



LEGAL COOPERATIVE FRAMEWORK ANALYSIS

Within the ICA-EU Partnership

NATIONAL REPORT FOR THE UNITED STATES OF AMERICA

I. Introduction

This report was produced within the investigation of the Legal Cooperative Framework Analysis initiated by the International Cooperative Alliance (ICA) and its regional offices. The investigation is carried out in the framework of an alliance signed between the European Union and ICA for the 2016-2020 period. The main goal is to strengthen the cooperative movement and its ability to promote the international development.

The legal framework analysis intends to improve the knowledge and evaluation of the cooperative law, with the goal of ensuring that legal regulations recognize the specificities of the cooperative model and the equality of conditions in comparison with other types of business forms. In the same way this analysis will be useful to the members of ICA as material to their defense and recommendations on the creation or improvement of legal frameworks, to document the implementation of laws and cooperation policies, and monitor its development.

In line with the established goals of the ICA-EU Project this report aims to provide a general knowledge of United States cooperative law and an evaluation of the degree of its ability to favor cooperatives development. In the same way, recommendations for the improvement of the law have been formulated to overcome some difficulties that cooperatives are currently facing.

The document has been prepared by Thomas Beckett, a licensed attorney with a Master of Business Administration practicing in North Carolina. He is Executive Director of Carolina Common Enterprise, a nonprofit cooperative development center and public interest law firm. Doug O'Brien, the president and CEO of NCBA CLUSA, also contributed to this article. This document also represents contributions and comments from several distinguished law and accounting professionals and ICA Americas members who are acknowledged below.

In the federal system of the United States of America, the national government and the fifty states plus several territories exercise dual sovereignty. Business organizational law is generally the domain of state law and taxation is exercised by both state and federal governments. There is no uniform cooperative law in the United States. Given the number of jurisdictions and different types of subject matter co-operative authorizing statutes, this paper cannot provide an exhaustive analysis of US cooperative law. The paper provides an introduction and general survey of cooperative organizational law and offer suggestions for areas of improvement.



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II. National Cooperative Legislation of The United States

i. General context

The United States of America is organized on a multi-layered system. With few exceptions, the federal government does not charter corporations or businesses. Each state enacts its own statutes authorizing creation of business entities. These jurisdictions include fifty states, the District of Columbia, and territories such as Puerto Rico. This paper will use the term “states” to include all such jurisdictions. For many non-cooperative business entities, such as investment corporations, there is uniformity in much of state law as regards business and commerce due to a concerted effort by the private sector Uniform Commission on Laws. In contrast, cooperative corporation law has no uniformity among the states.

Where the dominant corporate law evolved to meet the needs of financial capitalism nationally, cooperative statutes arose in different places at different times in response to different sorts of needs. State statutory law for co-ops varies widely from state to state. For example, the cooperative law of Mississippi is limited to rural electric, credit union, and agricultural marketing purposes only, while that of Wisconsin has been regularly updated and offers broad application to many sectors. The cooperative corporate statute of North Carolina was enacted in 1915, and while it has been amended since, remains in its that original form. This paper will review general features of such enactments but cannot analyze each in detail.

Federal law, enacted by the United States Congress, has significant influence on cooperatives in several ways. Federal income taxation of business entities is national in scope. To the extent states impose taxes on corporations, they tend to follow the pattern established by federal law.

Also, federal legislation and regulation is specifically directed to cooperatives in certain industries. The national network of rural electric cooperatives was initiated and financed by the Rural Electrification Act during the Great Depression of the 1930s. Financial institutions are regulated by both federal and state governments. The federal government charters some credit unions and created the National Credit Union Administration to supervise credit unions and provide deposit insurance for those institutions.

This sector-base approach to cooperative policy has contributed to a very robust presence of cooperatives in certain sectors amounting to about one out of every three people in the U.S. as a member of a cooperative. In agriculture, most of the nation’s 1.7 million farmers are members of cooperatives and certain agriculture sectors – such as dairy, citrus, crop inputs, and many specialty crops – are dominated by cooperatives. In rural electrification, the vast majority of the geography of the U.S. receives its electricity from member owned utility cooperatives. And in consumer finance, over 100 million people belong to credit unions. These sectors each feature a comprehensive policy enabling environment with specialized technical assistance, financing, and regulatory policies. Other sectors lack the specialized policy mechanisms, and as a result, are much smaller in scale. O’Brien, *Building the Next Economy*.



ii. Specific Elements of the Cooperative Law

The first U.S. cooperative incorporation statute was enacted by Michigan in 1865. Wisconsin adopted a general cooperative organizing statute in 1911 that became a model for similar laws in sixteen other states. In the 1920s a Californian cooperative activist, Aaron Sapiro, drafted a model incorporation statute which became so widely adopted it became known as the “Standard Act.” This Standard applied to farming producer cooperatives only, however. Vestiges of the Wisconsin law and Sapiro’s model exist in many state statutes to this day.

