

**COOPERATIVES 101- AN INTRODUCTION TO
AGRICULTURAL COOPERATIVES AND THE FEDERAL
REGULATIONS AND LEGAL CONCERNS THAT IMPACT
THEM**

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I. INTRODUCTION

For nearly a century, the Rural Business Cooperatives Program (the “Program”) of the Rural Development Agency of the United States Department of Agriculture (“USDA”) has provided technical assistance, education, legal, tax and policy advice to agricultural cooperatives (the terms “agricultural cooperatives” and “cooperatives” carry the same meaning for the purposes of this article). Its mission is to promote understanding and use of the cooperative form of business as a viable organizational option for marketing and distributing agricultural products.

The Program identifies the impacts of changes in federal legislation, law, regulations, and public policy on cooperatives and their members, and assists members in understanding and functioning in the changing environment. It also analyzes cooperative governance regarding member participation and organization, as affected by socio-economic change. The Program provides research that (i) focuses on unique cooperative economic, legal, financial, and organizational characteristics and contributions as they relate to public policy toward cooperatives; (ii) identifies factors that determine member participation patterns and techniques that enhance member involvement in their cooperatives; and (iii) serves to determine, analyze, and develop cooperative governance structures that facilitate member control, sound business operations, and realization of member needs and objectives.

We believe that agricultural cooperatives are leaders in providing the nation’s food and agricultural supply system. Their activities and earnings are vital to the economies of the rural communities they serve which help promote wealth in rural America, a key priority at the USDA. Therefore, it is imperative that agricultural cooperatives

understand the legal and regulatory dynamics on a state and federal level in order to maintain a measure of best practices in the agricultural industry.

This article will provide an overview of federal regulations and legal issues that currently affect cooperatives way of doing business. This is by no means exhaustive of the various legislation that govern cooperatives, but are the most pressing concerns according to the agricultural cooperatives we are in contact with on a regularly basis.

A. The Business of Cooperatives

In general, cooperatives are businesses like investor-owned businesses. They have similar physical facilities, perform similar functions and must follow sound business practices. They are usually incorporated under state law by filing articles of incorporation, which grants them the right to do business. The organizers draw up bylaws and other necessary legal papers. Members elect a board of directors, who sets policy and hires a manager to run the day-to-day operations.

But in some ways, cooperatives are distinctly different from other forms of businesses. These differences are found in the cooperative's purpose, its ownership and control, and how benefits are distributed. They are reflected in cooperative principles that explain the unique aspects of doing business on a cooperative basis, which is a business organization owned and operated by a group of individuals for their mutual benefit.¹

In addition, cooperatives are based on a particular set of values and principles for consideration as a cooperative. These cooperative values are collectively self-help, self-responsibility, democracy and equality, equity and solidarity. The most widely-agreed upon basic cooperative principles are: 1) user-owned cooperative is owned by

the people that use it; 2) user-control cooperative is controlled by the people who use it; and 3) user-benefit benefits generated by the cooperative accrue to its users on the basis of their use.²

B. The Definition of Agricultural Cooperatives³

An agricultural cooperative, also known as a farmers' cooperative, is a cooperative where farmers pool their resources in certain areas of activity. Agricultural cooperatives are distinguished between agricultural service cooperatives, which provide various services to their individual farming members, and agricultural production cooperatives, where production resources (land, machinery) are pooled and members farm jointly. Few agricultural production cooperatives are formed in the United States. For the purposes of this article, agricultural cooperatives will only refer to agricultural service cooperatives.

There are three primary types of agricultural service cooperatives in the United States: supply, marketing and service. Supply cooperatives supply their members with inputs for agricultural production, including seeds, fertilizers, fuel, and machinery services. Marketing cooperatives are established by farmers to undertake transformation, packaging, distribution, and marketing of farm products (both crop and livestock). Service cooperatives include various industries, such as, trucking, cotton ginning, drying and artificial insemination.

II. OVERVIEW OF FEDERAL REGULATION

There have been numerous federal and state laws which have impacted the way agricultural cooperatives are able to grow and market their goods. The most impacting of these laws have been environmental in nature. Several laws have contained

provisions affecting agricultural land use and land use patterns. Many of these laws were originally passed over 20 years ago and have outlived its original intent. An increased ability to monitor and measure environmental problems and new information on the environmental impacts of agricultural practices has prompted amendments to and changes in the laws. In addition, as environmental awareness and concern have grown, new environmental laws have been passed.

