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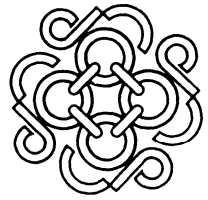
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# Cooperative Principles and Legal Foundations



FARMER COOPERATIVES IN THE UNITED STATES  
COOPERATIVE INFORMATION REPORT 1  
SECTION 1

UNITED STATES DEPARTMENT OF AGRICULTURE  
AGRICULTURAL COOPERATIVE SERVICE



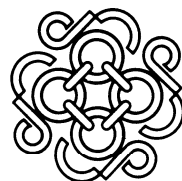
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*Annual meeting is the peak time of the year in which member owners of the cooperative get information, react with discussion, and register ownership responsibility through democratic voting on matters requiring member approval.*



# Cooperative Principles and Legal Foundations



American cooperatives are part of our private enterprise system the same as are individually owned businesses, partnerships, or other business corporations. Cooperatives are a part of the corporate segment, but have distinctive features.

Agricultural cooperatives have identifying characteristics that have emerged over the years from a combination of planned objectives and concrete accomplishments.

Agricultural cooperation in the United States places special emphasis on meeting the economic needs of farmers in marketing products, obtaining production supplies, and securing the many services needed in modern farming operations. This economic purpose requires the coordination of physical, financial, and human resources.

The basic objective of a formally organized farmers' business cooperative is to bring the benefits of permanent and efficient business organization to members in ways that temporary, informal arrangements cannot accomplish.

## DEFINITIONS

Many definitions of cooperation have been formulated. Some are all-inclusive; others emphasize particular aspects of cooperation, such as economic, social, or legal phases. Some representative definitions will clarify the nature and objectives of farmer cooperatives:

“An agricultural cooperative is a business organization, usually incorporated, owned and controlled by member agricultural producers, which operates for the mutual benefit of its members or stockholders, as producers or patrons on a cost basis after allowing for the expenses of the operation and maintenance and

any other authorized deductions for expansion and necessary reserves.”<sup>1</sup>

“A cooperative enterprise is one which belongs to the people who use its services, the control of which rests with all the members, and the gains of which are distributed to the members in proportion to the use they make of its services.”<sup>2</sup>\*

“Cooperation is organized working together for mutual benefits. Economic cooperation is a form of business with democratic ownership and control by member patrons having common needs, serving themselves on a nonprofit basis, and receiving benefits proportional to **participation.**”<sup>3</sup>

“A cooperative can be defined for practical purposes as a democratic association of persons organized to furnish themselves an economic service under a plan that eliminates entrepreneur profit and that provides for substantial equality in ownership and control.”<sup>4</sup>

“ .A cooperative is a business voluntarily owned and controlled by its member-patrons and operated for them and by them on a nonprofit or cost basis.”<sup>5</sup>

“A cooperative is a voluntary contractual organization of persons having a mutual ownership interest in providing themselves a needed service(s) on a nonprofit basis. It is usually organized as a legal entity to accomplish an economic objective through joint participation of its members. In a cooperative, the investment and operational risks, benefits gained, or losses incurred are shared equitably by its members in proportion to their use of the cooperative’s services. A cooperative is democratically controlled by its members on the basis of their status as member-users and not as investors in the capital structure of the **cooperative.**”<sup>6</sup>

Definitions vary, naturally, according to backgrounds and viewpoints of those making them. They do, however, present a general idea of what a cooperative is and how such organizations are set up and operate.

Most cooperatives are incorporated. The minimum number of persons required for incorporation varies under the statutes of different States. In at least one State, two persons, and in a few States, three persons, are the minimum; but under most State laws, five is the smallest number allowed to incorporate. Other requirements for an association are that it shall have officers, a name adequate for identification, and a mail address.

## **BASIC FEATURES**

Cooperation itself contains no business magic. It merely enables the owner-users to do business in a way that benefits accrue to them. Sound business policies and practices also are essential.

Some lists of cooperative principles or features include such business policies as cash trading or effective control of credit, competitive pricing, and building capital reserves. These business practices are not included because they are not distinctive of just cooperatives. They are sound practices for both cooperative and noncooperative businesses.

Certain unique principles do underlie the cooperative form of business. Knowledge of these principles or distinguishing features is basic to understanding farmer cooperatives.

The five underlying principles that distinguish cooperatives from other types of private enterprise business are:

1. Ownership is held by member-users.
2. Control is on the basis of one vote per member, or on volume provided.
3. Operations have an at-cost (nonprofit) objective.
4. Dividends on member capital are limited.
5. Education is necessary for understanding and support.

These principles stem from the inherent nature of cooperative business and give it its distinctive character. They provide the rules of action necessary to accomplish basic cooperative objectives. They also identify the traits that distinguish cooperatives from other types of businesses.

Not all cooperatives completely follow these principles, however, and some leeway is permitted under State cooperative statutes. For example, while these principles imply that all of a cooperative's business is with members, most statutes or regulations permit it to do up to 50 percent of its business with non-members.

### **Member-User Ownership**

A cooperative is primarily owned by members who are also the users or patrons of the cooperative. This contrasts with other corporations whose stockholders usually do not account for much of the business volume. The cooperative's objectives and policies therefore are user or service oriented, while those of other corporations are primarily investor or return-on-investment oriented.

Some cooperatives also may sell preferred stock to non-members, but this usually represents a small percent of the total equity capital.

Members' interest in their cooperative usually is greatest when they have a substantial equity or degree of ownership. They are more likely to exercise their responsibility of control and they have more of an incentive to support and protect or defend it. Thus, cooperatives encourage members to acquire an ownership equity in proportion to the use they make of the organization. Investors in other types of business, in contrast, usually have little personal identification with or reside in the trade areas of the firms in which they own stock.

Therefore, ownership by member-users is a basic feature because of its influence on the cooperative's objectives, control, and financing plan.