Much of the drive for establishment of cooperatives came from the need to improve economic conditions in agriculture. The U.S. Department of Agriculture promoted cooperative development in the nineteen-teens and remains the primary government agency supporting cooperatives nationally. Consequently, state cooperative law evolved and adapted to suit the market conditions and capital needs of local agriculture industries. Some states still provide for formation of only farming cooperatives. In many other states, economic conditions and advocacy have led to the inclusion other industries and sectors such as housing and consumer retail in the enactment of general cooperative corporation statutes.

a) Definition and Objectives of Cooperatives

While the statutes vary, a degree of consistency exists nationally. The first exercise for practitioners in the United States is to discover sources of law controlling the definition and activities of cooperatives. We review those here.

Federal Sources of Law

The United States Constitution does not contemplate cooperatives, nor do any state constitutions. Some state statutes do not acknowledge the *Statement on the Cooperative Identity* by the International Cooperative Alliance, or its *Cooperative Values* or seven *Cooperative Principles*. In practice, most U.S. cooperatives celebrate the seven Cooperative Principles, which stand as an aspirational guide star.

U.S. Internal Revenue Code determines taxation of cooperatives nationally. Therefore, that statute and the decisions of the federal tax courts are the primary source of uniformity among cooperative corporations nationally. The definition in that statute is quite vague and defines “cooperatives” as “any corporation operating on a cooperative basis....” 26 U.S. Code § 1381(2). This left the question to be clarified by court decision.

That came in 1965 with the tax case of Puget Sound Plywood, a worker cooperative that claimed cooperative status and certain revenue exemption under that provision. *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305 (1965), *acq.* 1966-2 C.B. The U.S. Tax Court reviewed the history and nature of cooperatives and concluded:



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“A cooperative is an organization established by individuals to provide themselves with goods and services or to produce and dispose of the products of their labor. *The means of production and distribution are those owned in common and the earnings revert to the members, not on the basis of their investment in the enterprise but in proportion to their patronage or personal participation in it.*” (emphasis original) (Id. at 306)

This description identifies member benefit as the key aspect of the cooperative form of enterprise, as distinguished from capital investment driven business. The *Puget Sound* court cited the Rochdale principles in its ruling, obliquely bringing those concepts into U.S. law.

“The founders of the above-mentioned Rochdale Cooperative formulated three guiding principles, which still persist as the core of economic cooperative theory:

“(1) Subordination of capital, both as regards control over the cooperative undertaking, and as regards the ownership of the pecuniary benefits arising therefrom; (2) democratic control by the worker-members themselves; and (3) the vesting in and the allocation among the worker-members of all fruits and increases arising from their cooperative endeavor (i.e., the excess of the operating revenues over the costs incurred in generating those revenues), in proportion to the worker-members' active participation in the cooperative endeavor.” (Id. at 308)

Ultimately the Tax Court declared:

“To avail itself of the exclusion, a cooperative must satisfy three requirements, (1) The allocation must be made pursuant to a legal obligation existing when the patron transacted business with the cooperative. (2) The allocation must be made out of profits or income realized from transactions with its patrons. (3) The allocations must have been equitably made.” (Id. at 322)

The Puget Sound case became the touchstone decision in cooperative law. Its pronouncement remains the current definition of a cooperative enterprise under United States law to this day. Aside from its reference to the Rochdale Principles, the Puget Sound decision focused strictly on economic concerns: the equitable allocation of profits. Perhaps because it was a tax matter, the question of democratic control or other internationally accepted criteria did not arise in the court's consideration.

Guidance issued by the U.S. Department of Agriculture (USDA) is another source of common understanding of cooperative identity. USDA is the primary federal agency charged with support of cooperatives, owing largely to the historical view of cooperatives as a rural and agriculture phenomenon. While not controlling authority with respect to courts or states, the agency's writing is national in scope and influence cooperative development.



“A cooperative is defined as a user owned and controlled business from which benefits are derived and distributed equitably on the basis of use or as a business owned and controlled by the people who use its services.” *USDA Rural Development Circular, Cooperative Information Report 45, Section 2 (1994).*

As in the Puget Sound case, the USDA focus is on economic issues. This understanding is encapsulated in the three “Use Principles” that have become widely accepted as the irreducible core of what makes a cooperative.

