

LAW OF COOPERATIVES
—Legal Framework of Cooperative Development—

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Cooperatives—Legal Structure Built on Principles

“Cooperation is not dead! The legal structure is tired, worn out, and needs to be buried,” announced a frustrated partner of mine. The law practice of working with producer-owned businesses, cooperative and otherwise, throughout the country seems to focus on the unreasonable restrictions of co-ops and the flexibility of limited liability companies (LLCs). The advance of business and economics has always outpaced the law. Producers and cooperators desiring social and economic change in the 1920s decried legal impediments to cooperation and the law changed.

In the past 20 years, producers have successfully formed hundreds of New Generation Cooperatives (NGCs), which are based on producer investment and proportional patronage returns; however, the financially successful co-ops are running into structural roadblocks resulting in conversion to LLC or taxable corporations, or the contribution of assets to joint venture entities that can operate profitably for the benefit of their owners. Now, many NGCs are starting the expensive conversion to LLCs because taxation issues have convinced their leaders that “all the co-ops are facing the same thing” and “everyone is making the change to an LLC” (Uecker and Talley 2002).

Successful NGCs do not fit well with many of the social and political principles developed and legislated 80 to 150 years ago that have remained part of American co-ops. These principles for member-financed cooperative stores simply do not work with the capital-intensive, value-added processing co-op of the twenty-first century. The economics of agriculture have changed from gaining efficiencies through direct marketing of raw agricultural products to users to further processing of unique or higher-quality agricultural products into higher-valued consumer products. The new business model is capital intensive and necessarily so to derive competitive market presence and economies of scale.

A new cooperative model has been developed called a “Wyoming Processing Cooperative,” which is essentially a co-op that operates in an LLC structure on the Rochdale cooperator’s business principle of returning profits to the patrons of the co-op (Hanson 2001b). Wyoming’s cooperative law allows outside investment and eliminates the restrictions imposed by federal corporate cooperative tax law while requiring profits returned to patrons based on patronage and allowing returns to investors based on capital investment. This structure has been praised by producers and cooperators as allowing the co-ops the flexibility to adapt their structures to changing business conditions, but it has also been criticized by traditional cooperators as not being a true cooperative law (Fredrick 2002; Torgerson 2002, 2).

This chapter reviews the formation of cooperative legal principles codified through the development of state statutes to organize co-ops. The provisions of typical state cooperative statutes and modern corporate cooperative statutes are analyzed, and the formation of a valued-added agribusiness is compared under corporate cooperative statutes versus LLC or Wyoming Processing Cooperative structures. The federal control of corporate cooperative legal structure through federal tax law and other statutes is then examined.

For those who believe that cooperation is not dead and needs to be given the opportunity to further develop, a number of state and federal objectives and legislative changes are identified that will foster cooperative development.

Formation of Cooperative Legal Principles

Farmers in the United States have organized companies to find markets for their products for 200 years (Goldberg 1928, 270). The development of legal principles to structure marketing companies as co-ops began with the Order of Patrons of Industry, commonly known as the Grange, which spread concepts for collective action to farmers in order for them to organize as Rochdale co-ops (Evans and Stokdyk 1937, 20; Goldberg 1928, 272).

Rochdale Cooperation

Workers in England formed a cooperative store in 1844 called the Rochdale Society of Equitable Pioneers. Their plan emphasized participation in profits according to business conducted with the co-op rather than participation in profits based on invested capital (Holyoake 1908, 277; Woeste 1998, 20). This principle defined and differentiated Rochdale cooperation. The society published twelve principles, four of which became the legal foundation for American co-ops and are referred to as the “Rochdale Principles”: (1) business at cost with net returns paid to members based on patronage, (2) democratic control—one person/one vote, (3) limited dividends on invested capital, and (4) ownership (or beneficial membership) limited to patrons (Woeste 1998, 20). The Rochdale store was not capital intensive and, in fact, limited the capital of its members (Holyoake 1908, 277).