Ownership by member-users might imply that all users or patrons are members, but in many cooperatives this is not the case. Most State and Federal statutes that pertain specifically to agricultural cooperatives specify that member business must be 50 percent or more of total business. Thus, a marketing cooperative would be permitted to do up to 50 percent of its business with nonmembers who are producers of farm products. A farm supply cooperative could do up to 50 percent with nonmembers who are either producers or nonproducers. However, if the supply cooperative wishes to operate under certain Federal tax regulations, then not more than 15 percent of its business could be with non-member, nonproducer patrons.

### **Member-User Control**

Control is closely related to ownership. It is fundamental that those who are to benefit from cooperatives must both own and control them. Member control may be achieved in different ways. In most cooperatives, it is accomplished by voting on the basis of one vote to a member. Members of such cooperatives believe that control should be related to the needs of people and not to capital investments. The one-member, one-vote practice has the advantage of making difficult any concentration of power in the hands of a few. To accomplish this, many State laws further provide that no member or shareholder of a cooperative shall be entitled to more than one vote, regardless of the amount of stock owned or the extent to which the owner patronizes the cooperative.





*A key requirement for keeping the cooperative oriented to members' needs is to get members' views. And the key leadership group for translating members' desires into cooperative operations is the board of directors, which sets overall policy and hires operating management.*



About a fourth of the States, however, now permit more than one vote to a member. The additional votes usually are based on the amount of business furnished, or in a few States on the number of shares of stock held in the cooperative:

Multiple voting by stockholders is regulated by both State statutes and cooperative practices. For example, 20 percent of the total is a common limitation; much smaller restrictions, however, such as 3 percent or 5 percent, are also used. Some fix a numerical upper limit, such as 5 or 10, on the number of voting shares.

Some State laws permit cooperatives to give members voting rights in proportion to the extent to which they use the services of their cooperative. This is referred to as voting on the basis of volume or patronage. This practice is based on the theory that the economic interests of member patrons are not equal.

Most States permit local cooperatives that are members of regional federated cooperatives to vote in proportion to number of members or volume of business they do with their regional. This practice seeks to give recognition to the desirability of maintaining some degree of proportional representation for members of locals. It recognizes that a one-vote, one-cooperative policy would not take into account wide variations that may exist in the number of members of these associations or the extent to which they use the services of the federation.

Opinion varies as to how member control is to be achieved. The key consideration is: How do members wish to operate? If on a one-member, one-vote basis they decide on multiple voting, there is no logical basis to oppose such a decision provided it complies with their State cooperative law. How members wish to control their cooperative is a prerogative they should be permitted to exercise.

## **Operations at Cost**

A key cooperative principle is adjustment of operations to a cost basis at yearend. This is usually accomplished by refunding to patrons any net margins remaining after deducting operating expenses on supplies sold to them or farm products purchased from them; or by paying all proceeds, above expenses, realized in marketing farm products on a pooling basis.

If such refunds or pool settlements are made to all patrons, operations are conducted on a cost (nonprofit) basis in the cooperative. And the member-patron would be using the cooperative to make a greater profit on his farming operations. If such

refunds or settlements are made only to member-patrons, a profit may occur on the business of nonmember patrons.

A typical section found in many State agricultural cooperative statutes to indicate operation at cost states: Nonprofit associations-associations organized hereunder shall be deemed nonprofit, inasmuch as they are not organized to make profits for themselves as such, or for their members as such, but only for their members as producers.

“Operation at cost” is the wording sometimes used as a distinctive cooperative feature because “nonprofit operation” may be associated with nonbusiness organizations such as churches, charities, or foundations.

Cooperatives that operate on a purchase-and-sale basis usually operate on a cost basis by: (1) charging prevailing market or competitive prices for supplies sold or paying prevailing market prices for farm products purchased; and (2) returning to patrons at the end of the year any “overcharges” on supplies or “underpayments” on farm products, above operating expenses, on the basis of the patron’s volume of business or use of the cooperative. These returns are called “patronage refunds,” although many cooperatives first pay a limited dividend on members’ capital and retain 10 percent or more of the net savings as “members’ or patrons’ allocated capital reserves.”

The patronage refunds may be distributed on the basis of dollar volume or the number of physical units of supplies purchased or products sold by the patrons. For example, a farmer who does an annual volume of \$10,000 through his cooperative gets twice as much in patronage refunds as one who does \$5,000 worth of business with it. When savings are distributed on a per-unit basis, the farmer who delivers 20,000 bushels of grain to his cooperative elevator has contributed 10 times as much volume to the business of his association as the farmer who delivers only 2,000 bushels. If the savings amount to 3 cents a bushel, patronage refunds are \$600 for the farmer who delivers 20,000 bushels and \$60 for the farmer who delivers 2,000 bushels.

Many supply cooperatives and most marketing cooperatives strictly adhere to the nonprofit principle by distributing patronage refunds to all patrons at the same rate. This is one of the requirements if they are to operate on the so-called income tax exempt basis. In such case, the initial refunds paid to nonmembers usually are credited toward the cost of a share of membership stock or membership fee.

Other cooperatives declare patronage refunds only to members. They pay corporate taxes on the earnings from nonmember business and usually retain the remainder in the capital structure as an unallocated general reserve or surplus.

A few cooperatives, because of unusual stability in cost and price relationships, are able to approach a cost basis of operation daily by carefully estimating costs and returns. In this way they hold net margins to a minimum and thus give "instant refunds" to members. This practice, however, is more risky as operating returns may be underestimated and little if any reserves can be accumulated for modernizing facilities or expanding services.

These methods of operation involving distribution of net margins are approved by members through adoption of provisions in bylaws or through binding membership or marketing agreements, or other preexisting consent arrangements. Bylaws, however, usually give the board of directors discretion on the form and timing of patronage refunds.

Cooperatives marketing on a pooling basis usually operate on a cost basis by: (1) making one or more cash advances to farmer-patrons, and (2) distributing the remaining net proceeds from the sale of products after deducting operating expenses and other authorized deductions such as "capital retains" to help finance the cooperative. Such retains may be specified amounts per box or per case marketed by the members each year. The final payment or final settlement after closing the pool, therefore, is not comparable to net margins or patronage refunds in a purchase-and-sale cooperative.