Additionally, federal cooperative laws have provided for regulatory legislation on business dealings practiced by agricultural cooperatives. Pursuant to federal laws such as the Capper-Volstead Act of 1922 and the Cooperative Marketing Act of 1926, they convey privileges to cooperatives that meet certain tests. For example, Capper-Volstead provides agricultural producers with limited antitrust protection to market their production on a cooperative basis. Under Section 5 of the Cooperative Marketing Act of 1926, this protection extends to the sharing of market information. To qualify for the limited protection from antitrust liability provided by these two laws, membership must be limited to agricultural producers. So a cooperative with government entities as members would not qualify for the protection to set prices and share information accorded under these laws.

The Secretary of the USDA is conferred by Congress the primary responsibility for establishing and maintaining orderly marketing conditions for agricultural commodities and parity prices for farmers via Agricultural Marketing Agreement Acts in the form of marketing orders. These Acts delegate to the Secretary the task of completing the legislative regulatory scheme set with respect to the handling of a commodity within the confinement of the terms and conditions set out in the Acts.

A. Environmental Legislation

1. Water Quality Act of 1987

The Clean Water Act was reauthorized and extensively amended by the Water Quality Act of 1987 (“Water Quality Act”).⁴ The goal of the Water Quality Act is to restore and maintain the chemical, physical and biological integrity of the surface waters of the United States. The Act addresses pollution from municipal and industrial sources, nonpoint sources, and dredge and fill activities to include nonpoint sources of water pollution.

The Water Quality Act also regulates the discharge of dredged and fill material into waters of the United States, including marshes and wetlands, and established a state permit program to ensure that such discharges comply with environmental requirements.⁵ Discharges of dredged and fill material are commonly associated with activities, such as port development; channel construction and maintenance; fills to create development sites; transportation improvements; and water resource projects, such as dams, jetties, and levies. Other kinds of activities, such as land-clearing, are regulated if soil is deposited in wet areas to change the hydrology of the area.

2. Federal Insecticide, Fungicide and Rodenticide Act as Amended (“FIFRA”) of 1988

FIFRA provides regulatory authority for registration and use of pesticides and similar products intended to kill or control insects, rodents, weeds, and other living organisms.⁶ Under FIFRA, a pesticide can⁷ not be legally shipped or sold in the United States unless it is registered by U.S. Environmental Protection Agency (“EPA”). Pesticide labels approved by EPA delineate the legal uses of the pesticide. Selling a pesticide with a label that does not meet EPA standards or using a pesticide in any way

other than provided for on its label is a violation of FIFRA. Thus, EPA can make it illegal to use a particular pesticide in specific locations or for particular pests by requiring the manufacturer to include those restrictions on the product's label. In addition, if a site or pest is not specifically included on a pesticide's label, then that pesticide is not legal for that site or pest.

3. Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") of 1980

CERCLA, commonly called the Superfund Law, requires cleanup of releases of hazardous materials in air, surface and groundwater, and on land.⁸ Both new spills and leaking or abandoned dumpsites are covered. The legislation established a trust fund to pay for cleaning up hazardous substances in the environment. EPA is authorized to collect the cost of cleanup from the parties responsible for the contamination. Liability for cleanup costs falls to the individual responsible for the spill or contamination.

4. Resource Conservation and Recovery Act as Amended ("RCRA") of 1976

RCRA was passed to regulate the disposal of all types of solid wastes.⁹ However, its major emphasis is the control of hazardous waste disposal. Under RCRA, EPA lists substances that are considered hazardous when disposed of on land. However, RCRA provides that states may assume responsibility for controlling hazardous wastes. Several pesticides are listed as hazardous waste materials; large agricultural producers and commercial pesticide applicators may be subject to RCRA or state hazardous waste regulations.

The regulation of underground storage tanks also falls under RCRA.¹⁰ The law requires EPA to develop rules for detection and correction of leaks and establish

performance standards for new tanks. States are required to make inventories of all underground storage tanks containing petroleum or other regulated substances.

B. Anti-Trust Legislation¹¹

1. The Sherman Act of 1890

The Sherman Act of 1890 (the “Sherman Act”) marks the first step in a long process of statutory, judicial and policy development of antitrust law in the United States. Congress derived its power to pass the Sherman Act through its constitutional authority to regulate commerce. Therefore, Federal courts only have jurisdiction to apply the Sherman Act to conduct that restrains or substantially affects either interstate commerce or trade within the District of Columbia. This requires the plaintiff must show that the conduct occurred during the flow of interstate commerce or had an appreciable effect on some activity that occurs during interstate commerce.