“Cooperatives follow three principles that define or identify their distinctive characteristics:

- user-owned
- user-controlled
- user-benefited

“The user-owned principle means the people who own and finance the cooperative are those who use it. ‘Use’ usually means buying supplies, marketing products, or using services of the cooperative business.

....

“The user-controlled principle (also called democratic control) means that those who use the cooperative also control it by electing a board of directors and voting on major organizational issues. This is generally done on a one-member, one-vote basis, although some cooperatives use proportional voting based on use of the cooperative (hence, a member who markets 10,000 bushels of a crop through the cooperative would have a greater vote than one who markets 1,000 bushels).

“The user-benefited principle says that the cooperative’s sole purpose is to provide and distribute benefits to members on the basis of their use. Members unite in a cooperative to receive services otherwise not available, to purchase quality supplies, to increase market access, or for other mutually beneficial reasons. Members also benefit from distribution of net earnings or profit based on their use of the cooperative.” *How To Start a Cooperative, Cooperative Information Report 7, USDA Rural Development (rev. 2015).*

Here, too, the principle of democratic control is soft. Indeed, this guidance specifically allows for voting based upon economic strength – voting by bushels delivered rather than on a one-person-one-vote basis.

In one instance, the USDA has issued a regulatory definition of cooperative, one which does have the force of law in limited circumstances. This definition governs the eligibility of cooperatives for USDA grant programs. It, too, sidesteps question of democratic control.



US State Cooperative Statutes

November, 2019

| | |
|---|----|
| General Purpose | 43 |
| Agricultural | 38 |
| Worker | 18 |
| Unincorporated Cooperative Associations | 14 |
| Credit Union | 48 |
| Utility | 40 |
| Mutual Insurance | 47 |
| Housing | 21 |
| Health Care | 7 |
| Educational Cooperatives | 10 |
| Seafood | 6 |
| Other | 13 |

| | |
|-------|-----|
| TOTAL | 305 |
|-------|-----|

* Includes 50 states, DC & PR

“Farmer or Rancher Cooperative—A farmer or rancher-owned and controlled business from which benefits are derived and distributed equitably on the basis of use by each of the farmer or rancher owners.” 7 CFR § 4284.3 (Definitions) (Under 7 CFR Ch. XLII, Subpart A - “General Requirements for Cooperative Services Grant Programs”)

State Sources of Law

As noted above, cooperative corporations are creatures of state law. A review of the laws of these fifty jurisdictions, plus those of the District of Columbia, Puerto Rico, and other territories is not possible here.

A yet unpublished report from the U.S. Department of Agriculture indicates that there are over 300 cooperative state statutes in the U.S.

If one were to state a generally accepted rule for the definition of a cooperative enterprise in the United States, it would likely fall to the Three Use Principles: User Benefit; User Ownership, and User Democratic Control. The Use Principles can be readily derived from the ICA *Statement on the Cooperative Identity* but fall short of its breadth and resonance. It falls to American cooperative organizers and members to reinforce the “democratic” nature of that user control.

b) Establishment, Cooperative Membership and Government

Creation of a cooperative corporation generally follows the pattern for other types of business corporation. The organizers file Articles of Incorporation with an agency of the state government. These articles contain essential identifying information for the cooperative, including its name, location, the identity of at least some of the organizers, the applicable statute that defines the business entity, and other features of its capital and organizational structure. Articles of Incorporation are public record and constitute binding notice to the world and anyone doing business with the cooperative with respect to their contents.

Organizers separately adopt Bylaws, a set of governance rules describing specific matters: defining membership; the purposes and nature of the cooperative enterprise; governance processes such as meetings, elections, and delegation of powers to a board of directors; financial processes and controls; and disposition of assets upon dissolution. Bylaws are not public record, but most statutes give members the right to receive a copy of the bylaws and records.



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While filing Articles initiates the process, a cooperative is generally not considered to be fully incorporated until several formal actions have taken place:

- Members have participated in an organizational meeting; and
- Purchased shares (or in nonstock co-ops, received certificates of membership);
- By vote adopted the Bylaws; and
- By vote elected an initial Board of Directors.

In the United States there are nearly as many types of governance structures as there are cooperatives, many without boards of directors, many operating by Consensus rules rather than by voting. An effective practitioner knows the formal requirements of the governing statute and drafts Bylaws to enable the client cooperative to pursue its own style yet comply with the statute.

Many states impose requirements for cooperatives that are not present in business corporation statutes. For example, some states require a minimum number of living persons to serve as original incorporators for a cooperative and sign the Articles, others only one person. While many states have general purpose cooperative corporation statutes, other states limit cooperative businesses to specific activities, usually agriculture.