Patronage refunds and capital retains are a convenient means of helping the member finance his cooperative. They often are paid or issued to members in the form of capital stock or some other form evidencing ownership to show that the member has a certain amount of accumulated equity capital credited to him. These may later be retired under a revolving capital plan.

The revolving fund method of cooperative financing is a working outgrowth of the basic cooperative philosophy that every man should support his organization in proportion to the extent he uses it and benefits from it.

Under the revolving fund program, when the cooperative has accumulated adequate capital, the oldest member equities are revolved or repaid with funds from equities or deferred refunds derived from current operations. Cooperatives are discovering, however, that because patronage refunds vary from year to year

and because financial requirements are increasing, this method does not always enable them to build a sound and stable financial structure. Therefore, many cooperatives are developing “adjustable revolving fund” plans to achieve greater financial stability. This is further discussed in Section 5, “Cooperative Financing and Taxation.”

### **Limited Dividends on Member Capital**

Capital invested in a cooperative is only a means to an end. When farmers set up a cooperative, they are not seeking outlets for capital investment. Their business is farming, and it requires large amounts of available capital. Their main motive in organizing a cooperative is to market farm products and obtain supplies or business services more effectively, rather than to make a profitable return on dollars invested in the cooperative. Therefore, payments for member equity capital are usually limited to the “going rate” so that most of the net margins above expenses will be distributed as patronage refunds according to use made of the cooperative. Also, this encourages members to dispose of their equity capital when they cease farming or otherwise become inactive. Farmers recognize, however, that capital is as necessary in a cooperative organization as in any other business. They know members must finance buildings and equipment, and obtain or provide operating funds for day-to-day operations. They would like for all members to provide capital in proportion to their use of services. In such case no dividends on capital would be necessary; but because many cooperatives cannot raise the full amount of capital on this basis, some farmers assist by making larger investments and receiving a modest dividend on their capital.

Limitation by cooperatives of returns on equity capital is recognized in both Federal and State laws. These laws merely specify the maximum returns that may be paid on member capital. Cooperatives may choose to pay any amount less than the maximum. In most State statutes, the limit on capital returns is fixed at 8 percent, although in a few States it is lower.

A basic Federal cooperative law—the Capper-Volstead Act—recognizes the principle of limited returns on member capital by setting a maximum rate of 8 percent, or the legal rate in the State, whichever is higher, *if* members vote on any basis *other* than one-man, one-vote.

**Agricultural** cooperatives that qualify under Section 521 of the Internal Revenue Code are required to limit dividends on their

member capital. This legislative recognition of the limitation of returns on member capital in a cooperative business enterprise provides legal sanction to a business procedure already recognized as sound among cooperatives.

## Constant Education

Early cooperators, including the Rochdale pioneers, recognized the importance of education in the cooperative enterprise. The 28 weavers who formed the first consumer cooperative in England, “The Rochdale Equitable Pioneers Society,” in 1844 included constant education in their cooperative principles, which have become widely accepted.

In the United States, many of the early cooperative efforts of general farm organizations and of Aaron Sapiro, the proponent of cooperative marketing on the basis of individual commodities in the 1920’s, ignored the need for informed leaders and members. Experience demonstrated that when cooperatives neglected education they sooner or later encountered considerable difficulty. Well planned educational programs can do much to eliminate “economic illiteracy” and move back the borders of “economic superstition and darkness.”

In later years, the need for cooperative education and communication was recognized by large regional associations, banks for cooperatives, national and State cooperative councils, the American Institute of Cooperation, land-grant universities, and Agricultural Cooperative Service. These agencies recognized there was little prospect that cooperative progress would advance beyond the knowledge and understanding of members and leaders. Moreover, they were aware, as one cooperative student expressed it that “not more than 25 percent of all cooperatives even approach operating at full potential.”

Unique features of cooperatives result in ownership, control, financial responsibility, patronage, and benefits being centered in the same **persons**—the members. If members and leaders are to make sound decisions, they must have the necessary facts and information about the operation of their cooperatives. Further, these members and leaders are but a passing parade that will continue with replacements only through effective education. There is ample reason, therefore, to conclude that the duty to educate constantly is a basic feature and a special obligation of cooperatives.

# OBJECTIVES AND STRUCTURE

Farmer cooperatives, as off-farm businesses, aim primarily to enhance the farmers' economic well-being by marketing farm products and obtaining needed supplies and services most effectively. A cooperative does this to help its members as producers increase their individual earnings. More specifically, the objectives of most farmer cooperatives are:

1. To increase the net income and standard of living of members by minimizing their costs of farm inputs and maximizing their returns from marketing the farm products they produce.

2. To provide needed services or to improve existing services involved in marketing products or handling supplies, or obtaining specialized business services.

3. To encourage the production and marketing of high quality products and to procure for members the type and quality of supplies that will produce maximum crop yields or livestock gains.

Cooperatives are used in almost all phases of farming activity. They may be grouped or classified in various ways depending on the objective in mind. Among the most common are major types of function or service for the farmer, commodities handled, integrated level of operation, areas served, size, organizational structure, and membership structure.

1. The principal types of cooperatives from the standpoint of functions performed for farmers are these: (1) marketing farm products; (2) purchasing farm supplies; and (3) providing specialized farm services (often related to farm production).

Of the more than 7,600 farmer cooperatives, about 62 percent engage primarily in marketing activities; 36 percent primarily in supply purchasing activities; and less than 2 percent in specialized services related to marketing or purchasing.

Principal products marketed are grain (including soybeans), dairy, fruits and vegetables, livestock, sugar, and rice. These products account for 90 percent of total marketing volume.

Principal products purchased are feed, fertilizer, petroleum, farm chemicals, seed, and building materials. These production supplies account for 80 percent of total purchasing volume.

Many cooperatives operate as multipurpose associations at the same time performing marketing, purchasing, and related service functions. Some associations are highly specialized and entirely or quite largely handle one commodity such as dairy, live-

stock, fruit and vegetables, or cotton. While most supply associations handle many basic farm supplies, some restrict operations to handling petroleum products or feed, seed, and fertilizer. Also, a large number of predominantly marketing cooperatives from the standpoint of dollar sales also handle farm supplies.