The Sherman Act is divided into three sections. Section 1 delineates and prohibits specific means of anticompetitive conduct, while Section 2 deals with end results that are anticompetitive in nature. Thus, these sections supplement each other in an effort to prevent businesses from violating the spirit of the Act, while technically remaining within the letter of the law. Section 3 simply extends the provisions of Section 1 to U.S. territories and the District of Columbia.

2. The Clayton Antitrust Act of 1914

The Clayton Antitrust Act of 1914 (the “Clayton Act”) proscribes certain additional activities that had been discovered to fall outside the scope of the Sherman Act. For example, the Clayton Act added certain practices to the list of impermissible activities such as, (i) price discrimination between different purchasers, if such discrimination

tends to create a monopoly; (ii) exclusive dealing agreements; (iii) tying arrangements; and (iv) mergers and acquisitions that substantially reduce market competition.

3. The Robinson- Patman Act of 1936

The Robinson-Patman Act of 1936 (the “R-P Act”) amended the Clayton Act. The amendment proscribed certain anticompetitive practices in which manufacturers engaged in price discrimination against equally-situated distributors.

4. Capper-Volstead Act of 1922

The Capper-Volstead Act of 1922 (“Capper-Volstead”) provides a limited exemption from the antitrust laws for agricultural producers to process, handle, otherwise prepare for market, and market their farm products on a cooperative basis. Capper-Volstead specifically authorizes separate and competing cooperatives to form a common marketing agency to set prices and market member products as if the cooperatives were a single entity. Several court decisions have held that farmers, through a single cooperative or a common marketing agency, may acquire substantial or even monopoly control over the sale of products they produce, so long as only farmers are involved in the scheme and the decision to work together is a voluntary one, and not the result of coercion or intimidation by the cooperative against nonmembers.

5. Cooperative Marketing Act of 1926

The Cooperative Marketing Act of 1926 (the “Marketing Act”) expanded Capper-Volstead by allowing farmers and their local, regional and national cooperatives to exchange a host of information within their marketing system at a local cooperative meeting. It enabled federated cooperative systems and marketing agencies-in-common to effectively function as coordinated entities. The Marketing Act created the Division of Cooperative Marketing within the USDA to assist cooperatives in gathering and sharing

data on output, prices, and demand. The Marketing Act also created the Cooperative Research and Service Division, now the Rural Development Cooperative Programs division, which conducts research studies and service activities relating to problems of management, organization policies, merchandising, sales, costs, competition and membership arising in connection with the cooperative marketing of agricultural products and the cooperative purchase of farm supplies and services.

C. Marketing Orders¹²

The Agricultural Marketing Agreement Act of 1937 and the Agricultural Adjustment Act of 1938 (the “Acts”) authorize the Secretary of Agriculture to issue orders regulating the interstate marketing of agricultural products to establish a “parity price” for farmers.¹³ The purpose of the Acts is to overcome the disruption of the orderly exchange of agricultural commodities in interstate commerce and conditions found to burden and obstruct the normal channels of interstate commerce. The goal is to protect the interest of the consumer and the purchasing power of the farmer. It is a measure intended primarily to benefit producers.¹⁴ That is, to stabilize agricultural prices and to assure producers of a fair return through the effective control of the supply of basic agricultural commodities.¹⁵

D. The Tax Code- Subchapter T

The federal government and state governments recognize the way that cooperatives operate and tax them accordingly. Cooperatives generally do not pay income tax on surplus earnings that are refunded to members. Under Subchapter T of the federal tax code, these distributions are called “patronage dividends.” The members, however, must include these refunds in their taxable income unless the

refunds arise from personal expenses, such as electricity for the home, groceries and other consumer goods.

Under the requirements of Subchapter T, when a business is “operating on a cooperative basis”, according to federal rules, the cooperative may deduct “patronage dividends” from its taxable income. Patronage dividends are the refunds “paid to a patron 1) on the basis of quantity or value of business done with or for such patron, 2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and 3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.” The “preexisting legal obligation” rule requires that some formal obligation exist in writing to pay out patronage dividends. This obligation can be found in the cooperatives bylaws or the membership agreement.

Subchapter T allows cooperatives to retain patronage dividends and allocate them to the patrons’ equity accounts with the cooperative through “written notices of allocation.” If the equity is qualified as defined in the code, the cooperative can deduct the amount of allocations from its taxable income in that same year. Patrons include the amount allocated in their taxable income in the year they receive the qualified written notices of allocation. Subchapter T requires that at least 20% of the patrons’ patronage dividends be paid out in cash in order for the allocation to be qualified. Cooperatives can retain up to 80% as equity investments without owing tax on those investments.

