**Cooperative Legal Environment**

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**The Legal Structure of Cooperatives**

In terms of their legal identity, cooperatives are corporations. Cooperatives are incorporated under separate statutes which gives them some distinct and unique legal features. This makes it important to understand the legal environment under which cooperatives operate and to understand some of important areas where their legal characteristics differ from other corporations.

As mentioned, cooperatives are a special form of corporation. A corporation is a separate legal identity that has rights and responsibilities just like a natural person. A corporation can be chartered with unlimited life, can loan and borrow money, can enter into contracts and it can sue and be sued. An important characteristics of a corporation is that of limited liability. Shareholders have the right to share in profits and losses but are not held personally liable for the corporation’s debts. Corporations are regulated under corporate laws of the state in which they are incorporated. Corporate law deals with the formation and operations of corporations and the regulations they must follow to enjoy the tax and legal benefits of a corporation.

The majority of the corporations in the United States are referred to as C corporations. In a C corporation the business’s profits are taxed at the corporate level and any dividends distributed to the owners are taxed again as part of the shareowner’s taxable income. A number of these corporations are publicly traded which means that they issue stock that can be bought and sold in an organized stock exchange. The owners of publicly traded companies include institutional investors such as mutal funds and pension funds. When a publicly traded corporation retains funds and invests it in profitable projects it tends to make the stock price increase. The shareholders of C corporations share in the firms profits in proportion to their ownership, either directly through dividends paid in proportional to ownership or indirectly through stock price appreciation, As mentioned, cooperatives are a special class of corporation which use a different structure of profit distribution.

**The Hierarchy of Documents**

Three documents relating to the legal structure of a corporation are the articles of incorporation, bylaws and policies. The articles of incorporate are the legal basis for chartering the corporation with the state in which it is incorporated. The articles of incorporation contain general information about a corporation such as the name, location, purpose, length of existence (which can be perpetual) and the names of incorporating directors. The criteria for disposing of assets if the cooperative is dissolved are also usually specified in the Articles. The articles of incorporation are signed by the incorporating directors and filed with the state. The articles describe the procedure for amendments and any amendments to the articles of incorporation require not only a vote of the membership but also refilling with the state. For that reason, corporation tend not to specify any structures in the articles of incorporation that could be addressed in the bylaws.

The bylaws contain information about the rules and regulations that govern the corporation such as membership, voting procedures, annual meeting procedures, structure of officers and the board of directors. The bylaws often describe specific powers for shareholder action such as the procedures for a group of members to call a special meeting or the procedures for removing a board member. The initial set of bylaws is voted on an approved by the membership at the first annual meeting. Amendments to the bylaws must then be approved by the membership under the procedures described in the current bylaws. While amending the bylaws is less burdensome than amending the articles of incorporation it still requires specific procedures for notifying the members and a membership vote at the next annual meeting (unless a special meeting is called). While rules and procedures of governance issues are often covered in the bylaws, rules of operational manners and some of the specifics for governance procedures are typically covered in the corporation’s policies.

A corporation’s policies are formulated and passed by the board of directors. The membership does not generally vote to approve policies but the board may inform the members of key policies which affect them such as the credit policy. Policies typically specify guidelines and procedures for dealing with foreseeable situations and reoccurring events. Policies may place limitations on certain actions or establish risk management procedures. Policies can help a corporation make a consistent response to a reoccurring situation. Policies can also help ensure that the corporation is complying with laws and regulations and generating the appropriate documentation. While corporate laws do not require that a corporation have policies they can be an important issue in legal disputes. In many disputes centering on whether the board of directors acted properly or treated a member or employee fairly, the first line of investigation will be whether they complied with the organizations policies.

Cooperative statutes tend to be brief and focus on the unique structural requirements of a cooperative corporation. When there are legal aspects not covered by the cooperative statutes the provisions of the state’s general corporate statues apply. As an example in cases where a cooperative board member is alleged to have violated their duty of care to the company the courts will evaluate the case based on the business judgment rule. Under this standard a board member is not liable for any outcomes from their decisions on the board as long as the decision was made (1) in good faith without a conflict of interest, (2) with the care that a reasonably prudent person would use when faced with a similar decision and (3) with the reasonable belief that the they are acting in the best interest of the corporation. This is just one example of how when an issue is not specifically covered in the cooperative statutes, the courts look to general corporation statues.

In addition to statues specifically related to cooperative corporations of general these unique legal restrictions corporations face all of the legal regulations that individuals and other forms of business face. These include environmental law, employer/employee law, credit and finance law, real estate law, immigration law, bankruptcy law and many other areas of laws and regulations. Many areas of these laws are extremely significant to cooperatives. Part of the oversight role of the board of directors is to ensure that the cooperative is in compliance with its own articles of incorporation, bylaws and policies and is also in compliance with all other laws and regulations.