Business service cooperatives include those providing fire and wind and life insurance, credit, electricity, telephone, irrigation, health, transportation, artificial breeding of cattle, **hand**-crafts, recreation, soil conservation, and production services, among others.

In addition to agricultural cooperatives there are consumer, retailer-owned, and worker cooperatives.

2. In marketing farm products, the more common levels of operations are: Local assembling, storing, packing and selling; local or regional processing; central or terminal storing and selling-usually for local cooperatives; and regional or national storing and selling, including exporting-for regional federated cooperatives or large centralized cooperatives.

In purchasing farm supplies, the major levels of operations are: Retailing at the local level to farmers and other patrons; wholesaling for local retail cooperatives; manufacturing, refining or processing; and production of raw materials. Transportation is also involved in each of these levels of operation in both marketing and purchasing cooperatives.

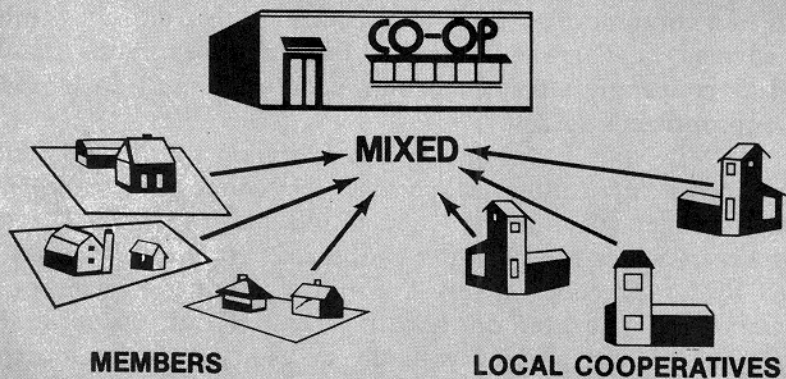
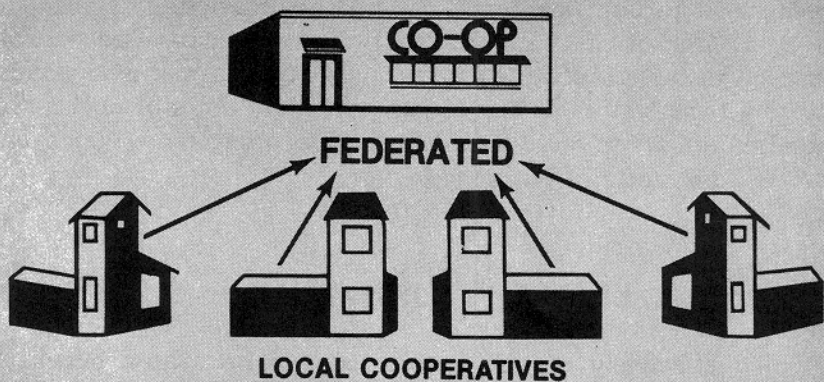
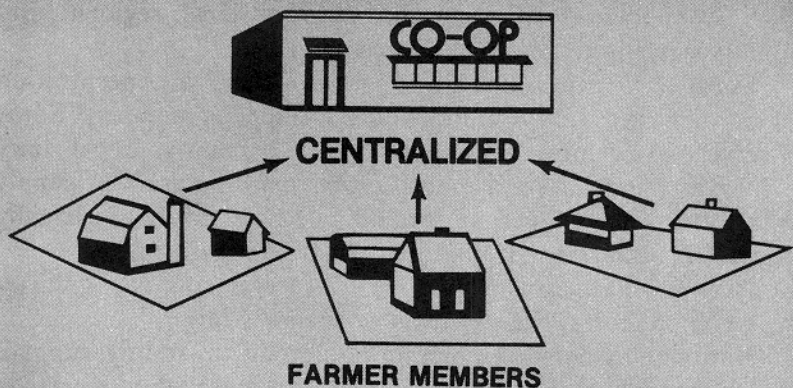
3. Legally, cooperatives may be classified as incorporated or unincorporated or they may be classified as stock or nonstock, depending on their corporate structure. Legal status may vary without relation to size, area covered, or type of membership.

From the standpoint of type of membership, associations may be classified as centralized, federated, or mixed, which means a combination of both (fig. 1). Centralized associations have individual farmers as members and may be local or regional in scope.

4. Local associations make up the membership of regional federated cooperatives. In the regional federation, control rests with the local associations that comprise its membership. Each local association in turn is controlled by its own individual members, who are the final beneficiaries of the operation of the federation. There may be area, national, or international federated cooperatives also whose members consist of regional cooperatives-either of the centralized or federated type. These also may be called interregional cooperatives.



**FIG. 1 — TYPES OF COOPERATIVE STRUCTURE**



In the combination or mixed type of cooperatives, both farmers and local cooperatives are members.

5. Cooperatives are designated as being local, regional, and national according to geographic area served.

Local associations usually operate around a concentration point or trading center with individual farmers as members. Some may serve two or more trading centers or a county. Local dairy cooperatives usually serve a much larger area than grain or supply cooperatives. The services performed by these locals are usually more limited than those of regional or national associations.

Regional associations may cover several counties within a State, parts of several States, or all of several States.

National associations handle commodities or buy supplies on a countrywide scope. Both regional and national cooperatives usually engage in manufacturing or processing and provide a wide range of integrated services. More recently, some associations are even starting to operate across national boundaries.

6. One of the simplest classifications is that based on volume of business. According to business done, farmer associations range all the way from those with annual volumes of only a few hundred dollars to large-scale associations doing more than a billion dollars' worth of business.

## **LEGAL FOUNDATIONS**

To effectively represent the members for whose benefit a cooperative is formed, and to operate efficiently in the business community, a cooperative must be recognized as a legal entity. One of the legal forms under which a cooperative may operate is that of a corporation, a form of organization that offers a number of advantages. There is no general Federal incorporation statute, and all cooperatives that choose to incorporate must do so under an appropriate State law.

Every State has a general incorporation statute. All States have special "agricultural cooperative" or "cooperative marketing" statutes under which farmer cooperatives may incorporate, and a number of States have broader cooperative statutes that might be used by farmer cooperatives. A group of producers intending to form an incorporated cooperative must consult the applicable State statute and proceed with the necessary steps for incorporation.