The national Grange endorsed the “Rochdale Principles” to be adopted as rules by local organizations of farmers for any commercial organization (Nourse 1927, 35). The rules included organization as stock companies with the purchase of at least one share of stock required for membership, required purchases each year, interest on capital limited to 8 percent, and profits distributed in proportion to purchases (36). One vote per member was also a Grange principle (Goldberg 1928, 272).

The Grange Fails, But Cooperative Principles Succeed

The explosive growth of the Grange movement relied in part on cooperative strategy to overcome failed or unprofitable marketing conditions. The Rochdale Principles were appropriately developed for purchasing co-ops, and the Grange rules were developed for cooperative stores, with the legal structure fitting the business. These same rules were applied to Grange elevators and shipping associations with minor changes to the purchasing or store requirements (Nourse 1927, 37). The Grange’s attempt to use a collective purchasing or cooperative store model for marketing ventures failed. Rochdale Principles restrict business volume to a level supported by the members’ pooled capital, generally from operations. Marketing activities, especially those of storing, grading, or processing products, requires significant outlays of capital, and the Rochdale cooperative business model had limited capital per member (Woeste 1998, 24).

The meaningful operations of the Grange were short, rising rapidly and generally collapsing in the 1870s (Hanna 1931, 6; Nourse 1927, 34). Even so, the impacts of organizing farmers and promoting the Rochdale Principles as cooperative legal requirements have carried forward to co-ops today (Fite 1978, 8; Woeste 1998, 22).

Development of State Organizational Statutes

Farmers Allowed to Form Cooperatives Under General Statutes

In many states, the formation of corporations in the mid-1800s was by special legislative act. As states developed general business incorporation acts by industry, union movements and the Grange farmer protest movements led farmers to appeal to their state legislatures for general statutes to form local co-ops (Hanna 1931, 5-7; Nourse 1927, 39-50).

Michigan authorized the formation of cooperative stores in 1865 (Michigan Laws 1865; Nourse 1927, 39). Massachusetts passed a cooperative law in 1866 (Massachusetts Laws 1866) governing cooperative procedures that were a pattern for the statutes of Pennsylvania (1868), Minnesota (1870), Connecticut (1875), and Ohio (1884) (Nourse 1927, 40). The Massachusetts statute generally allowed co-ops to be formed as a corporation to conduct lawful pursuits, including agricultural businesses, with capital stock limiting a member's interest in the co-op to \$1,000, voting power of not more than one vote per member, and limited liability of members. The statute also authorized a distribution of the profits to the purchasers and stockholders as described in the bylaws, provided that 10 percent of the net profits were deposited in a sinking fund until the amount of the sinking fund balance was a sum equal to 30 percent in excess of the capital stock (Massachusetts Laws 1866).

In 1877, Kansas, Wisconsin, and Pennsylvania enacted cooperative laws (Nourse 1927, 42-43). The Kansas law was brief, requiring "one-man-one-vote" (42). The Wisconsin law was similar to the Massachusetts law but limited debts to two-thirds of the paid-up capital and prescribed voting: "members and not shares of stock shall vote in electing officers and transacting any business of the association of whatsoever nature, but no proxies shall be allowed" (42).

The Pennsylvania law was longer and more detailed, covering limited voting, patronage dividends, trade for cash, and so forth; it also included a unique base capital provision characterized as "permanent" and "ordinary" stock. "Ordinary" stock could be bought and sold, but each member held permanent stock allowing one vote and patronage dividends that were applied to payment for the stock until the \$1,000 maximum was attained (Nourse 1927, 43).