**Legal Issues Handled Differently by Cooperatives Relative to Other Corporations**

There are a number of legal areas that are handled differently by cooperative corporations. One of these areas involves anti-trust regulations which is the topic of the next chapter. Areas of differences include voting systems, member eligibility, board member eligibility, restriction of dividends on invested capital, distribution of losses, and the distribution of the residual value at liquidation. From a legal standpoint, cooperative members often to not have an greater right to information relative to stockholders in a general corporation. However, information is often more continuous in a cooperative.

Voting Systems

In most investor-owned corporation, and in investor-owned firms in general, voting rights are allocated in proportion to ownership. A shareholder who owns the majority of the corporation’s equity gains a controlling interest in the firm. In contrast, one of the fundamental principles that distinguishes a cooperative is the principle of democratic control. Voting rights in a cooperative are either allocated on a one member-one vote basis or, less commonly, in proportion to business volume. Voting rights are not allocated on the basis of ownership. It should be noted that the internal revenue service tends to favor the on member-one vote system when analyzing whether a business is operating on a cooperative basis and qualifies to taxed as a cooperative. While the federal statues providing limited anti-trust exemptions for cooperative specifies either one member one vote or a restriction on dividends, many state cooperative statutes strictly specify one member one vote.

Issues Requiring a Vote of the Membership

As discussed, the articles of incorporation and bylaws generally specify the actions that require a vote of the membership. In general, members vote to elect the board of directors, vote on amendments to the articles of incorporation and bylaws and vote on very significant structural changes such as mergers or liquidation. While cooperative corporations do not generally have stricter requirements for membership (shareholder) votes relative to other corporation, the nature of the cooperative firm leads to more frequent questions about what issues should be taken to a vote of the membership.

For example, a cotton ginning cooperative in Texas decided to exit the agronomy business and sell off all of its fertilizer warehouses, applicators and farm supply stores. The board was concerned that the time and publicity of taking the issue to a membership vote would cause them to lose an attractive offer for the assets. For that reason they made the decision at the board level. While the board of directors likely had the legal authority to make the decision, many members felt that the board had a moral obligation to take the issue to a membership vote. In a cooperative, where the owners are also customers, there are more often issues as to whether member input should be obtained. On the other hand, in order to operate as an efficient business organization, the board cannot bring all “gray area” issues to a vote of the membership.

Voter Eligibility

In an investor owned corporation any individual or corporation owning a share of stock is entitles to vote in proportion to their stock ownership. In a cooperative voting eligibility can be more complicated. In the scenario where the cooperative uses a one member one vote system there can be questions as to whether a husband and wife get one vote or two. Similarly, if a farm operation also involves the children, questions as to their eligibility to vote, and at what age arise. Most farm operations are now operating as limited liability companies or family corporations. In the case where there are four farm families operating under a limited liability company defining who has voting rights is obviously an important issue. In some cases voter eligibility issues are defined in the bylaws. In many cases, the bylaws specify that an individual must be engaged in agricultural production to hold a membership and have voting privileges. That creates another criteria for a cooperative to consider as it “looks through” the farm business structure to define the voting members. Some cooperative require a base level of patronage during a specified period of time to maintain voting privileges. The goal of those provisions is to ensure that control is vested with active users.

Director Eligibility

Most corporate statues allow any natural person to be a corporate director. The shareholders can elect virtually anyone to serve on the board. In practice the existing board and the CEO have great influence on who is nominated. That allows the corporate board to have a formal succession plan and to identify persons with specific skills, such as finance or legal expertise to bring a specifically needed skill set to the board. In a cooperative, only a member of the cooperative can be elected to the board. In an agricultural cooperative a board member must therefore be an agricultural producer who is a member of the cooperative. While the cooperative model brings “customers into the boardroom” it also inherently limits the diversification and potential skill sets of directors. That is one of the reasons that board education is an important ingredient for cooperative success. Other ways to compensate for the lack of diversity in backgrounds include outside advisory members who typically provide insights but have no voting rights. The use of consultants and reports from staff members can also help to fill gaps in skills and analysis.

In regard to diversity, agricultural cooperatives have traditionally had a low level of gender diversity. Progressive cooperatives are making more efforts to identify, recruit and nominate female board candidates. In order to achieve that goal the cooperative must also consider its membership eligibility guidelines and ensure that potential candidates are listed on the membership/voting roles.