Cooperatives can choose to delay the pass-through by retaining patronage dividends as nonqualified investments. The cooperative can retain any amount of the

patronage dividends and take the amount into its taxable income for the year. When the patronage dividends are later redeemed in cash by the patrons, the cooperative can deduct the amount from its taxable income for the year of redemption.

III. OVERVIEW OF LEGAL CONCERNS

Many agricultural cooperatives have various legal concerns pertaining to cooperative governance, membership control and the legal documents that control them.

A. Board of Directors' Duties and Obligations

Some of the legal issues faced by both cooperatives and investor-owned businesses start at the corporate board level. Key decisions about organizational practices and procedures are made by boards of directors ("Directors"). Thus, it is essential for the cooperative to understand the standards of conduct required to be performed by all Directors, and the unique challenges faced by cooperative boards of directors ("Cooperative Directors") when performing their duties and responsibilities, but how they will implement the business plan. In general, Directors are elected or appointed persons who jointly oversee the activities of a company or organization, which are determined by the powers, duties, and responsibilities delegated to it or conferred on it by an authority outside itself specified in their bylaws. Once the bylaws have been adopted, Cooperative Directors should meet as soon as possible to avoid having to send out legal notices of it to the other Cooperative Directors. In addition, Cooperative Directors approve various resolutions designed to make the cooperative an operational business and ready to serve members.

In most cases, the Cooperative Directors act immediately on specific items, such as to: 1) conduct a membership drive; adopt a form of membership application or stock subscription; 2) adopt the forms for contractual agreement if used; 3) acquire capital; 4) select a bank in which to deposit funds; initiate steps to hire a manager; 5) authorize officers or employees to handle cooperative funds and issue checks; 6) design and install an accounting system; 7) provide for bookkeeping and auditing services; 8) print the articles of incorporation, bylaws, and other member documents for distribution to all members; 9) bond officers and employees in accordance with bylaws; and 10) pick a business location and seek bids for facilities and equipment.

Directors are held to three standards of conduct: 1) a duty of obedience; 2) a duty of care and 3) a duty of loyalty to the company or organization for which they serve, and act in “good faith” as a decision-maker for a company or organization. Directors have various responsibilities including (i) governing the organization by establishing broad policies and objectives; (ii) selecting, hiring, supporting and reviewing the performance of management; (iii) ensuring the availability of adequate financial resources; and (iv) accounting to the stakeholders for the organization's performance. In the case of a breach of these duties to uphold their responsibilities, Directors can be held personally liable to the organization for any injury it may have suffered due to the breach.

Cooperative Directors must conduct themselves at an even higher level due to the complexity and nuance of how cooperative businesses are structured. Unlike in a typical corporate environment, Cooperative Directors must be strong supporters and patrons of the cooperative as a general rule. They must understand its unique role in business. Thus, it is very important that the cooperative members select Cooperative

Directors who show a high level of competency and trust in their ability to lead. The standards of conduct by cooperative directors include: (a) Duty of Obedience; (b) Duty of Care; (c) Duty of Loyalty; and (d) The Good Faith Test.

1. Standards of Conduct

- a. Duty of Obedience

Directors must exercise their powers for a proper purpose. While in many instances an improper purpose is readily evident, such as a director looking to feather his own nest or divert an investment opportunity to a relative, such breaches usually involve a breach of the director's duty to act in good faith. Greater difficulties arise where the director, while acting in good faith, is serving a purpose that is not regarded by the law as proper.

Cooperative Directors are held to the same standard as other Directors. Cooperative Directors must ensure that they do not or the cooperative does not engage in illegal or improper actions. They must make decisions for the cooperatives based not only on generally applicable laws, but laws that are especially applicable to cooperatives. Cooperative Directors bear the responsibility for cooperative's adherence to laws and other legal obligations. Thus, it is critical that Cooperative Directors have a reputation for integrity, honesty and respect for the law to effectively communicate to the cooperative the legal obligations that it must meet. Thus, they must seek appropriate and adequate counsel to assist them in these endeavors to ensure that their actions are done in a proper and legal manner.

- b. Duty of Care

Directors are held to a standard of care with respect to how they handle the company or organization's business affairs. They set policies such as credit, pricing, purchasing, marketing and services. They manage relations with members, professional management, employees and the public. The duties imposed upon Directors are fiduciary in nature, because Directors exercise their control and management over the company on behalf of the company or organization. Although the duties of Directors are several, they must exercise those duties jointly.

