members."

that the store was not capital intensive.[5]

State statutory provisions are generally consistent with these general principles (no matter of their exact formulation). Thus, for example, state statutes variously govern the voting rights of members. It is fair to say that most statutes provide for voting based on the one member – one vote principle. That is, each member has one vote regardless of the amount of patronage by that member in the current or preceding year and regardless of the amount of capital either contributed by that member or allocated but retained in the member's equity account. Such a voting scheme is similar to default voting in the Uniform Partnership Act (both 1914 and 1997) and some limited liability company acts. Some states, however, provide for outside investment by allowing the issuance of preferred stock with very limited governance and dividend rights.

As stated previously, most statutes also allow for open use by non-members of the cooperative. Net income derived from nonmember use is sometimes called "non-member patronage." Other miscellaneous and variable provisions in state statutes strictly govern board membership (to "members" and, sometimes but rarely, to citizens or residents of specific states or municipal subdivisions); capital retention requirements; limitation on dividends; and, limiting membership to a specific occupation (agricultural producers). Older statutes at least *used* to require ten or more *incorporators*.

According to Mark Hanson: "The non-uniform development of agricultural cooperatives and cooperative law has resulted in significant variations in state cooperative statutes many of which were enacted from 1910 to 1925. In fact, few states have the same cooperative statute."[6] William H. Henning, NCCUSL Executive Director, briefly outlined the Conference history concerning cooperatives in a memorandum to the Joint Editorial Board on Uniform Unincorporated Organization Acts dated November 18, 2002. Therein he succinctly stated:

> [I]n 1936 NCCUSL promulgated a Uniform Agricultural Cooperative Association Act…that was especially designed for producers of agricultural products (The Act was adopted, with modifications, in Utah, and declared obsolete by the Conference in 1944.). The procedures for organizing a cooperative under the uniform act were consistent with the procedures for organizing ordinary business corporations, but stock ownership was limited to members and there were restrictions on the payment of dividends.

The United States Department of Agriculture developed a model non-stock cooperative act in 1927. Approximately seven states adopted some version of the USDA model. The most widely adopted national model for commodity marketing purposes, however, was based on the Bingham Act which predated the USDA model. It was adopted in Kentucky, for example, in 1922 and is sometimes referred to as the "Standard Act."[7]

The variety of state cooperative statutes is evidenced by an obviously stale, but still useful, book written by James Baarda and published by the United States Department of Agriculture (USDA) in 1982.

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[5] Hanson, *supra*, at 1.

[6] *Id.* at 8.

[7] Hanson, *supra* note 4, at 5.

It is titled *State Incorporation Statutes for Farmer Cooperatives* and, as the title indicates, it is limited to those statutes applicable to farmer cooperatives. Current secondary sources and conversations with individuals actively involved in cooperative law by this Reporter confirm that, with the exception of recent legal developments introduced in the following section, much of Baarda's analysis remains valid at least for the current purposes of illustrating variety in state law.

Even though Baarda analyzed 86 statutes, he cautioned that his selections do "not include all statutes that may be actually used by associations, and includes some that may not be available under most circumstances."[8] Thus, the analysis neither includes general corporation statutes nor nonprofit association laws even though, according to Baarda, those "statutes are occasionally used for incorporation of farmer cooperatives. . . ."[9] Important for current purposes, Baarda's preface lists two pages of non-state specific comparative "Highlights." For illustrative purposes only, the "Highlight" concerning the financial structure and operation of cooperatives (circa 1982) is set forth below in its entirety:

> Financial structure and operation of cooperative associations are addressed by a majority of statutes, thought the detail with which financial subjects are described varies widely. Some statutes apply only to nonstock associations, but most apply to cooperatives with or without capital stock. Subscription, payment, limits on ownership, and limits on transfer of membership stock are common statutory provisions. Preferred stock is noted in a majority of statutes. Other aspects of capital structure noted in many statutes are: Number of shares and their value, limits on capital stock dividends, reserves, and stock redemption.[10]

Interestingly Baarda suggested that, "[i]n a few States, cooperative provisions are structured so identification of separate statutes is difficult; one, two, or three statutes may be involved in one cluster of cooperative principles."[11]

The cooperative acts upon which most cooperatives in the United States are built date from mid-twentieth century and, therefore, it is probably reasonable to assume that there has been a lock-in effect with other sources of law and regulation that effect cooperatives.

C. Other Law

1. Tax Law

The reason tax law might be particularly relevant is because the daily operation of cooperatives is often coordinated and constrained by the unique interaction of state law and the tax treatment of cooperatives.

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[8] James R. Baarda, *State Incorporation for Farmer Cooperatives*, 30 U.S.D.A. COOPERATIVE INFORMATION REPORT at 2 (1982).

[9] *Id.* at 3.

[10] *Id.* at xiii.

[11] *Id.* at 3.