## Organization Documents

The basic documents involved in incorporation are the articles of incorporation and the bylaws. These documents are prepared by the incorporators and filed with the appropriate State officer.

Articles of incorporation describe the organization and its basic structure.<sup>7</sup> When approved by the appropriate agency such as the Corporation Commission or Secretary of State, a certified set of articles or charter may be issued. Items normally included in the articles of incorporation are the cooperative's name, its purposes, powers and limitations, place of business, the number and terms of directors, a description of membership requirements and rights, and the capital stock structure, if necessary.

Bylaws are a more detailed description of the internal operations and structure of the cooperative. They vary in length and detail but normally include rules of membership qualification and suspension or termination; meetings of members, including voting rights; the qualifications, election, and duties of directors and officers; duties of the manager; use of committees; capital structure; rules of cooperative operations, including distribution of net margins; use of capital retains and revolving capital; dissolution and property interest of members; end of fiscal year; amendment provisions; and other items necessary or desirable under the relevant State statute.

The articles of incorporation and the bylaws must be drafted to meet the statutory requirements of the relevant statute. An example of how States vary in requirements is seen in voting restrictions. Most States specify one-member, one-vote but a few permit voting on the basis of shares of capital stock held or business volume with the cooperative. Many other statutory features vary widely among States.

When the cooperative has met the legal requirements of the State corporation laws, it is recognized as a legal entity. As such, the cooperative and its directors and officers are subject to all laws applicable to a business enterprise. The basic documents to which it must look for powers and restrictions are the articles of incorporation, the bylaws, and the incorporation statutes. These three documents form the authority for its organization and operation.

Some marketing cooperatives, especially those on a pooling basis, also use marketing contracts or agreements. These vary in

length or detail but usually state that the producer applies for membership in the cooperative and agrees to deliver a specified quantity of product under specified conditions, appoints the cooperative as his agency to sell the product, agrees to provide capital as may be stipulated by the board of directors, agrees to pay a specified penalty for all products marketed in violation of the contract, and agrees to abide by the bylaws of the association.

The contracts also state what the cooperative agrees to do, such as market the product, properly account for sales proceeds and for capital received from patrons, and the like.

It is important to recognize that the cooperative has full responsibility for informing itself of the laws applicable to its operation in addition to the basic law previously mentioned. At the State level, examples of laws that might apply to cooperatives include basic contract law, the uniform commercial code, banking and insurance laws, workmen's compensation, unemployment insurance, securities laws, State taxation, and all other laws and regulations under which a business concern operates. Federal laws and regulations are also numerous and must be considered in conducting cooperative business.

### **Antitrust Laws**

No legal restrictions existed initially on the formation or activities of agricultural cooperatives.<sup>8</sup> These early cooperatives were seriously threatened, however, by Congress's passage in 1890 of the Sherman Antitrust Act.<sup>9</sup>

The ***Sherman Antitrust Act*** was the first of three separate acts commonly referred to as the antitrust laws. It was directed at restraints of trade in interstate commerce and the existence of monopolies or attempts to establish them. Violations of its provisions were made misdemeanors punishable by fines up to \$50,000, or imprisonment for a maximum of 1 year, or both.<sup>10</sup>

Farmers were among the most enthusiastic supporters of passage of the Sherman Act, for they were particularly susceptible to monopoly practices of large business organizations such as the railroads and grain dealers.

During congressional debate over the act, unsuccessful attempts were made to amend it to exempt agreements among farmers, and combinations or associations of farmers, intended to enhance the price of agricultural products.<sup>11</sup> Failure of these attempts was probably due more to a belief that farmers would be unable to form such organizations than any antifarmer sentiment.

Nevertheless, concern arose among agricultural interest groups that the Sherman Act would be interpreted as a total prohibition of the existence and functioning of agricultural cooperatives. This concern was increased in 1911, when a Circuit Court of Appeals held that a combination of farmers was prohibited by the Sherman Act.<sup>12</sup>

In the meantime, Congress was demonstrating that it did not intend such a result by providing regularly in appropriation bills that no part of the funds appropriated for enforcement of the Sherman Act should be expended for prosecution of agricultural cooperatives seeking to ensure fair and reasonable prices for their products.<sup>13</sup>

In 1914, Congress passed the *Clayton Antitrust Act*.<sup>14</sup> This Act prohibited certain practices such as price discrimination and the merger of separate business entities when the effect would be “to lessen competition, or to tend to create a monopoly.” It also established a private right of action in which any person injured by another’s violation of the antitrust laws could recover treble damages and the cost of the suit (including reasonable attorney’s fees).

Congress also used this opportunity to partially exclude from the antitrust laws agricultural cooperatives (and labor unions). Section 6<sup>15</sup> of the Clayton Act provides:

“Nothing contained in the antitrust laws shall be construed to forbid the existence and operation of labor, agricultural, or horticultural organizations, instituted for the purposes of mutual help, and not having capital stock or conducted for profit, or to forbid or restrain individual members of such organizations from lawfully carrying out the legitimate objects thereof; nor shall such organizations, or the members thereof, be held or construed to be illegal combinations or conspiracies in restraint of trade, under antitrust laws.”

Furthermore, Section 7<sup>16</sup> of the Act provides that its prohibition of certain mergers and acquisitions does not “apply to transactions duly consummated pursuant to authority given by the . . . Secretary of Agriculture. under any statutory provision vesting such power in . . . (the Secretary).”

Section 6 did not fully satisfy the agricultural interests, for its language appeared to provide by implication that the existence and operation of agricultural cooperatives with capital stock could be violative of antitrust laws. There was also concern whether the

term “legitimate objects” was broad enough to protect all necessary cooperative marketing procedures.

In 1922, Congress responded to these concerns by enacting the *Capper- Volstead Act*.<sup>17</sup> Section 1 of this act expressly authorizes producers of agricultural products to “act together in associations, corporate or otherwise, with or without capital stock ...” This section also sets forth examples of the types of activities in which agricultural cooperatives are authorized to engage: (1) Collective processing and marketing of its members’ products in interstate and foreign commerce; (2) making of marketing agreements in common with other agricultural cooperatives; and (3) execution of necessary contracts to accomplish 1 and 2 above.