Cooperative Directors have the added pressure of maintaining the cooperative character of the organization. They must be familiar with and understand the importance of the cooperative principles, which are: 1) The User-Owner Principle where the people who own and finance the cooperative are those who use the cooperative; 2) The Use-Control Principle where the people who control the cooperative are those who use the cooperative; and 3) The User-Benefits Principle where the cooperative's sole purpose is to provide and distribute benefits to its users on the basis of their use. Cooperative Directors establish policies based on these principles, which must be well-communicated to the membership. Also, Cooperative Directors must make decisions not only based on corporate law, but on specific cooperative state statutory laws. These laws may include special tax laws that apply to cooperatives, cooperative antitrust laws that mandate or prohibit certain business structures and behavior, and state cooperative incorporation statutes that mandate certain special requirements for cooperatives.

Also, Cooperative Directors are required to have a clear understanding of financial documents, performance measures and the short- and long-term consequences of

decisions made and actions taken. They must handle unusual financial issues, because cooperatives have special techniques to finance the organization since they operate for the mutual benefit of the members and not purely to maximize the value of the business. Thus, cooperatives have financial needs, opportunities and limitations not found in other businesses due to their unique business structure. The earning structure of cooperatives is different from other business structures. Cooperatives pay out to their member's patronage refund distributions. Cooperative Directors must determine and distribute these patronage refunds. They are involved in the balance between current monetary returns to members and additions to the cooperative's equity structure. There is also tension between the Cooperative Directors and the members as to whether the cooperative should choose debt or equity as a source of financing the business. Not only must Cooperative Directors act prudently when making these important decisions for the cooperative, they must also communicate these decisions to the members, such as, their decision to distribute year-end earnings to owner-patrons, and/or carefully explain to the members when some portion of earnings is retained as operating or equity investment.

c. Duty of Loyalty

As fiduciaries, Directors may not put themselves in a position where their interests and duties conflict with the duties that they owe to the company or organization. The single action most likely to impose personal liability on Directors is a conflict of interest. The law takes the view that it is not enough for Directors to attempt to be loyal to their company or organization. Their actions must be manifested so that they are transparent and accountable to the company or organization. Thus, a director will not

be able to escape liability by asserting that his decision was in fact well founded, although his actions show otherwise.

Cooperative Directors are in a different position than other type of Directors. Cooperative Directors are required to balance deeply held issues by members both professional and emotional in nature. And like other members of the cooperative, Cooperative Directors deal personally with the cooperative. They have their own obligations toward the cooperative and their own expectations of benefits from it. Decisions that Cooperative Directors make about the cooperative will affect them as member-users just as they affect the cooperative and other members. Thus, the personal dealings that Cooperative Directors have with the cooperative place them in a precarious position. What appears to be innocent when done may in hindsight look very bad for Cooperative Directors. However, Cooperative Directors should not have problems if the conflict is clearly recognized, decisions are made solely with the interests of the cooperative foremost and all questions are addressed openly and honestly.

d. "The Good Faith Test"

Directors must act honestly and bona fide ("in good faith"). Courts have long held the view that the test to determine if a director acts in "good faith" is a subjective one, in which they consider the unique interests of the company or organization. However, Directors may still be held to have failed in this duty where they fail to direct their minds to the question of whether in fact a transaction was in the best interests of the company or the organization.

Cooperative Directors must balance any possible conflict of interest since as discussed above they are members of the cooperatives as well as directors. The single most action likely to impose personal liability for Cooperative Directors is the fact that they use the services of the cooperative and their duty of loyalty can easily be called into question. They are elected by members from within the membership and provide leadership by overseeing the cooperative's business affairs and establishing broad policies. Thus, it is imperative that Cooperative Directors are sensitive to their dual role and measure each step of their actions utilizing the "good faith test" measuring stick.

2. Legal Recourse for Breach of the Standards of Conduct

There are a variety of remedies available to members or organizations which seek legal recourse against Directors in case of breach of duties, to include, injunction, damages, rescission, account of profits and summary dismissal. Electing members to the board of directors is one of the most important functions of a cooperative member. Cooperative Directors can have a direct impact on the success of the cooperative and in turn on the profitability of the member's own business. They must be willing to communicate with members, legislators and regulators, and represent the cooperative at public functions. In addition, Cooperative Directors must be receptive to new ideas that may enhance the benefits or lessen the limitations of cooperative membership. It is worth noting that in most cases, serving on a board is not a career unto itself. Cooperative Directors are usually compensated very modestly for serving on a board, with the duties considered part of their responsibility as a member.