Therefore tax law provides an important part of the current context in which the state law of cooperatives is evolving even though any thumbnail outline of this area of taxation probably raises more questions than it answers. A far better, and shorter description of the taxation of cooperatives appears in the Appendix.

The federal income tax of many, but not all, cooperatives is found in Subchapter T of the Internal Revenue Code (§§ 1381 et seq.). Subchapter T governs the taxation of most farmers cooperatives including *exempt farmer cooperatives* under IRC § 521. Nonetheless, the cooperative need not be a farmer cooperative to be governed by the general provisions of Subchapter T. That is, as a general matter, "[a]ny business 'operating on a cooperative basis' uses Subchapter T when computing its tax liability."[12] There are exceptions to the general statement. Indeed, Subchapter T expressly excludes utility cooperatives (rural electric and telephone cooperatives taxed under § 501(c)(12)). It also expressly excludes mutual savings banks, mutual insurance companies and cooperative housing corporations.

Perhaps the most efficient way of explaining the general taxing scheme of Subchapter T is simply to quote the two introductory paragraphs from the BNA Tax Management Portfolio on the subject:

> In general, earnings of a cooperative flow through the cooperative to the patrons, with the cooperative not retaining any margins as profit. Thus, earnings are taxed only once. The tax is ultimately paid by the cooperative patron, although under some circumstances, the cooperative pays tax on a temporary basis, then receives a deduction when the money is finally passed on to the patron. The rule of single taxation, however, only applies if business income sources and distribution methods are "cooperative" in nature. Earnings derived form nonpatronage sources and margins not distributed in accordance with the Code are generally ineligible for single-level tax treatment.
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> Upon the satisfaction of certain statutory conditions, cooperatives treat retained patronage refunds and per-unit retains as if the funds retained had been paid to the patron, deducted by the cooperative, accounted for in the patron's income as ordinary income, then invested in the cooperative. Conditions for this tax treatment include agreement by the patrons to recognize full patronage refund for tax purposes even though not received in cash or negotiable form.[13]

Taxation under Subchapter T, therefore, is a variant on regular corporate tax provisions and could be seen *in approach* as roughly analogous to the way S corporation tax provisions vary the regular corporate tax scheme for electing small business corporations.

Cooperatives eligible to be taxed as *exempt* farmer cooperatives under § 521 receive a couple of tax benefits in addition to the benefits more generally afforded to cooperatives under Subchapter T. The label "exempt" is a misnomer because "exempt" farmer cooperatives are *not* exempt from income taxation but, rather, are allowed deductions for distributions on capital stock (as compared with

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[12] *Taxation of Cooperatives, supra* note 1 at 7 (citing IRC § 1381(a)(2)).

[13] *Id.* at 5-6.

patronage-based distributions) and for patronage-based distributions of nonpatronage dividends.

Eligibility for the § 521 exemption has several specific requirements and limitations some of which reference underlying state governing law. One of the requirements, as set forth in § 521 (b)(1), mandates that the organization must be "a farmers', fruit growers', or like association organized and operated on a cooperative basis . . . for the purpose of marketing the products of members or other producers . . . or . . . for the purpose of purchasing supplies and equipment for the use of members or other persons. . . ."

Finally, as previously mentioned, other kinds of cooperative organizations are "truly" exempt (but not necessarily charitable; charitable status allows for deductibility of donations by a contributor) under IRC § 501. These exempt organizations must pay tax on such things as unrelated business income but are taxed separately and independently from treatment under Subchapter T.

3. Anti-trust Law, Securities Law, Farm Credit & the USDA.

State law and federal tax law are not the only law that shapes cooperatives. Anti-trust law, federally encouraged debt financing programs, and an exemption from securities regulation are important features in the cooperative law landscape.

The Capper-Volstead Act was enacted by Congress in 1922. It provides an exemption from anti-trust enforcement for cooperatives. "Cooperatives" are defined narrowly for purposes of the exemption. The definition includes, generally, farmer cooperatives "that limit membership to agricultural producers, restrict voting to one vote per member or limit dividends on equity to 8 percent per year, and handle products for members that exceeds the value of the products handled for nonmembers."[14]

The Farm Credit System is important for two reasons. *First*, it is generally organized as a cooperative under federal law. *Second*, and more relevant for current purposes, it includes elements specifically designed to loan to cooperatives. According to secondary sources cooperative leaders like CoBank provide about 80 percent of the lending to farmer cooperatives. In 1997 these organizations had about $11 billion in outstanding loans to farmer and rural utility cooperatives.[15] Rural electric and telephone cooperatives also have access to funds from the National Rural Utilities Cooperative Finance Corporation. Finally, the National Cooperative Bank (NCB) "has become a leader in providing development funding for new, non-agricultural cooperatives and in devising methods of attracting outside capital to leverage its investments."[16]

The exemption from securities registration, too, has eased the cost of capital formation for farmer cooperatives. Generally, this exemption is from the provisions of the Securities Act of 1933 and is available only to farmer cooperatives exempt from taxation under § 521 of the Internal Revenue Code. It is, however, a limited exemption. Indeed one of the most famous cases construing the definition of a

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[14] Hanson, *supra* note 4 at 4.