For an agricultural cooperative to qualify for the provision established in the *Capper-Volstead Act*, it must be organized to meet certain statutory requirements: (1) It must be operated for the mutual benefit of its members as producers; (2) either it must limit each member to one vote regardless of the amount of stock or membership capital he may own, or, if it pays dividends on the basis of members’ stock or membership capital, it must limit these dividends to a maximum of 8 per centum per annum; and (3) it cannot handle a greater amount of products from nonmembers than it does from members.

Section 2 of the *Capper-Volstead Act* establishes a procedure where the Secretary of Agriculture can issue a cease and desist order whenever he has reason to believe that an agricultural cooperative qualified under the act has monopolized, or restrained, trade “in interstate or foreign commerce to such an extent that the price of any agricultural product is unduly enhanced by reason thereof. ..” If the cooperative fails to comply with this order, the Secretary is authorized to request the Attorney General to file suit in Federal district court to enforce it.

Congress amended the Clayton Act in 1936 by enacting the *Robinson-Patman Price Discrimination Act*.<sup>18</sup> This act expanded the prohibitions against price discrimination to include “any transaction of sale, or contract to sell, which discriminates to his (the seller’s) knowledge against competitors of the purchase .. ”

Section 4 of the act<sup>19</sup> provides that nothing in 7 U.S.C. subsections 13, 13a, or 21a, “shall prevent a cooperative association from returning to its members, producers, or consumers the whole, or any part of, the net earnings or surplus resulting from its trading operations, in proportion to their purchases or sales from, to, or through the association.” This language ensures that



*Volstead Co-operative Marketing Law,  
February 18, 1922, Witnessed by Authors of  
the Bill and Representatives of Farmers' Union  
American Farm Bureau, The Grange, and  
National Board of Farm Organizations.*

an agricultural cooperative's customary patronage refunds will not be held to be in violation of the antitrust laws. This recognition of the distinctive features of cooperatives does not, however, authorize a cooperative to engage in buyer-seller practices prohibited by the act's other provisions.

In 1974 Congress enacted the Antitrust *Procedures and Penalties Act*<sup>20</sup> which amended the penalty provisions of 15 U.S.C. subsections 1-3 so that violations of those sections were made felonies rather than misdemeanors. It increased the maximum fines from \$50,000 to \$1 million for corporations and \$100,000 for individuals, and the maximum imprisonment from 1 year to 3 years.

Shortly after Congress passed the Sherman Act, several States enacted their own antitrust laws to regulate intrastate commerce. Unlike Congress, however, many State legislatures exempted agricultural cooperatives completely from the restrictions of their antitrust laws. In 1902, the Supreme Court held that this practice was violative of the 14th Amendment Equal Protection Clause in that antitrust laws with the exemption applied to non-agricultural producers but not **agricultural ones**.<sup>21</sup>

The Court modified this holding in 1928<sup>22</sup> but did not overrule it until 1940.<sup>23</sup> The States are now free to exempt the formation and intrastate marketing practices of agricultural cooperatives from coverage of their antitrust laws. Virtually all have done so.

## Other Legislation

The *Packers and Stockyards Act* of 1921<sup>24</sup> contains one section<sup>25</sup> that prohibits stockyard operations from refunding any portion of charges made under the schedule they are required to file with the Secretary of Agriculture. It specifically provides, however, that this prohibition "shall not prohibit a cooperative association of producers from bona fide returning to its members on a patronage basis, its excess earnings on their livestock ..."

Section 5 of the *Grain Futures Act of 1922*<sup>26</sup> authorized the Secretary of Agriculture to designate boards of trade as contract markets when they complied with certain requirements. Among these was one that they not exclude from full membership "any duly authorized representative of any lawfully formed cooperative association of producers having adequate financial responsibility which is engaged in cash grain business ..."<sup>27</sup> This section also contained a provision similar to that in the Packers and Stock-



yards Act that no contract market rule was to be interpreted to prohibit a cooperative association from making patronage refunds “to its bona fide members of moneys collected in excess of the expense of conducting the business of such association.”<sup>28</sup>

The Grain Futures Act was replaced by the *Commodity Exchange Act* of 1936<sup>29</sup> which contained language virtually identical to that discussed above.<sup>30</sup> The language is retained intact in the *Commodity Futures Trading Commission Act* of 1974.<sup>31</sup>

The U.S. *Grain Standards Act* of 1976 established a new Federal Grain Inspection Service (FGIS) within the U.S. Department of Agriculture, effective Nov. 20, 1976. One of the most important features of the new law was to require public inspection at ports by Federal or authorized State officials, and to require that they supervise the entire weighing process. The new law eliminated inspection by private agencies at ports but allowed private and State inspection at inland terminals.

In the *Cooperative Marketing Act* of 1926,<sup>32</sup> Congress went beyond the Capper-Volstead Act in its recognition of the cooperative marketing principles in agriculture. It provided for the establishment of a division of cooperative marketing within the Department of Agriculture to “render service to associations of producers of agricultural products, and federations and subsidiaries thereof, engaged in the cooperative marketing of agricultural products ...”<sup>33</sup> This function is currently the responsibility of the Agricultural Cooperative Service.

The Act also authorizes agricultural cooperatives to “acquire, exchange, interpret, and disseminate past, present, and prospective crop, market, statistical, economic, and other similar information by direct exchange between such persons (producers of agricultural products), and/ or such associations or federations thereof, and/or by and through a common agent created or selected by them.”<sup>34</sup>

In 1927, Congress legislated against *discrimination by boards of trade*. It provided that no board of trade that engaged in the buying or selling of agricultural products could exclude representatives of bona fide agricultural cooperatives from membership, and that such boards could not make any rule that would prohibit agricultural cooperatives from making patronage refunds to its members.<sup>35</sup>

Congress stated in the *Agricultural Marketing Act* of 1929<sup>36</sup> that it was “the policy of Congress to promote the effective merchandising of agricultural commodities in interstate and foreign

commerce . . . (3) by encouraging the organization of producers into effective associations or **corporations** under their own control for greater unity of effort in marketing . . .”<sup>37</sup>

With passage of the *Farm Credit Act* of 1933, Congress greatly reinforced efforts toward that goal. It laid the foundation for the farmer-owned Farm Credit System, which provided for 13 banks for cooperatives and a network of production credit associations.