a. Directors- Investor-Owned Businesses

After the Enron scandal in 2002, Congress passed the Sarbanes-Oxley Act (the “Act”) which introduced new standards of accountability on the board of directors for U.S. companies or companies listed on U.S. stock exchanges. Under this Act, Directors risk large fines and prison sentences in the case of accounting crimes. Internal controls of the company or organization are now the direct responsibility of Directors. This means that the vast majority of public companies now have hired internal auditors to ensure that the company adheres to the highest standards of internal controls. Internal auditors are required to report to an independent audit board accounting and financial business activities of the company for independent review.

b. Directors- Cooperatives

The same remedies are available to cooperatives except for remedies allowed for under the Act. The Act is only applicable to publicly-traded companies under jurisdiction of the Securities Exchange Commission, but some states are pushing for application to large non-profit organization. Although the provisions of the Act do not directly affect Cooperative Directors, they should be used as a guide for “*best practices*.”

Additionally, Cooperative Directors may be held personally liable if they fail to act in accordance with statutory laws and regulations on behalf of the cooperative. They may in fact look to the cooperative to be indemnified in defense of a lawsuit. Legal fees and costs could nearly bankrupt a cooperative even if there is an eventual recoupment of its loss. Thus, Cooperative Directors are charged to think through business problems independently and to communicate to the members any events that may adversely impact the cooperative with the eye of avoiding possible litigation.

A director training schedule should be established to discuss topics such as legal liability, cooperative finance, management supervision, and member relations. Session topics for the entire membership should include member responsibilities, cooperative operating policies, and tax treatment of patronage refunds.

B. Membership Rights

One of the fundamental principles of cooperatives is the ability for each member to have an equal voice in the voting process. Cooperatives uniquely allow for every member of the cooperative to have one voting share since it is a user-controlled and not an investor-controlled organization. Unlike in investor-owned businesses, democratic control equals one member/one vote. However, the notion of “defining” democratic control has been a major topic of discussion as it relates to the voting treatment of outside investors which may contribute a larger percentage of equity capital than the cooperative members to the cooperative. These issues are usually discussed at a charter member’s meeting.

1. Federal Legislation Response

Federal laws do not necessarily set forth requirements as to satisfying “democratic control.” The federal laws related to cooperatives, such as, Capper Volstead; CoBank Borrowing eligibility statute; and the Ag Marketing Act of 1929, allow for alternative voting, but do not specify what those alternatives are. Internal Revenue Code Section 521 and Subchapter T, which govern a majority of agricultural producer cooperatives, are silent on this issue.

The Internal Revenue Service (“IRS”) has not provided a statutory definition of “democratic control.” It has, however, long been in favor of one member/one vote

based on its reliance of case law as revealed in certain prior revenue rulings. In Rev. Rule 93-21, it held that the cooperative principles provide the basis for determining whether a corporation is operating on a cooperative basis for purposes of Subchapter T.¹⁶ In fact, the IRS has generally referred to “democratic control” as “the periodic assembly of the members at a democratically conducted meeting at which each member ordinarily has only one vote.”¹⁷ However, the IRS training materials have referred to “member control” which means that members can control a cooperative either through one vote per member or through a voting system that relates to the size of the patronage each does with the cooperative.” In two private letter rulings, the IRS determined that a cooperative’s proxy voting arrangement satisfied the democratic control requirement and approved a weighted vote for the nomination of directors of a federated cooperative.¹⁸

2. State Legislation Response

As confusing as this may be, cooperatives can have some level of comfort in how to govern their organization based on the statutory requirement of their state laws. Some state laws do require one member/one vote. Those states that do not, cooperatives have several alternative forms of governance. The most widely used is “Weighted Voting” based on a member’s patronage, delivery rights and/or equity investment. Cooperatives would also issue preferred shares and common shares to differentiate the member and/or outside equity investor’s level of control. The “Membership Delegate System” would allow for members to choose a delegate to be represented at a meeting, or a “Board Nominating System” which would allow for multiple directors to be determined per geographical districts. The governing aspect of cooperatives is evolving

in order for cooperatives to compete in a more competitive and diversified financial and economic environment. At the end of the day, however, cooperatives must still maintain the basic cooperative principles, such as having “democratic control” in the governance of their organization in order to keep their status as a cooperative.