[15] *Co-ops 101, infra* note 21, at 21.

[16] *Id.* at 9.

security is *Reves v. Ernst & Young*, 494 U.S. 56 (1990), which involved the "sale" of demand promissory notes to both members and nonmembers of a cooperative (and the "notes" that were found to be securities).

Finally the USDA's Cooperative Services unit is part of its Rural Business-Cooperative Service within the Rural Development Mission Area. Ways in which Cooperative Services assist cooperatives include development assistance, technical assistance, education, research, and grant programs that fund cooperative research and educational efforts.

D. Cooperatives in the Economy

Cooperatives are major players in the national economy. For example: (1) the net business value of agricultural cooperatives in 2000 was $99.7 billion; (2) there are 3,346 agricultural cooperatives marketing about thirty percent of farmers' products in the United States; (3) more than twenty cooperatives have annual sales in excess of $1 billion; (4) retailer-owned food and hardware cooperatives make it possible for independent store owners to compete with large "chains"; (5) cooperative health maintenance organizations (HMOs) provide health care services to nearly 1.4 million people in the United States; and (6) more than 48,000 different cooperatives provide more than 120 million people with a wide range of goods and services and nearly forty percent of the U.S. population belong to a cooperative.[17] Moreover, a study published by the United States Department of Agriculture (USDA) reported that "new-generation and traditional co-ops have major beneficial impacts on rural communities."[18] An official summary of the Report states:

> During the 1990s, more than 50 new cooperatives were established in the Upper Midwest, with most of them based in rural communities. This surge of interest in forming new-generation cooperatives (NGCs) is creating spin-off economic benefits to the communities where these businesses locate.[19]

The study focused only on the Midwest during late 1997 and early 1998.

"New generation cooperatives" (NGC) are discussed in greater detail later in this memorandum (see, *supra*, "Recent Legal and Economic Developments"); however, a case study illustrates the organizing principles of the NGC and its potential economic benefit to members and the community.

One of the most successful and well-known value-added agricultural cooperatives was Dakota Growers Pasta Company (DGPC) which was owned by approximately 1,000 farmers in North Dakota, Montana, and Minnesota. It began operation in a $40 million pasta factory near Carrington, North Dakota in 1993. By 1995 it produced about 100 million pounds of its own branded pasta in fifty different varieties. It doubled its capacity in 1997 with a $5 million plant expansion funded, in part, by the sale of equities. In 2001 it purchased two processing plants near Minneapolis and, again, expanded

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[17] National Cooperative Business Association website, www.ncba.coop/stats.cfm (last visited 6/10/2003).

[18] "Generating Rural Progress: A Summary of USDA/RBS Research Report 177" at www.rurdew.usda.gov/rbs/pub/aug00 (last visited 4/23/2003).

[19] *Id*.

its production facility at Carrington.

The plant provided premium prices to farmers, created almost 200 jobs in Carrington, and earned farmer-members a twenty percent annual return through 1995. In 1999 the shares, which were originally issued at $3.85, were worth approximately $10.[20] Obviously, not all NGCs (or even most of them) have achieved this kind of success. Nonetheless the DGPC cooperative is an example of the NGC model.

Interestingly, Dakota Growers Past Company might be an example, too, of the restrictions of the current cooperative structure because in July 2002 it converted from a cooperative to a corporation. A story in the Grand Forks Herald (Ap. 7, 2002) which quoted SEC filings stated:

> The filing says the change would enhance the possibility of relationships with strategic partners and improve the liquidity of the corporation's capital stock. Conversion will afford greater access to capital markets, which may allow it to expand its business over time, the company says in the filing.
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> The document says the company is unlikely to obtain significant additional capital from its current members or other durum wheat producers and has been having difficulty getting durum - a consequence of widespread disease problems in recent North Dakota crops.
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> In the last three years, the company has relied on non-members for durum but doesn't say how much. The co-op maintains it hasn't run afoul of federal income tax rules but acknowledges concerns.
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> (T)here is legal authority suggesting that, if a cooperative's inputs are obtained predominantly from non-patron sources, its tax status as a cooperative might be jeopardized, the filing says.

Cooperatives are limited neither to agriculture nor marketing and may be categorized several ways. A few of the most important are by geographical territory served, by governance system, and by the function served.[21] Geographical territory categorization is based on the area served and the best known categorization scheme includes local, super local, regional, national and international. For geographical categorization purposes "super local" cooperatives typically serve an area of two or more counties and frequently have several branches within that territory while "regional cooperatives" serve an area anywhere from a few counties to one or more states.