The First Model Statutes. In 1911, Wisconsin and Nebraska enacted cooperative laws that prescribed by statute the distribution of profits by patronage dividends to members. Prior laws had allowed co-ops to distribute dividends as provided in the bylaws (Nourse 1927, 46). The Wisconsin law required earnings to be apportioned first to pay dividends on stock not to exceed 6 percent; then, of the remainder, not less than 10 percent for a reserve fund until it was equal to 30 percent of capital stock; 5 percent for education to teach cooperative development; then, of the remainder, one-half according to purchases of shareholders and upon wages of employees, and the other half according to the purchases of shareholders and nonshareholders, providing that for processing co-ops the dividend would be on raw products delivered instead of purchases (Wisconsin Laws 1911). The Wisconsin law was generally adopted in sixteen other states in the following eight years (Nourse 1927, 46). The cooperative laws based on the Wisconsin model generally required capital stock co-ops to operate on the Rochdale Principles of limited capital holdings, democratic voting, and distribution of profits based on patronage (48).

Non-Stock Cooperative Alternative

An alternative to capital stock co-ops was developed concurrently with the Wisconsin and Nebraska state statutes primarily to avoid the corporate attributes associated with capital stock. Critics alleged that capital stock co-ops were merely a modified form of for-profit corporations and that an alternative organization should (1) avoid capital stock by putting all invested capital on a “loan” basis, (2) eliminate the competitive-price relationship with the member (transfer price for product) and substitute a net returns settlement, and (3) restrict cooperative transactions to members only (Nourse 1927, 52-58).

In 1909, California enacted a nonstock cooperative law (Statutes of California 1909), providing for a membership association on a nonprofit basis that allowed equal or unequal voting and property interests as provided in the articles of incorporation. Capital contribution from members was authorized as “membership” fees. Six states adopted nonstock cooperative laws based on the California model from 1909 to 1921 (Nourse 1927, 65).

Nonstock cooperative laws were further modified by provisions of a U.S. Department of Agriculture (USDA) model nonstock cooperative act under the title “Suggestions for a State Co-operative Law Designed to Conform to Section 6 of the Clayton Act” (Nourse 1927, 73-92). The USDA model act required co-ops to only conduct business with members. Seven states enacted statutes based on the USDA model nonstock cooperative act (Hanna 1931, 42).

The Capper–Volstead Cooperative Definition

The initial period of cooperative statutes allowed the farmer businesses considerable flexibility to form and adapt co-ops to business conditions. As co-ops formed to exert market power, the principles were litigated in the context of antitrust violations (Guth 1982; Sapiro 1923).

The Clayton Act provided certain exemptions for co-ops organized without stock. In 1922, the Capper–Volstead Act was enacted by Congress to provide an exemption from antitrust enforcement for narrowly defined farmer co-ops organized as stock or nonstock co-ops whose membership was limited to agricultural producers, restrict voting to one vote per member or limit dividends on equity to 8 percent per year, and handle products for members whose value exceeded that of products handled for nonmembers (Lauck 1999, 491-493).

The Capper–Volstead Act definition of co-ops continued to be the federal definition of co-ops for purposes of federal regulatory relief and financial assistance. The impact of federal financial assistance institutionalized the cooperative business structure. The federal government loaned \$330 million to co-ops from 1929 to 1932, an additional \$68 million by 1934, and more than \$400 million on an annual credit basis by the end of World War II (Lauck and Adams 2000, 67-68).

By 1970, one-third of the capital used by co-ops (subject to the Capper–Volstead definition with some modification) stemmed from debt, and the federally chartered banks for co-ops provided nearly all of the remaining debt financing (Lauck and Adams 2000, 68). The restriction of outside capital and limited capital returns did not impede cooperative development when favorable federal debt financing was available.

Commodity Marketing Acts

The most pervasive development in cooperative law occurred from 1921 through 1926, with more than forty states enacting a commodity marketing act to incorporate co-ops (Sapiro 1927, 8).

Sapiro's Plan. The movement was started by Aaron Sapiro based on his California commodity cooperative marketing experiences (Larsen 1967, 446-454). Sapiro's plan consisted of (1) organization of the association on a commodity basis; (2) limitation of membership to and democratic control by actual growers; (3) control of the deliveries by means of a long-term, legally binding contract signed by every member; (4) pooling of product according to grade, basing returns to each member on the average annual price received for the pool to which they contributed, and providing orderly marketing of the product throughout the productive period; and (5) control of a sufficient portion of the entire crop to be a dominant factor in the market and to make possible an economic distribution of overhead expenses (Knapp 1973, 9; Sapiro 1923, 200-201).