With the *Agricultural Adjustment Act* of 1933<sup>38</sup> Congress authorized the Secretary of Agriculture to enter into marketing agreements with producers of certain agricultural products and provided that nothing in the terms of such agreements “shall be held to be in violation of the antitrust laws of the United States, and any such agreement shall be deemed to be lawful . . .”

The *Agricultural Marketing Agreement Act* of 1937<sup>39</sup> reenacted and amended the Agricultural Adjustment Act of 1933 but did not change the language stated above.<sup>40</sup> Congress added a section, however, authorizing the Secretary of Agriculture to arbitrate disputes between dairy cooperatives and handlers or distributors that concern “the sale of milk or its products.” Arbitration proceedings conducted pursuant to this authorization are exempted from the antitrust laws, but the Secretary is directed not to approve any award or agreement “if it permits any unlawful trade practice or any unfair method of **competition**.”<sup>41</sup>

Congress enacted the *Agricultural Fair Practices Act* of 1967<sup>42</sup> to protect farmers’ right “to join together voluntarily in cooperative organizations as authorized by law.”<sup>43</sup> It expressly prohibits persons having business dealings with producers of agricultural products relating to those products from engaging in, or permitting their employees from engaging in, certain practices that could adversely affect this right to form or to join an agricultural cooperative.<sup>44</sup> The Act authorizes injunctive relief to enforce these prohibitions.

## Securities Laws

The issue and exchange of a security interest in an interstate business are within the jurisdiction of the Federal Securities Exchange Commission. The Securities Act of 1933 requires the “registration” of a security issue before it can be sold to the public, and has as its purpose full disclosure of information needed by the buyer to make an informed decision to purchase. Failure to properly register has some serious consequences.

Registration of securities under the 1933 act generally applies to all securities issues, but is not required of farmer cooperatives if the cooperative meets certain conditions. Exemption from registration extends only to those cooperatives that qualify for tax treatment under Section 521 of the Internal Revenue Code. Securities issues of less than \$500,000 are also treated specially. Most provisions of the Securities Exchange Act of 1934 do not apply to cooperatives meeting the definition of a cooperative in the Agricultural Marketing Act of 1929, a more inclusive definition covering most cooperatives.

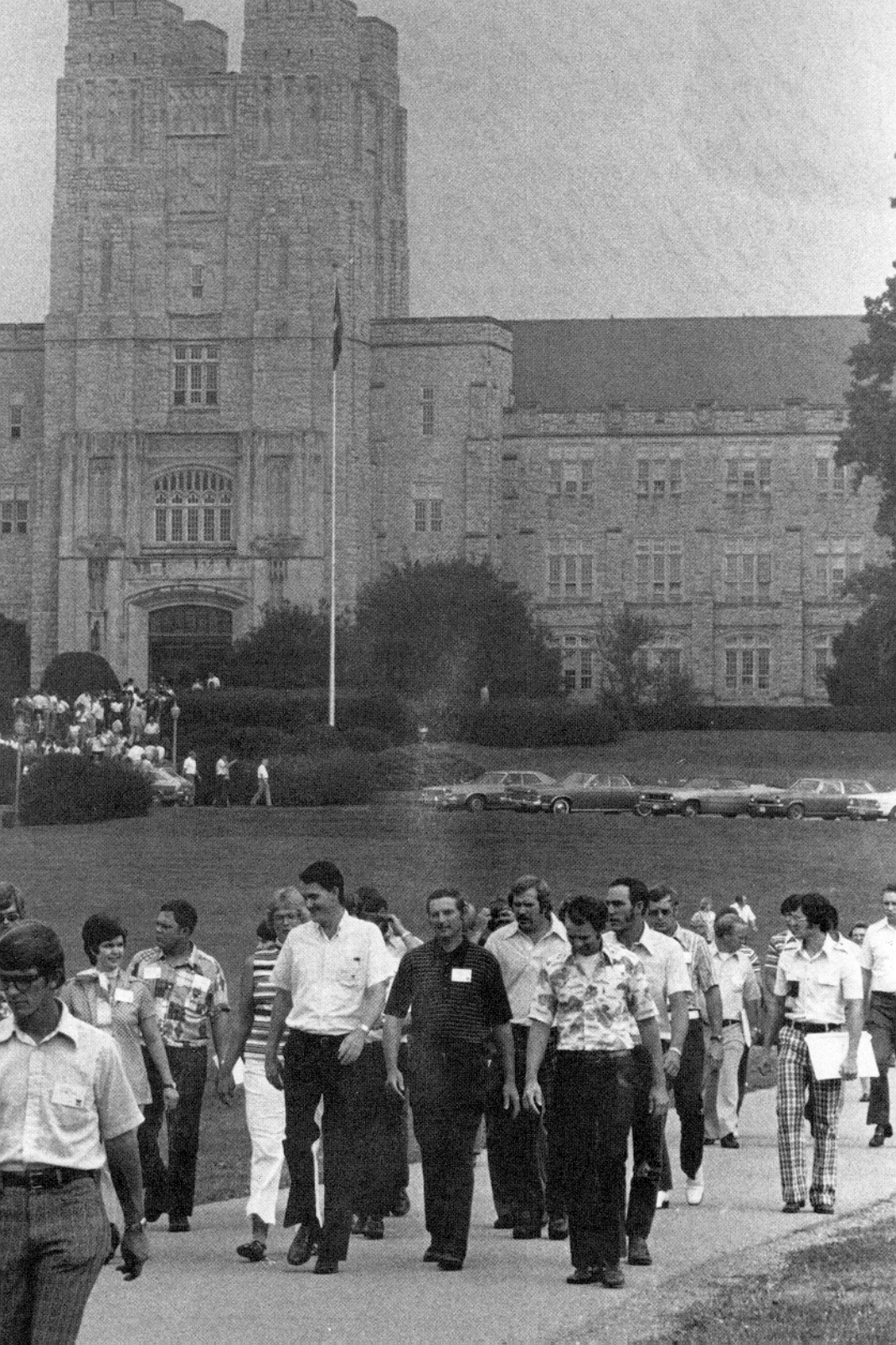
It is important to note that the antifraud provisions of both the 1933 and 1934 acts apply to all cooperatives whether or not the cooperative issue is exempt from registration. In addition, a legal question being discussed in 1977 and not yet settled is whether or not retained patronage refunds and per-unit capital retains are securities subject to registration under SEC regulations.