Cooperatives are also categorized by governance system (or membership structure). This categorization includes division between and among centralized cooperatives, federated cooperatives and mixed cooperatives. The "centralized cooperative" has individuals and other business entities as members. "Federated cooperatives," on the other hand, have other cooperatives as members:

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[20] New Generation Cooperative Case Studies Expanded 2001, p.27 (Illinois Institute for Rural Affairs).

[21] Frederick, *Co-ops 101: An Introduction to Cooperatives*, Cooperative Information Report 55, p.20 (USDA, Rural Business-Cooperative Service, 1997) (hereinafter "*Co-ops 101*").

Local cooperatives commonly form federateds to perform activities too complex and expensive for them to do individually, such as manufacturing production supplies, tapping major financial markets, and marketing on a national or worldwide scale.[22]

"Mixed cooperatives," unsurprisingly, have a mixture of membership which may include either individuals or other non-cooperative entities *and* other cooperatives.

The most detailed categorization system is based on function performed. The basic functional types include marketing, purchasing, and service provision but each of the basic functional types may be subdivided much further.[23] Most marketing cooperatives involve some portion of a broadly defined agriculture industry. Nonetheless: "New marketing ventures are developing in such diverse industries as handicrafts, professional services and information technology."[24]

Marketing cooperatives may negotiate favorable prices for members, serve as "first-handlers" by aggregating bulk produce for sale, or further process or manufacture goods from the base product or commodity (value-added processing cooperatives). Some marketing cooperatives process and brand products and integrate all processes including delivery to grocery or other retail or consumer cooperative stores. Examples of the cooperatives engaged in processing, branding, and distribution include Land O'Lakes, Ocean Spray, Tree Top, and Welch.

In addition to providing farmers' supplies like fertilizer, fuel and feed; *purchasing cooperatives* include many well known non-farm business purchasing cooperatives like True Value, Ace Hardware, IGA, and Shurfine Foods. Restaurant purchase cooperatives have been established for franchisees in the Burger King, KFC and Popeyes organizations and Wendy's franchisees use a financing cooperative. Finally, one of the fastest growing areas is pharmaceutical purchasing for hospitals and independent pharmacies.

Service cooperatives apply fertilizer for farmers and provide electricity and telephone service. According to the USDA:

> Nonagricultural service cooperatives are also flourishing. Credit unions and the National Cooperative Bank provide credit on a cooperative basis to nonfarm individuals and cooperatives. School systems, health care providers, and insurance buyers are among the general public segments making use of service cooperatives.[25]

Insurance service cooperatives are sometimes known as cooperative health alliances and such

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[22] *Id.* at 21.

[23] A slightly different functional classification includes the following categories: Marketing Cooperatives, business Purchasing Cooperative, Worker's Productive Cooperatives, Financial Cooperatives, Insurance Cooperatives, Labor Unions, Trade Associations; Self-Help Cooperatives, and Consumer Cooperatives. Consumer Cooperatives, in turn, include consumer stores, housing cooperatives, concominiums, electric, telephone and other utility cooperatives, and health cooperatives. Packel, *The Organization and Operative of Cooperatives*, p.xv (1970).

[24] *Co-ops 101*, *supra* note 21 at 21.

[25] *Id.* at 23.

alliances have been formed by employers in Seattle, Memphis, and Sacramento, among other cities. Direct health care is provided by HMOs. Moreover, *financing cooperatives* are anecdotally becoming popular.

Finally, for purposes of categorization, there is another "old" kind of co-op that is more popular in Europe than the United States. It is the "Workers' Productive Cooperative" which in some ways resembles the operation and function of an Employee Stock Ownership Plan (ESOP). "Workers' is broadly defined to include professionals.

E. Recent Developments.

In the late 1980s and 1990s, at least Minnesota, Colorado, Iowa, Oregon and Ohio redrafted their cooperative statutes.[26] The recodification of Minnesota's cooperative statutes is instructive: "In Minnesota, five different stock and nonstock cooperative statutes were recodified and revised into one corporate cooperative statute" in 1989.[27] Moreover, Hanson states that "many" states loosened the statutory restrictions in their commodity marketing acts to allow nonagricultural producers to form cooperatives. Again according to Hanson, "[t]he modern corporate cooperative statutes are general cooperative statutes with certain provisions to accommodate agricultural producer cooperatives."[28]

A major part of this renewed interest in cooperative business organizations and cooperative organization statutes is the evolution of value-added agricultural cooperative illustrated by the case vignette, *supra*, in "The Cooperative Industry" portion of this memorandum. A book published by the Illinois Institute for Rural Affairs delineates this evolution as follows:

> The development of cooperatives in the Upper Midwest from the 1970s through the 1990s provides vivid examples of several new phenomena and trends. Among the most important are the New Generation Cooperatives (NGCs). The term, used since the mid-1990s, was proposed by the Centre for the Study of Cooperatives, University of Saskatchewan, Canada [citation omitted].
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> These NGCs represent the newest wave of U.S. co-ops. While earlier generations had emerged in the 1900s, the 1920s, and again in the 1940s, NGCs have several features that distinguish them from traditional farmers co-ops.[29]

These distinguishing NGC features include: (1) a focus on value-added processing; (2) expanded use of equity as a funding source; and, (3) restricted membership with equity shares limited by the requirements to build plant, process, and/or product (thus, many NGCs are "closed-end" while generally retaining the one member one vote concept and maintaining effective governing control in producers

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[26] Hanson, *supra* note 4 at 6.