According to Sapiro (1927), the fruit growers in California experimented with cooperation to suit their needs and federated local associations of growers for marketing all of the growers' fruit:

[T]his was an organization by the commodity in contrast to organization by locality This adjustment could not be made by a single farmer; nor by a local association or even a small group of locals. But it could be made by farmers who could control and be certain of the control of a large percentage of the commodity and could help guide the flow of that commodity into the markets of the world The inevitable happened. Law began to conform slowly to the economic advance. The farmers had found a definite trend; and law put flesh on its dry bones and grew again in the same measure. (Sapiro 1927, 2-3)

A National Model: The Bingham Act. Sapiro, whose national stature with farm organizations allowed him to participate in preparing drafts of the Capper-Volstead Act, prepared a draft commodity marketing law based on the cooperative requirements of the Capper-Volstead Act and the California marketing principles. The first commodity marketing act was adopted in Texas in 1921, but the best form and most widely adopted model was the Bingham Cooperative Marketing Act (Bingham Act) enacted by Kentucky in 1922 (Sapiro 1927, 7).

The Bingham Act was uniquely conformed to the Capper-Volstead Act. It thwarted unwarranted judicial intervention of competitors by legislatively announcing public policy issues requiring farmers to cooperate while providing a legal framework for cooperative organization and operations. The key features of the Bingham Act are as follows:

- public policy statements of the producers' right to conduct cooperative marketing;
- provisions for a preliminary investigation of the marketing conditions to ensure success of the co-op;
- statutory authority to conduct the commodity marketing for the members of the co-op;
- restriction of members to agricultural producers, including share crop landlords and tenants;
- authorization of district voting for directors, directors and officers elected from the membership other than by appointment, or election of directors to represent the interests of the general public;
- statutory authorization of a marketing contract with members, including remedies of liquidated damages and injunction as a penalty for breach of the contract;

- criminal penalty for inducement of breach of the contract or spreading false reports about the finances or management of the co-op;
- penalties against warehousemen for soliciting or persuading members to breach marketing contracts;
- a declaration that commodity marketing or the marketing contracts shall not be deemed to be a conspiracy or combination in restraint of trade, an attempt to lessen competition, or an attempt to fix prices arbitrarily in violation of any law of the state (Acts of Kentucky 1922 1922).

A substantial amount of litigation ensued in many jurisdictions following the enactment of the commodity marketing acts, but the acts were held to be constitutional (Sapiro 1927, 10-11; Meyer 1927, 90-93; Tobriner 1928, 19-34). The general adoption of the Bingham Act started the uniform acceptance of legal principles for marketing co-ops and was referred to as the “Standard Act” (Evans and Stokdyk 1937, 298). Many legislatures modified the Standard Act with local concerns over operations; however, the main provisions of the Bingham Act were enacted.

A Ten-year Effort for National Uniformity Fails. The push for uniformity of the commodity marketing acts was undertaken by the National Conference of Commissioners on Uniform State Laws in 1925. After consideration of five consecutive drafts over ten years, the Conference and the American Bar Association approved the draft for submission to state legislatures. A national uniform cooperative law was referred to as an “epochal development in the field of marketing law” (Evans and Stokdyk 1937, 300), but the uniform law was not widely included. Only two states had adopted the Uniform Act with modifications by 1945 (Jensen, 1950, 12). Even so, with the Uniform Act and substantial case law supporting the principles and language of the Bingham Act, the co-op as an organizational structure had reached legal maturity by 1950 (Ela 1950, 524).