3. Prevailing View

The risks that cooperatives face if your cooperative does not have democratic control are (i) loss of subchapter T eligibility¹⁹, (ii) loss of eligibility as a 501(c)(12) organization²⁰, and (iii) possible lawsuits from members. As cooperatives start to “think outside the box” regarding the governing structure of their organization, make sure your cooperative is in compliance with not only the cooperative principles, but current and pending state laws that inevitably dictate how your cooperative should operate either as a one member/one vote organization or alternative systems.

C. Legal Documents²¹

Agricultural cooperatives, like other businesses, are tasked with the requirement to have documentation to prove their legal existence. Perhaps one of the most important aspects of legal representation is drafting articles of incorporation and bylaws. Other legal documents include the membership application, membership or stock certificate, revolving fund certificate, marketing/purchasing agreements, and meeting notices and waivers of notice.

1. Articles of Incorporation

In general, cooperatives organize as a corporation under a state statute. When a cooperative incorporates, it is given a distinct legal standing. Members generally are not personally liable for the debts of an incorporated organization beyond the amount of

their investment. Each state has special enabling laws under which cooperatives may incorporate. It may be preferable to incorporate under the state's general corporation enabling act, but structure bylaws to operate as a cooperative.

Articles of Incorporation (the "articles") indicate the nature of the cooperative business. Articles usually contain the name of the cooperative, principal place of business, purposes and its powers, proposed duration of the cooperative, names of the incorporators as may be required in most states, and information about the capital structure. In some states, the names of the first officers of the cooperative must be included. They should specify rather broad operating authority when incorporating even though services may be limited at the beginning.

The cooperative corporation is formed upon the filing of the articles, which is usually with the Secretary of State. After the organizing committee approves the articles, the attorney files for the corporation charter and include the recording fees. Once chartered by the state, the cooperative should promptly adopt bylaws.

2. Bylaws

The bylaws provide how the cooperative will conduct business. The language set forth within the bylaws must be consistent with both state statutes and the articles of incorporation.

Bylaws usually have membership requirements and lists rights and responsibilities of members; grounds and procedures for member expulsion; how to call and conduct membership meetings, methods of voting, how directors and officers are elected or removed, and their number, duties, terms of office, and compensation; time and place of director meetings; dates of the fiscal year; requirement to conduct business on a

cooperative basis; how net margins will be distributed; process for redemption of members' equity; a consent provision that members will include the face value of written notices of allocation and per-unit retain certificates as income in the year they are received; distribution of non-patronage income; handling of losses; treating nonmember business; dissolution of the cooperative; indemnification of directors; and the process for amending the bylaws.

Also covered is how the board is structured to represent the membership, given geographical distribution and size of the membership and the scope of business and function of the cooperative. Directors may be selected to represent districts based on membership density, to reflect commodities or services to be handled, or some other basis that provides equitable representation. The organizing committee's recommended management structure should include the basis for director representation, voting methods, and board officers, and their terms.

For agricultural marketing cooperatives that lack a marketing agreement, the bylaws specify the extent of members' obligation to market through the cooperative. They outline the terms and conditions under which the products will be marketed and accounting procedures.

The committee prepares the articles and bylaws with the help of an attorney so provisions comply with laws of the state in which the cooperative is incorporated. The committee's role also is to assure the bylaw provisions will not conflict with operating procedures.

3. Membership Application

The membership application has five main parts: 1) applicant's statement asking to become a member of the cooperative; 2) signature of the applicant; 3) statement of cooperative acceptance of applicant; 4) signatures of the president and secretary; and 5) a statement of the duty and intent of the member.

The membership application signed by the member and approved by the board of directors is the legal proof that a patron is a member. A cooperative should have a completed membership application on file from every member. Membership and the amount of business done with members and nonmembers are important factors for certain antitrust and taxation provisions.

A membership certificate may be issued to each member as evidence of entitlement to all of the rights, benefits, and privileges of the association.

4. Marketing Agreements

In the marketing agreement, the cooperative agrees (i) to accept specified products of stated or better quality; (ii) to market them to the best of its ability; and (iii) to return to members all marketing proceeds less deductions for expenses and continuing capital needs. A similar contract with members can be structured for agricultural service and supply cooperatives.

The marketing agreement contains self-renewal provisions which should specify that after it has been in force for some initial period, it should continue indefinitely unless the member or the cooperative states in writing a desire to cancel or modify it. A cancellation request must be made during a specified annual period as noted in the contract.

A marketing agreement ensures sufficient control over products or services to be delivered so the cooperative can function. This is especially helpful in the first few years of operation when the cooperative is establishing its reputation as a responsible and successful business. Marketing agreements have helped some cooperatives get needed outside financial help. In some cases, cooperatives that use contractual agreements must file them with the state government.