[27] *Id.*

[28] *Id.*

[29] Igor Kotov, "New Generation Cooperatives: A Short History of the Idea and the Enterprise," NEW GENERATION COOPERATIVES: CASE STUDIES *EXPANDED 2001* at 19 (2001).

while at the same time providing a governance "voice" for nonproducer outside investors).[30]

In 1996 Iowa enacted a cooperative statute specifically designed for agricultural value-added purposes. It was a corporation-based statute and it required, among other things, that "farming entities" have at least 60 percent of the voting and financial rights.[31] Further, it provided "authorized persons" to have 75 percent of the voting and financial rights.[32] Some organizations incorporated under the 1996 Iowa Act sought "Exempt Farmer Cooperative" Certification from the IRS under § 521 and, according to Hanson, questions were raised whether they qualified for § 521 status as operating on a cooperative basis.[33] As a result of these questions the Iowa statute was amended to replace corporate terms like "incorporation," "stock" and "shareholders" with unincorporated entity terms like "organizers", "members" and "interests" so that the organization might qualify for partnership income tax status (like a limited liability company under state law) and, therefore, be taxed on a purer flow-through basis under Subchapter K.

This different statutory design approach which attempts to take advantage of partnership tax classification should not be underestimated because it evidences that the organizers were willing to leave the traditional protective confines of the corporate tax structure as modified by Subchapter T in order to make value-added processing financially viable based on a different capital structure. In other words, the approach evolved from perceived real-world need.

Wyoming enacted a "Wyoming Processing Cooperative Law," effective in 2001, for purposes similar to Iowa's law. The impetus for the Wyoming law was from lamb producers in Wyoming and adjoining states. Its purpose was to allow the producers to "acquire lamb, meat, wool and pelt processing and marketing businesses to make lamb production more marketable on a cooperative basis."[34] It was drafted to allow for partnership taxation or, at the discretion of the particular entity, to elect corporate taxation and thereby be eligible for Subchapter T and, perhaps, § 521 tax treatment. As a result, the Wyoming Act is more flexible than traditional cooperative acts and gives far more freedom to the organizers in their entity documents than typically afforded under traditional cooperative statutes.

Neither the Wyoming nor the Iowa cooperative statutes have received revenue rulings, however, an entity organized under the Wyoming Act has apparently received a private letter ruling (PLR) from the Internal Revenue Service indicating that it will be eligible for partnership income tax classification. Identifying facts are excised from published letter rulings. Nonetheless PLR 2001-125369 included the following statement of relevant fact:

> Company A is a new entity that will be organized on Date 1, under the State Cooperative LLC Act (Act). The Act was enacted on Date 2, with an effective date of Date 1. The

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[30] *Id.* at 19-20.

[31] Hanson, *supra* note 4 at 10.

[32] *Id.*

[33] *Id.* (Citation omitted.)

[34] *Id.*

> Act defines “Cooperative” as association organized under this article conducting business on a cooperative plan as provided under this Article.
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> It concluded:
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> In the present case, Company A is organized as an unincorporated association under the Act, which does not refer to an association as incorporated or as a corporation, body corporate, or body politic… Therefore, it is an “eligible entity” and not a per se corporation under section 301.7701-2(b)(1).

An article in the 1995 *American Journal of Agricultural Economics* lists five problems inherent in operating within the traditional cooperative structure. All five relate to “vaguely defined property rights.”[35] According to the article, a *free-rider problem* exists for open-membership cooperatives because new members receive the same patronage dividends as do members who originally invested in the cooperative; *portfolio* and *horizon* problems arise due to lack of share transferability; that is, members cannot adjust their investment over time to match their investment profiles; and, there is a disincentive for members to invest more capital because of lack of liquidity of the investment and lack of the ability for the investor to time sales (e.g. redemption fixed upon death or retirement). Finally, the *control* and *influence cost problems* (*e.g.*, agency cost and monitoring costs) inherent in any nonpublicly traded business are present in cooperatives. According to follow-up research conducted in 1996 and 1997, “[e]mpirical work confirmed the connection between theory and practice.”