Modern Corporate Cooperative Statutes

In the late 1980s and 1990s, Minnesota, Colorado, and Ohio redrafted their cooperative statutes. While commodity marketing acts were restricted to agricultural producers marketing their products, many states had modified these statutes to allow nonagricultural producers to form co-ops for other purposes. The modern corporate cooperative statutes are general cooperative statutes with certain provisions to accommodate agricultural producer co-ops. In Minnesota, five different stock and nonstock cooperative statutes were recodified and revised into one corporate cooperative statute (Hanson 1993; *Minnesota Laws* 1989).

Colorado repealed and reenacted one of its corporate cooperative statutes (Colorado Session Laws 1996, 1996; The New Colorado Cooperative Act 1996), and Ohio adopted a corporate cooperative statute in 1998 (Ohio Laws 1998). The impetus for revision was the increased interest and formation of a new generation of value-added co-ops (Hanson 2001a, 41-42). Most of the NGCs are processing co-ops with a different focus than commodity marketing co-ops.

A Comparison of Modern Corporate Cooperative Acts to a Commodity Marketing Act. The modern corporate cooperative acts generally differ from commodity marketing acts in facilitating modern corporate functions. The Rochdale Principles embodied in the commodity marketing acts are largely unchanged. Table 5.1 compares the major distinctions.

Cooperative Organization Under Noncooperative Statutes. State cooperative statutes provide a framework for organization and incorporation (Baarda 1982). Co-ops can also be organized under general business corporation statutes to meet federal cooperative tax criteria, and under LLC statutes to operate on a cooperative basis and to be taxed on a pass-through or partnership tax basis. Organization and incorporation under noncooperative statutes require substantial modification of articles, bylaws, and operating agreements to achieve operation on a cooperative basis.

A New Model Under Old Statutes: New Generation Cooperatives

Starting in the 1970s and 1980s and rapidly developing in the 1990s, a new form of co-op—the “value added” or “new generation” co-op—was being organized throughout the Midwest by agricultural producers to further process agricultural products (Hanson 2000b; Patrie 1998).

The New Generation Cooperatives (NGCs) were formed under existing cooperative statutes but were capitalized and operated differently from supply and marketing co-ops. The NGCs acquired or constructed processing facilities through 40 to 50 percent member equity and 50 to 60 percent debt financing. The member equity is obtained from each member subscribing to stock in proportion to the amount of crops or livestock committed to be delivered to the co-op.

Through stock subscriptions, the member producers essentially purchase the processing and marketing capacity of the co-op to process and market the agricultural products committed for delivery under marketing contracts. Products delivered are in proportion to stock purchased, and patronage is paid to the producers based on product delivered. The different variations of this model utilize common stock for the voting membership stock, and preferred stock is divided into delivery shares. In both cases, the amount of product committed to be delivered under uniform delivery and marketing agreements are proportional to delivery share ownership (Hanson 2000a).

Table 5-1. Comparison of Modern Corporate Cooperative Statute With Commodity Marketing Act.

<u>Modern cooperatives statutes</u>	<u>Commodity marketing act</u>
<p>1. Organization</p> <ul style="list-style-type: none"> • <i>Statutory policy declarations</i> • <i>Purpose</i> – any lawful purpose • <i>Incorporators</i> – one or more persons • <i>Stock and nonstock organization</i> – with same power and authority • No similar provisions • No similar provisions 	<ul style="list-style-type: none"> • Policy declaration – orderly marketing stabilizes marketing of agricultural products • Marketing, processing, handling agricultural products of members; or manufacturing, selling, or supplying members with machinery, equipment or supplies • Requires 10 to 20 persons; a majority must be residents of state • Grants powers to both stock and nonstock co-ops • Preliminary investigation of marketing conditions by university • Statement that cooperative marketing is in public interest