5. Revolving Fund Certificates

When a cooperative retains funds from business with or for patrons as capital investments, it issues a written patronage refund certificate or a similar document to the member as a receipt for capital investments that will eventually be revolved or redeemed. Meanwhile, the “retain” is used to finance the business. Member investments may be deductions based on per-unit of product handled or services used, reinvested patronage refunds, or original capital subscriptions, if it is a non-stock cooperative.

D. Charter Member Meeting

According to most statutes under which cooperatives are organized, articles and bylaws must be adopted by a majority vote of the members or stockholders. For convenience in organizing, only the persons named in the articles, called the charter members, must vote to adopt the bylaws. These persons are regarded as members or stockholders as soon as the articles are filed. A good practice, however, is to invite everyone who has signed a pre-membership agreement to the meeting to ratify the bylaws.

A temporary presiding officer conducts this first meeting and reports that the articles have been filed. A draft of the proposed bylaws is presented, discussed and adopted as read or amended.

Further action is usually needed to accept those members or stockholders who have subscribed for stock or agreed to become members but are not named in the articles. Under some statutes, however, the incorporators can adopt the bylaws as incorporators rather than as members or stockholders.

If members of the first board of directors have not been named in the articles, they should be elected at this meeting. Here are some suggestions for selecting the first board of directors: 1) use a nominating committee to develop a panel of candidates for the board; 2) select only members as candidates; 3) nominate two candidates for each position; and 4) vote by secret ballot.

IV. CONCLUSION

Agricultural cooperatives have contributed greatly to the development of one of the world's most productive and scientific-based agricultural systems. On a macro-level, they have not only played a crucial role in creating wealth in rural America, but in shaping America's economy as a whole. On a micro-level, they encourage democratic decision-making processes, leadership development and education for their members.

Thus, it is imperative that their legal professionals understand the operational nature of agricultural cooperatives and agribusiness, in general. Due to the changing nature of federal regulations and laws, legal professionals must stay abreast on current topics that may impact cooperatives to ensure their compliance. The ultimate challenge is for

legal professionals to effectively represent their agricultural cooperative-clients in order for them to thrive as successful businesses.

¹O'Sullivan, Arthur and Sheffrin, Steven M., Economics: Principles in Action, Pearson Prentice Hall., p. 202, 2003.

²"Agricultural Cooperatives in the 21st Century", USDA, Rural Business- Cooperative Service, Cooperative Information Report 60, November, 2002.

³Deville, Katherine C., Eversull, Eldon E., and Penn Jacqueline E., Rural Development Service Report, Cooperative Statistics 2008, Service Report 69, November 2009.

⁴33 U.S.C.A. §1251 et seq.

⁵ 33 U.S.C.A. §1342(b).

⁶7 U.S.C.A. §136 et seq.

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⁸42 U.S.C.A. § 9601 et seq.

⁹42 U.S.C.A. § 6901 et seq.

¹⁰ 42 U.S.C.A. §6901, Ch. 82, Subch. 1X.

¹¹Baarda, James R., "Anti-Trust Policy and Farmer Cooperatives," LL.M. Course, University of Arkansas, 2007.

¹²7 U.S.C.A. § 601 et seq.

¹³Parker v. Brown, 317 U.S. 341, 63 S. Ct. 307, 87 L. Ed. 315 (1943), sets forth the definition of a "parity price" which is computed by multiplying an index of prices paid by farmers for goods used in farm production and for family living expenses, together with real estate taxes and interest on the farm indebtedness, by the average price during the base period of the commodity in question; and Agricultural Adjustment Act of 1938, generally, see § 46.

¹⁴Bailey Farm Dairy Co. v. Anderson, 157 F.2d 87 (C.C.A. 8th Cir. 1946).

¹⁵ Stroud v. Benson, 155 F. Supp. 482 (E.D. N.C. 1957), judgment vacated on other grounds, 254 F.2d 448 (4th Cir. 1958).

¹⁶ Puget Sound Plywood, Inc. v. CIR, 44 TC 305, June 14, 1965 and Etter Grain Co. V. United States, 462 F.2d 259, 263 (5th Cir. 1972).

¹⁷ GCM 38061, 1979 WL 52855.

¹⁸ PLR 200629018 and PLR 9725011.

¹⁹ IRC §1381(a)(2).

²⁰ IRC §501(c)(12).

²¹<http://www.rurdev.usda.gov/rbs/pub/cir40/cir40rpt.htm#Articles%20of%20Incorporation>.