> The research analyzed,
> [A]ll rural or agricultural-related cooperative formations in the Upper Midwest between 1988 and 1996 . . . and made the following observations:
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> 1. More than 80 percent of cooperative formations in the Upper Midwest adopted non-traditional cooperative organization characteristics.
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> 2. Why? According to the results of the survey – to solve for a set of problems cause by vaguely defined property rights.
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> 3. A coordinated set of simple organizational policies to solve for vaguely defined property rights; transferable and appreciable equity shares, defined membership, uniform grower agreements, and a minimum upfront equity investment requirement were identified.
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> 4. Ninety-six percent of the cooperatives in the survey reduced the free-rider problem by linking member investment to use.
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> 5. Ninety-four percent allowed members the ability to adjust their asset portfolio to meet the risk preferences by allowing the transfer of equity shares.
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> 6. In addition, 93.6 percent of the cooperatives allowed producers to realize

[35] Michael L. Cook, *The Future of U.S. Agricultural Cooperatives: A Neo-Institutional Approach*, 77 AMER. J. AGR. ECON. 1153 AT 1156 (1995).

changes in the cooperative's value upon divestment of their equity shares.

7. Defined (closed) membership policies were popular among newly organized agricultural cooperatives with 98 percent of the survey cooperatives implementing a defined membership structure.

8. Direct investment through the sale of nonvoting equity stock was the primary method employed to raise producer equity in these cooperatives. Nearly 98.7 percent of equity raised from producers took this form.[36]

The findings, above, are consistent with theoretical suggestions to amend the cooperative form to include some combination of such features as transferability of equity shares, appreciable equity shares, defined membership, legally binding delivery contract or uniform grower agreement, and minimum up-front equity investment.[37]

Flexibility, too, is a feature worth considering. An article in *The McKinsey Quarterly*, for example, stated:

> In general, a co-op that has a strong plan and uses alternate governance structures such as the LLC will find it easier to raise capital from both farmers (who are willing to invest in strong plans) and outside sources (which are now put off by the convoluted governance of most large co-ops).[38]

Another possible reason for renewed interest in agricultural cooperatives might be the changing international trade climate concerning direct farm subsidies. As a past Deputy Administrator of the Rural Business-Cooperative Service stated at the USDA Economists Group Meeting in late 1999:

> Current trends that are leading to a renewed interest in cooperatives include industrialization and concentration, increased contracting, phase-out of farm price supports… and the "new generation" cooperative phenomena.[39]

He also noted that there was an increase of mergers or consolidation of cooperatives in many sectors in order for cooperatives to become global competitors.

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[36] Michael L. Cook, Constantine Iliopoulis, *Beginning to Inform the Theory of the Cooperative Firm: Emergence of the New Generation Cooperative* 1999 THE FINNISH JOURNAL OF BUSINESS ECONOMICS 525 at 530 (Issue 4).

[37] *Id.*

[38] Jack J. Dempsey, Ashish A. Kumar, Barnard Loyd and Loula S. Merkel, "A Value Culture for Agriculture," *The McKinsey Quarterly*, Issue 3, 2002, p. 64 at 72.

[39] *Id.*

APPENDIX

COOPERATIVE LAW: A HISTORICAL PERSPECTIVE[40]

Philadelphia Contributionship for the Insurance of Houses from Loss by Fire

- Formed in 1752, still operating today
- Benjamin Franklin, “An ounce of prevention is worth a pound of cure”

Rochdale Society of Equitable Pioneers

- An English consumer cooperative formed in 1844 to purchase food and clothing for its members, who were dissatisfied with the prices and quality of goods sold by local merchants
- Drew up a set of rules based on what the members knew of other English and European cooperatives

Four Cooperative Principles (Wayne Rasmussen, agricultural historian)

- Cooperatives are owned and democratically controlled by those who use their services
- Net income is distributed to users in proportion to their use of the cooperative
- Returns on ownership capital are permissible, but limited
- Cooperatives are financed substantially by those who use their services

Early Cooperative Development

- Throughout the 1800's, many producer groups in the Northeast and Midwest, particularly dairy farmers, formed small cooperatives to serve local markets. While long on spirit, most failed because they were short on capital and business sense.
- In the 1880's, Californians needed a mechanism to profitably sell crops grown in specialized producing areas far from their markets. They formed cooperative marketing associations that hired top management talent and developed tools, including marketing agreements, product pools, and federations, that still serve farmers well today.
- So, by the time Congress shook off its laissez faire attitudes of the 1870's and 1880's, farmer cooperatives were well established throughout the country.

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1. This paper was prepared by Donald A. Frederick, Program Leader, Law, Policy & Governance, USDA/Cooperative Services, Washington, DC. This paper does not represent official policy of the U.S. Department of Agriculture or any other Government agency. It is provided only as source of information to persons interested in learning about cooperatives.

Sherman Act of 1890

- Section 1 outlaws "*Every* contract, combination...or conspiracy, in restraint of trade or commerce."

- Section 2 makes it a felony to "monopolize, or attempt to monopolize, or combine or conspire with any other person on persons, to monopolize any part of...trade or commerce."