Modern cooperatives statutes

Commodity marketing act

2. Articles of incorporation

- Board Authority to designate classification of shares if not designated in articles
 - General statement of rights and obligations of shares
 - Statement of governance rights (voting) – description of voting allocations
 - Statement of restrictions on share transfer (approval of board) and whether bylaws and board may further restrict transfer
 - Limitations on dividends on stock (typically 8 percent)
 - Allocations and distributions of income in excess of dividend based on patronage
 - *Amendment* – by board majority and majority of members voting; board may amend articles until co-op has members or stockholders with voting rights; board authority to adopt specified amendments or without shareholder approval
 - *Bylaws* – cooperative may have but need not have bylaws. Initial adoption by board; subsequent adoption by members unless bylaw authorizing board.
 - Admission, withdrawal, and suspension of members
 - Voting rights; privileges of members
 - Reports and financial statements to members
- No similar provision
 - Similar
 - One vote per member, no variance
 - Bylaws required to only allow transfer to producers
 - No similar provision
 - No similar provision
 - Approval by two-thirds of board and majority of all members; no authority for board amendments
 - Must have bylaws adopted by members
 - Note mandatory redemption upon withdrawal
 - One vote per member
 - No similar provision

3. Powers

- Generally, all acts necessary and proper to conduct co-op's business or to accomplish purposes of co-op
 - Accept deposits from co-op members
 - Acquire and dispose of stock or ownership interests in other entities
 - Establish, pay and operate pension plans, share bonus and option plans and benefit plans for directors, employees, and agents
 - Indemnify directors, officers, and employees
 - Create subsidiary corporations, co-ops, limited liability companies, and other business entities
- Generally similar; may be more restrictive
 - No similar provision
 - Restricted to co-ops with similar producer membership
 - No similar provision
 - No similar provision
 - Similar but related to tax, no authority for LLCs

4. Agricultural Marketing Contracts

- Generally same except no penalty for contract interference, and restrictions on warehousemen

5. Board of Directors

- *Board governance of cooperative* – all authority of co-op exercised by board unless otherwise provided by articles or bylaws
 - *Limitation of directors' liability*
 - *Encumber all assets without shareholder approval*
 - *Sale or disposition of all property without shareholder approval* – to subsidiary, in ordinary course of business
- Board governance; authority to exercise powers not explicit
 - No similar provision
 - No similar provision
 - No similar provision

Modern cooperatives statutes

Commodity marketing act

6. Members

- *Districts* – authorized in bylaws implemented by board
 - *Member violations of bylaws* – surrender or conversion of equity; cancellation of membership; redemption authorized not mandated
 - *Required reports to members*
 - *Access to records by members*
 - *Voting* – who may vote, mail and absentee voting, proportional patronage voting
 - *Limits of liability for corporate debts*
 - *Approval required for certain transfers of all or substantially all of the assets*
- Authorized in bylaws
 - Similar; however appraisal of interests and redemption within one year of withdrawal or expulsion required
 - No similar provision
 - No similar provision
 - One vote per member
 - Similar
 - No similar provision

7. Stock

- *No similar provision*
 - *Authority and rights for preferred stock*
 - *Perfected lien of co-op for debts and obligations to co-op*
- No member may own more than 1/20 of stock of co-op, common stock may only be owned by producers
 - With or without right vote; purchase of property, value
 - No similar provision

8. Allocations and Distributions

- *Reserves authorized, net income in excess of dividends distributed at least annually on basis of patronage, form of distribution prescribed*
- No similar provision; distributions of income referenced in marketing contract

9. Mergers and Consolidations

- *Generally authorized with co-ops and in certain cases with corporations*
- No similar provision

Nonuniform State Cooperative Laws Impede New Generation Cooperative Organization

The nonuniform development of agricultural co-ops and cooperative law has resulted in significant variations in state cooperative statutes—many of which were enacted from 1910 to 1925. In fact, few states have the same cooperative statute. This author and his partners have formed NGCs under stock and nonstock cooperative laws of many of the agrarian states, and although some state cooperative statutes have impediments, these can be generally overcome by shareholder agreements, article or bylaw provisions, or financing provisions.