While the myriad and diversity of cooperative statutes can make it complicated for a group of people to identify which state law under which to incorporate, people in the U.S. do have the advantage of being able to choose to incorporate in other states as long as the entity has a registered agent in the state where incorporated. This type of “out-of-state” incorporation can be cumbersome as it may subject the cooperative to dual regulation, that is the state where the co-op actually resides may still require tax and regulatory compliance along with the state where the co-op is incorporated.

Because many states do not have general co-op statutes and it can be difficult or cumbersome to incorporate in another state, many people seeking to establish cooperatives incorporate the business under a non-co-op statute and then choose to operate the business in a cooperative manner. Most commonly, people choose to incorporate under a “limited liability company” (LLC), a business form popularized in the 1990’s and that generally allows tax liability to pass through to the members while limiting liability to the entity. While LLC’s do make it possible for a business to operate as a cooperative, the statute does not in any way promote best practices or prevent members of the LLC from changing their bylaws in ways that violate the cooperative way of doing business in the future.

In terms of state variation, by far the most significant is whether the state law even encompasses the type of cooperative people seek to form. Some states do have general statutes, other states have statutes that allow for the incorporations of certain types of cooperatives, such as credit unions, rural electric cooperatives, or agricultural cooperatives. Some states prohibit businesses that are



not cooperatives from using the term “cooperative.” Many states do not have such a requirement, and even those that do tend to have very lax enforcement mechanisms.

c) Cooperative Financial Structure and Taxes

IRS rules largely govern financial structure.

Patronage – distribution of surplus based on participation

Capital –

- Member shares
- Retained patronage
- Preferred shares
- Debt capital
- Currently no tax-free mechanism for permanent capital or indivisible reserves.
- IRS rules allow for non-statutory co-ops to elect taxation as co-ops. LLC can file as co-op.

III. Degree of Ease of National Legislation for Cooperatives

As a general matter, relative to other types of businesses, co-ops are difficult to establish. With no uniform law, relatively little understanding by regulatory entities, and very sparse investment in technical assistance, people find it difficult to navigate the legal and regulatory landscape. A clear example is in how the federal government approaches supporting technical assistance for co-op development. A grant program exists within the U.S. Department of Agriculture that provided co-op development entities about \$6 million (USD) per year that goes to about 40 entities and can be used only in rural areas. Meanwhile, the Small Business Administration that supports thousands small business development centers but does very little co-op focused technical assistance. Further, the SBA premier guarantee loan program essentially prohibits cooperatives from participating as it requires all members of the cooperative to provide a personal guarantee.

Exacerbating this problem is that a relatively small number of professionals (accountants, lawyers, and others) understand cooperatives, and thus few professional advisors recommend the business form to people seeking to establish businesses. While a few universities and professional schools feature cooperative education, their ranks are few. That said, there is increasing interest in using cooperatives by not only state but also local governments.



IV. Recommendations for the Improvement of the National Legal Framework

For people to be able to use cooperatives to better serve their economic and societal interests, federal and state policy makers should do the following:

- Adopt general cooperative incorporation statutes at the state level to make it easier for people to establish cooperatives. Many jurisdictions do not have a statute allows people to incorporate a business as a cooperative beyond certain sectors.
- Ensure that agencies with the mission of supporting and regulating businesses treat cooperatives fairly and appropriately. Many agencies designed to support businesses fail to include co-ops in their work; further, many agencies lack awareness or understanding of cooperatives. Meanwhile, other regulatory bodies do not recognize the special nature of cooperatives in regulation.
- Increase support for cooperative development by providing greater resources for technical assistance at in both rural and urban places. Federal, state, and local governments should increase resources to increase public awareness and technical assistance for the establishment of cooperatives.
- Increase direct and guaranteed loan programs for cooperatives in all sectors. Many cooperatives are challenged in acquiring financing for start-up or growth phases. The Federal government should increase support for direct or guaranteed loans for these cooperatives.

V. Conclusions

Cooperative policy in the U.S. is varied. In some sectors, there exists a robust set of national and state policies that enable the development and growth of cooperatives. While in other sectors, sparse and erratic policy face those who seek to use cooperatives in their economic and social endeavors. Thus, there is significant opportunity for federal, state and local policy makers to improve the policy environment with greater support for public awareness, technical assistance, and financing of the cooperative business model.

VI. Acknowledgements

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Thomas Beckett

Doug O'Brien

The legal frameworks analysis is a tool developed under the ICA-EU Partnership #coops4dev. It is an overview of the national legal frameworks at the time of writing. The views expressed within are not necessarily those of the ICA, nor does a reference to any specific content constitute an explicit endorsement or recommendation by the ICA.



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