Allocation of Profits and Loss

In an investor owned corporation, profits and losses are distributed in proportion to ownership. An investor owned corporation generally has the freedom to retain all of their earnings to maintain cash flow and to reinvest in equipment and infrastructure. In contrast, in a cooperative earnings and losses are distributed in proportion to business volume. If a cooperative elects to retain funds by issuing qualified stock (which give them an immediate tax deduction) they face the restriction that they must distribute at least 20% of profits as cash patronage. The IRS has also taken the position that a cooperative cannot retain excessive amounts of earnings as unallocated reserves. In recent years, the level of unallocated reserves (unallocated retained earnings) relative to the amount of allocated equity (stock held by specific members) has increased. Many cooperatives now have unallocated reserves representing more than 50% of total equity. To date, the IRS has not challenged these equity structures. It is still safe to say that a cooperative has much less flexibility in retaining funds as unallocated reserves (retained earnings) relative to investor owned firms.

In neither an investor owned firm nor a cooperative do the owners directly reimburse the company for their share of the firm’s losses. Losses are allocated to the owners by reducing the value of their ownership. Differences in the systems for allocation of losses between cooperatives and investor owned firms relate to which owners have their equity values reduced. When an investor owned firm experiences a loss the value of all of the owner’s holders are effectively reduced in proportion to ownership in the firm. One function of unallocated reserves in a cooperative is to absorb losses. When a cooperative experiences a loss the board may elect to absorb the loss by reducing unallocated equity. In that case the treatment of losses is similar to that of an investor owned firm. However, when the loss exceeds the amount of unallocated reserves, or the board determines it is more equitable, the loss may be absorbed by reducing the value (writing down) the value of membership stock. In determine which stock to write down the cooperative generally considers the amount of business volume done during the most recent fiscal year or the time period associated with the loss. This implies that in a cooperative losses, are allocated to the members who did business with a cooperative during some recent time period and is allocated in proportion to use. In simple terms, in a cooperative losses are distributed in proportion to past ownership while in an investor owned firms losses are allocated in proportion to ownership.

Liquidation

A corporation (investor owned or cooperative) can be dissolved using a process called liquidation. In liquidation, a liquidator is appointed and the corporation’s assets are sold. The value received for the assets is first used to pay the creditors in the order of their established claim. Any remaining value is distributed to the owners. The difference in liquidation treatment between investor owned firms or cooperatives relates to the basis by which the owners receive their share of the residual value. In an investor owned firm the residual value of a firm is distributed in proportion to ownership. In a cooperative the residual value is distributed in proportion to business volume during some “look back period”. This system of distributed the residual value favors active users. A common length for the look back period is 5-6 years.

Dividends

In an investor owned firm there are no restriction on the amount of profits that can be distributed as dividends. (A dividend refers to a payment made in proportion to stock ownership. While the IRS uses the term “patronage dividend” the preferred term for a profit distribution made in proportion to use is “patronage refund.”) In some corporations, particularly firms with stock that is not publicly traded, the receipt of dividends is the major avenue by which owners benefit from their ownership in the company. Some corporations with publicly traded stock also pay dividends. In other cases the corporation retains the profits which tends to increase the stock price. While not every investor owned firms pays dividends on their stock, there are no restrictions as to the level of the dividends.

In a cooperative dividends are often limited not to exceed 8%. This is referred to as “subordination of capital” and is intended to limited the returns on ownership so that the primary focus can be on distributing profits in proportion to use. The limitation of dividends to 8% was one of the original Rochdale principles and is still reflected in statues effecting cooperatives. The specific limit of 8% is also referred to as “bright line” limit on dividends. The anti-trust exemption legislation which enables cooperatives at the federal level includes a provision that a cooperative must either limit dividends to 8% or use a one member one vote system. Many state statures include both requirements and thus have a firm limitation to 8%.

The IRS tax code for Section 521 cooperatives, a more restrictive structure of cooperatives which qualifies for more favorable tax treatment and exemption from security registration, also has the 8% dividend restriction. In regard to taxation it should be noted that in a cooperative patronage refunds (profit distriubutions in proportion to business volume) are deductive from the cooperative’s taxable income. Dividends (profit distributions based on ownership) are not deductible. A cooperative distributing profits as dividends must therefore make the payment out of their after tax profits and the dividends received by the cooperative member are essentially taxed twice. Once at the cooperative level and again when they are added to the member’s taxable income. While this tax treatment is a separate issue from the restriction on dividends it does explain why the practice of paying dividends on member stock is not common in cooperatives.

Summary

Cooperatives are a special form of corporation. As such they must act within the structure of their articles of incorporation, bylaws and policies to maintain their treatment as a separate legal entity. A board operating outside of the cooperative’s structure, or one that does not exercise an acceptable duty of care risk being held personally liable for errant decisions. Cooperative statutes tend to be brief and focus on the unique structural requirements of a cooperative corporation. When there are legal aspects not covered by the cooperative statutes the provisions of the state’s general corporate statues apply. Cooperatives, like other companies must also comply with a wide range of general laws and regulations. There are some key legal areas that are treated differently by cooperatives relative to investor owned corporations. These include voting systems, member eligibility, board member eligibility, restriction of dividends on invested capital, distribution of losses, and the distribution of the residual value at liquidation.