- An amendment offered by Senator Sherman and passed by the Senate to exempt both labor unions and farmer cooperatives from the law was not enacted.

Interpreting the Sherman Act

- In 1911, after 20 years of legal wrangling over whether the Sherman Act literally outlawed every contract or combination that restrained trade, the Supreme Court, in the *Standard Oil* and *American Tobacco* decisions, laid out two rules for applying Sherman.

- Rule of Reason: Sherman only forbids contracts that unreasonably restrain trade.

- Rule of Per Se Illegality: Certain conduct is so inherently anti-competitive as to be *per se* unreasonable (price fixing, allocating trade territories and customers, boycotts).

- What do farmers do when they market their products on a cooperative basis? They agree on prices they will charge and to only sell to buyers who will meet their price and other terms of trade, activities that are *per se* illegal under Sherman.

Early State Antitrust Laws

- Many States also enacted versions of the Sherman Act. Many of these laws contained a provision exempting farmer cooperatives from their State antitrust law. However, the courts struck down these limited exemptions as a violation of the "equal protection" provision of the 14th Amendment.

- This left farmer marketing cooperatives vulnerable to antitrust attack under State laws as well.

Congress Responds to *Standard Oil* and *American Tobacco*

- Federal Trade Commission Act of 1914 creates the FTC to investigate and order the cessation of unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce.

- Clayton Act of 1914 prohibits specific business practices (price discrimination, tying arrangements, acquisitions) where the effect may be to substantially lessen competition.

- Section 6 of Clayton provides that the antitrust laws shall not be construed to forbid the existence of labor unions and agricultural organizations "not having capital stock or conducted for profit."

Capper-Volstead Act of 1922

- Agricultural producers may act together in associations, corporate or otherwise, with or without capital stock, to collectively process, prepare for market, handle and market their agricultural products.

- To be eligible for this limited antitrust protection:
    (1) Only agricultural producers may be voting members of the association,
    (2) The association must be operated for the mutual benefit of the members as producers,
    (3) No member may have more than one vote *or* dividends on stock may not exceed 8% per year, and
    (4) The value of products marketed for members must be greater than the value of products handled for nonmembers.

Early Federal Income Tax Law and Cooperatives

- In 1913, ratification of the 16th Amendment clears the way for the Federal government to tax income.

- The Revenue Act of 1916 created a statutory exemption for farmer cooperatives.

- By 1918, Treasury Department pronouncements provided that patronage refunds were to be treated as price adjustments and were not taxable income at the cooperative level.

The Patronage Refund System

- While cooperatives strive to return earnings to members, this can't be done on a transaction-by-transaction basis. Rather, cooperatives usually charge market prices for supplies and services furnished to members and competitive prices for products delivered for further processing and marketing. Normally, this allows them to generate sufficient income to cover costs and meet continuing needs for operating capital.

- After the fiscal year is over, a cooperative computes its earnings on business conducted on a cooperative basis. Those earnings are returned to the patrons--as cash and/or equity allocations--on the basis of how much business each patron did with the cooperative during the year. These distributions are called patronage refunds.

- For example, if a cooperative has earnings from business conducted on a cooperative basis of $20,000 for the year, and Ms. Jones does 2 percent of the business with the cooperative, she receives a patronage refund of $400 ($20,000 x .02).

- This allows the cooperative to return margins to members on an annual basis, consistent with standard accounting conventions and without regard to how much was earned on each transaction.

Tax Treatment of Cooperative and Patron

Cooperative		Patron	
Expenses		Income	
Crop	$600	Crop	$600
Other	$300		
Total	$900		
Income	$1000		
Margin	$100	Refund	$100
Taxable Income	0	Taxable Income	$700

- The cooperative is allowed to deduct the cost of the crop it purchased from the patron ($600), its other operational expenses ($300), and the patronage refund it paid to the patron ($100), leaving it with no taxable income.

- The patron reports the payment received for the crop ($600) and the patronage refund ($100), resulting in taxable income of $700 (disregards timing issues).

Current (post-1951) Federal Income Tax Law and Cooperatives

- Under Subchapter T of the Internal Revenue Code, patronage refunds are not taxable income at the cooperative level.

- Under Section 521, farmer cooperatives meeting a number of specific tests can deduct (1) dividends on capital stock and (2) patronage-based distributions of nonpatronage sourced income.

- To qualify for Section 521 tax status, a cooperative must:
  (1) Be a farmers marketing and/or supply cooperative
  (2) Return margins to all patrons (member and nonmember alike) on a patronage basis
  (3) Limit dividends on capital stock to 8 percent or the legal rate of interest in the State of incorporation, whichever is greater
  (4) Substantially all (85%) of capital stock must be owned by producers who use the cooperative's services, and
  (5) The value of marketing and purchasing transactions with members must be greater than that of similar transactions with non-members.