Organization Under Commodity Marketing Acts: Indiana. Indiana enacted a commodity marketing act in 1925, which has had few amendments, to incorporate stock and nonstock, nonprofit co-ops whose members must be agricultural producers (West's Annotated Indiana Code 1998). Forty other states have similar commodity marketing acts. The statute requires all members to be individuals or political subdivisions of Indiana engaged in the production of agricultural products, with the redemption of expelled or retired members' interests to be as provided in the bylaws. The co-op may restrict voting to one vote per member regardless of number of shares owned or capital invested. Distributions after restoration of deficits, payments of stock dividends, and allocations to reserved are as provided in bylaws to members, nonmembers, and patrons, but only on the basis of patronage. The limitations of a commodity marketing act require skillful lawyering to organize NGCs.

Organization Alternatives Under Separate Stock and Nonstock Cooperative Statutes: Missouri. Missouri enacted stock and nonstock cooperative statutes in 1923 and 1925. In these statutes, twelve persons may incorporate a stock co-op to produce or furnish goods or services; to conduct an agricultural or mercantile business on a cooperative plan; or to sell to or buy from all stockholders, groceries, or other merchandise (*Missouri Statutes* 2001, § 357.010). Stock may only be owned by natural persons (as opposed to juridical persons such as corporations), and co-ops must be organized in Missouri on a cooperative plan. As enacted until 1945, the directors were elected on a basis of one vote for each share of stock owned, but now the legislation requires one vote per shareholder and states that the policies of the co-op, including declaration of dividends, setting aside reserve funds, and method of distributing profits are reserved and conferred upon the shareholders (§§ 357.090, 357.100). Profits are distributed to shareholders or, if authorized, to nonstockholders on a patronage basis after first setting aside 10 percent for a reserve fund until the fund equals 50 percent of the paid-up capital stock (§357.130). Dividends on stock may be declared not to exceed 10 percent.

Missouri also enacted a commodity marketing act which requires eleven or more persons, a majority of whom are residents of Missouri, to incorporate a nonstock, nonprofit co-op (*Missouri Statutes* 2002, §§ 274.010-274.300). Membership is restricted to agricultural producers. The nonstock co-op is governed by the board of directors, who must be members; however, one-third of the directors may refer any question to the membership (§ 274.150). In the case of the death, withdrawal, or expulsion of a member, the directors, when authorized by the membership, must appraise the value of the former member's property rights and pay the amount to the former member or the member's heirs or representatives as if the member had continued membership (§ 274.090). This requirement can be burdensome or cause the dissolution of an NGC in that the statute shifts the burden of the member to the co-op to find replacement equity for a member who leaves.

The Missouri stock cooperative restrictions on stockholders to natural persons or Missouri co-ops and the high statutory reserve in excess of paid-up capital stock (50 percent) significantly impair the formation of NGCs or other contemporary cooperative businesses. As a result, most new co-ops are organized on a nonstock basis with stock-like equity participation units established in the organizational documents.

Organization Under Unique For-profit and Nonprofit Distinctions: Michigan. Michigan generally organizes its corporate law into for-profit and nonprofit corporations. Each division has provisions for incorporating a co-op, while for both the operation is on a cooperative basis similar to other statutes. Other than the differences in the operational provisions between a for-profit and nonprofit co-op, a primary consideration is that the shares or equity of a for-profit co-op offered to members is subject to the Michigan securities registration requirements, while the shares or equities offered to members of a nonprofit co-op are generally not required to be registered.

NGCs that organize in Michigan typically organize initially under the nonprofit corporation cooperative laws but are operationally better suited to the provisions of the for-profit cooperative corporation laws. The nonprofit and for-profit distinctions for corporations do not appropriately apply to co-ops.

A New Era: Unincorporated Cooperative Associations

As more NGCs were organized, farmers voiced their complaints about state law restrictions and impediments of federal law. Midwestern states with anticorporate farming laws (*Iowa Code* 2001, Ch. 9H; *Minnesota Statutes* 2001, § 500.24) did not allow co-ops to participate in confined hog feeding, dairy, and egg laying operations. In these cases, corn farmers desired to process corn into feed to be fed to the poultry or livestock owned by the co-op

and to realize profits from marketing pork, milk, or eggs. Iowa and Minnesota both modified their anticorporate farming laws to allow restricted farmer entities, including co-ops, to engage in these ventures.