State securities laws, often called “blue sky” laws, may also apply to agricultural cooperatives. Both coverage and requirements vary considerably from State to State, with some States having specific exemptions for farmer cooperatives and some having no special exemption at all. Because of the variation among States, no generalizations can be made about State blue sky laws. Antifraud provisions under the State consumer protection statutes apply to all cooperatives whether or not the cooperative issue is exempt from registration.

Basic income tax legislation at the Federal and State levels that applies to farmer cooperatives is discussed in Section V, entitled “Cooperative Financing and Taxation.”

*Authors: Martin A. Abrahamsen, former deputy administrator / J. Warren Mather, former assistant administrator / James R. Baarda, senior agricultural economist / James Michael Kelly, assistant general counsel.*

*The underlying principle that affects the success in fulfilling all other principles unique to cooperatives is constant education. This educational principle comes to focus each year when the American Institute of Cooperation conducts the National Institute on Cooperative Education. The picture on the next page is of the NICE session at Virginia Polytechnic Institute, Blacksburg, in 1976.*



## Footnotes

<sup>1</sup>Evans and Stokdyk, *The Law of Agricultural Marketing*, Lawyers Cooperative Publishing co., 1937.

<sup>2</sup>*Report of the Inquiry on Cooperative Enterprise in Europe*, 321 p. U.S. Govt. Printing Off. Washington, D.C., 1937.

<sup>3</sup>Fetrow, W. W. and Elsworth, R. H., *Agricultural Cooperation in the United States*, Farm Credit Admin. Bul. 54, 214 p. 1947.

<sup>4</sup>Packel, *The Organization and Operation of Cooperatives*, 4th ed., American Law Institute (1970), p. 2.

<sup>5</sup>Schaars, *Cooperatives, Principles and Practices*, University of Wisconsin Extension, Madison, Wisconsin, 1973, p. 7.

<sup>6</sup>Savage and Volkin, *Cooperative Criteria*, FCS Service Report 71, Farmer Cooperative Service, U.S. Dept. Agr. (1965).

<sup>7</sup>Examples of legal documents used by farmer cooperatives are found in *Sample Legal Documents*, Part 1, Information 100, *Legal Phases of Farmer Cooperatives*, 1976.

\*Material for the remainder of this section was obtained from *Agricultural Cooperatives*, Practising Law Institute Corporate Law and Practice Course Handbook Series Number 151 (1974).

<sup>9</sup>15 U.S.C. Secs. 1-7 (1970).

<sup>10</sup>*Id.*

<sup>11</sup>*E.g.*, 21 Cong. Rec. 2726 (1890).

<sup>12</sup>*Steers v. United States*, 192 F.1 (6th Cir. 1911).

<sup>13</sup>*Hanna, Cooperative Associations and the Public*, 29 Mich. L. Rev. 148, 170 (1930).

<sup>14</sup>15 U.S.C. Secs. 12-27 (1970).

<sup>15</sup>15 U.S.C. Sec. 17 (1970).

<sup>16</sup>15 U.S.C. Sec. 18 (1970).

<sup>17</sup>15 U.S.C. Secs. 291-292 (1970).

<sup>18</sup>15 U.S.C. Secs. 13, 13a, and 21a (1970).

<sup>19</sup>15 U.S.C. Sec. 13b (1970).

<sup>20</sup>P.L. 93-528, 93d Cong., 2d Sess. (1974).

<sup>21</sup>*Connolly v. Union Sewer Pipe Company*, 184 U.S. 540 (1902).

<sup>22</sup>*Liberty Warehouse Company v. Burley Tobacco Growers Cooperative Marketing Association*, 276 U.S. 71 (1928).

<sup>23</sup>*Tigner v. Texas*, 310 U.S. 141 (1940).

<sup>24</sup>15 U.S.C. Sec. 181 *et seq.* (1970).

<sup>25</sup>15 U.S.C. Sec. 207(f) (1970).

<sup>26</sup>42 Stat. 998 (1922).

<sup>27</sup>*Id.* at 1000-01.

<sup>28</sup>*Id.* at 1001.

<sup>29</sup>15 U.S.C. Sec. 1 *et seq.* (1970).

<sup>30</sup>15 U.S.C. Sec. 7(e) (1970).

<sup>31</sup>P.L. 93-463, 93d Cong., 2d Sess. (1974).

<sup>32</sup>15 U.S.C. Sec. 451 *et seq.* (1970).

<sup>33</sup>15 U.S.C. Sec. 453 (1970).

<sup>34</sup>7 U.S.C. Sec. 455 (1970).

<sup>35</sup>15 U.S.C. **Secs.** 431-33 (1970).

<sup>36</sup>12 U.S.C. Sec. 1141 *et seq.* (1970).

<sup>37</sup> 12 U.S.C. Sec. 1141(a) (1970).

<sup>38</sup>48 Stat. 31 (1933).

<sup>39</sup>7 U.S.C. Sec. 601 *et seq.* (1970).

<sup>40</sup>The exemption from the antitrust laws for marketing agreements is currently codified as 7 U.S.C. Sec. **608b** (1970).

<sup>41</sup>7 U.S.C. Sec. 671 (1970).

<sup>42</sup>7 U.S.C. Sec. 2301 *et seq.* (1970).

<sup>43</sup>7 U.S.C. Sec. 2301 (1970).

<sup>44</sup>7 U.S.C. Sec. 2303 (1970).