Federal Securities Law and Cooperatives

- The Securities Act of 1933 exempts farmer cooperatives that qualify for Section 521 tax status from its registration and prospectus requirements covering the initial offering and sale of securities.

- The Securities Act of 1934 exempts farmer cooperatives as defined in the Agricultural Marketing Act of 1929 from its requirement to file registration statements.

- The Securities and Exchange Commission has issued a number of letter rulings stating that investments by patron members in a cooperative, intended to acquire access to the services provided by the cooperative and redeemable only by the cooperative at cost, are not securities subject to regulation.

- Investments by nonpatrons and any investment that can fluctuate in value are subject to regulation, unless covered by a statutory exemption.

State Cooperative Laws

- Prior to 1911, few States had cooperative laws and those that did were provisions in the general business corporation law.

- 1910's saw a backlash against "corporate cooperatives." Several States enacted laws based on a cooperative model of the Farmers Alliance, one the eschewed equity capital, conducted each transaction on an "at-cost basis," and refused nonmember business. This approach is reflected in Section 6 of Clayton Act of 1914's language sanctioning agricultural cooperatives "not having capital stock or conducted for profit." This sounded good, but simply didn't work. Cooperatives couldn't accumulate equity, or even cash, to carry themselves through inevitable business downturns.

- The need for a more pragmatic approach was most evident in California, where numerous new producer groups were being formed. Aaron Sapiro, a sharp and enthusiastic San Francisco attorney, who represented many of the California marketing associations, drafted a model state law. Then he traveled around the country to market his draft legislation. Between 1921 and 1928, 46 states and Puerto Rico enacted new state cooperative statutes based on the Sapiro model. Among its features, the Sapiro model:

    1. Is strictly an agricultural cooperative law. Membership in an authorized cooperative is limited to agricultural producers and other associations of agricultural producers.

    2. Authorizes both stock and nonstock cooperatives. It also facilitates the accumulation of capital by authorizing nonvoting stock which can be sold to nonmembers.

    3. Permits limited business with and for nonmembers.

    4. Includes a one-member one-vote provision. Some states, including California, were sensitive to the dissatisfaction of large producers with this rule and did not include it in their law. This opened the way for limited weighted voting based on patronage, at the discretion of the members of each cooperative.

    5. Specifically provides for long-term marketing contracts with members and remedies for member breaches of these contracts.

    6. States that any association organized thereunder is not a conspiracy or combination in restraint of trade or an illegal monopoly. These State antitrust exemptions were found legal by the State courts.

- The Sapiro model was sweeping the country just as Congress was debating whether to strengthen the protection from antitrust liability for farmers marketing on a cooperative basis. The Capper-Volstead Act is consistent with the Sapiro model in that it covers any marketing cooperative (stock and nonstock) which limits membership to agricultural producers, either limits each member to one vote or limits the return on stock to 8 percent per year, and permits business with nonmembers, provided it is less than business conducted each year with or for members.

Co-ops in a Nut Shell (Rasmussen's Four Cooperative Principles)

- Cooperatives are owned and democratically controlled by those who use their services (voting is on the basis of one-member/one vote or limited proportional voting based on patronage; not on investment)

- Net income is distributed to users in proportion to their use of the cooperative (not on the basis of investment)

- Returns on ownership capital are permissible, but limited (frequently 8 percent)

- Cooperatives are financed substantially by those who use their services (limited initial investment to join, reliance on retained earnings [patronage and nonpatronage sourced] , systematic redemption of patronage-based investments).

Check-the-Box Regulations and Limited Liability Companies

- From the late 1920's until the late 1990's, cooperatives were the only business structure (other than Subchapter S corporations) that provided business owners with both limited personal liability and single Federal income treatment of their earnings (under Subchapter T of the Internal Revenue Code).

- In December 1996, IRS adoption of the "check-the-box" regulations (effective January 1, 1997) permitted any unincorporated business entity to elect single tax treatment as a partnership (under Subchapter K of the Internal Revenue Code).

- All 50 States have enacted Limited Liability Company laws that authorize unincorporated business entities with limited personal liability for the owners, the flexibility of a partnership, and passthrough Federal income taxation as a partnership under the "check-the-box" regulations.

- LLC's have become a frequently used option for organizing businesses that, until 1997, would have been organized as a sole proprietorship, partnership, general business corporation, or a cooperative corporation.

Cooperatives (Rasmussen's Four Cooperative Principles) **v. LLC's**

- Cooperatives are owned and democratically controlled by those who use their services
  Anyone can own an interest in and participate in the control of an LLC, with voting on whatever basis the owners can agree to accept

- Net income is distributed to users in proportion to their use of the cooperative
  In an LLC, earnings can be allocated on whatever basis the owners can agree to accept

- Returns on ownership capital are permissible, but limited
  In an LLC, returns on ownership capital can be limitless

- Cooperatives are financed substantially by those who use their services
  Anyone can be tapped to provide equity for an LLC