Iowa Chapter 501 Statute. Iowa enacted a cooperative statute in 1996 “to provide an opportunity for producers of agricultural commodities to contribute a portion of their production for a single enterprise for purposes of enhancing the value of that production and to restrict control of these enterprises to agricultural producers” (*Iowa Laws* 1996, Ch. 1010, § 1). This corporate cooperative statute required “farming entities” (*Iowa Code* 2001, §§ 501.101, 9H.4) to have at least 60 percent of the voting control and financial rights, and required “authorized persons” to have 75 percent of the voting control and financial rights (§§ 501.101[2][6]), with the profits distributed on a patronage basis and interests in the co-op not exceed 8 percent of the total. In some cases, profits may be allocated to reserves or retained savings (§ 501.503).

The statute also requires redemption of a member’s interest over a period not to exceed seven years upon withdrawal or expulsion. Some ventures had incorporated and attempted to obtain a § 521 certification as a farmer’s co-op from the Internal Revenue Service. The process resulted in questions as to whether such a co-op operated on a cooperative basis (Brown 1998). In 1998, the Iowa legislature substantially amended the corporate cooperative statute to eliminate the terms of “incorporation,” “incorporators,” “stock,” “shareholders,” and similar corporate terms and replace them with “association,” “organizers,” “members,” “interests,” and similar LLC terms (*Iowa Laws* 1999).

With these changes, promoters claimed that a co-op organized under the statute would be considered an unincorporated association and qualify for partnership type pass-through taxation similar to an LLC (Brown 1998). A revenue ruling confirming this approach has not been obtained.

Wyoming Processing Cooperative Law. In 1999, lamb producers in Wyoming and its surrounding states desired to acquire lamb meat, wool, and pelt processing and marketing businesses to make lamb production more profitable. The lamb producers realized that more capital would be needed than could be supplied by producers on a per lamb basis. They wanted to organize their business on a cooperative basis but the existing models did not fit their business plan (Hanson 2001b, 8-9).

The Wyoming legislature adopted changes in the existing cooperative statute, and a new processing cooperative statute was enacted to be effective on July 1, 2001 (*Wyoming Laws* 2001). A ruling request submitted to the Internal Revenue Service confirmed that a co-op organized under the Wyoming processing cooperative statute would be considered an “unincorporated association” and subject to partnership taxation or corporate taxation by election similar to an LLC (PLR 2001).

A Wyoming processing co-op may be formed and organized on a cooperative plan as provided in the Wyoming Processing Cooperative Statute to market, process, or otherwise change the form or marketability of crops, livestock, and other agricultural products and purposes necessary or convenient to facilitate the production or marketing of agricultural products by patron members.

A Wyoming processing co-op has flexibility in two important areas that are not available to corporate co-ops. The nature of the patronage relationship with its members can be determined by the organizational documents, and the co-op can enter what would otherwise be considered nonpatronage source business without tax at the

co-op thereby passing income, losses, and tax credits through to the members; the co-op can also attract capital through outside investments (Hanson 2001b, 6-8).

The co-op's owners are its members divided into two classes. Patron members have rights and obligations to deliver the product to the co-op, while nonpatron members do not have product delivery obligations and are primarily "investment" members. Patron members may also participate as investment members. The patron members have preference in both governance and financial rights.

The voting rights of the members are differentiated between patron and investment members. Patron members vote on a democratic basis of one vote per member subject to certain exceptions. The patron member vote, however, is counted collectively based on a majority of the patron members voting on an issue. Investment members have voting rights proportional to their investment or as otherwise provided in the bylaws. The collective nature of the patron member's vote ensures patron members maximum representation in cooperative voting.

The co-op is governed by a board of at least three directors. At least one director must be elected by the patron members. Directors elected by patron members have at least 50 percent of the voting power of the board or voting power on an equal governance basis.

The financial rights are distinguished between patron members and investment members. The patron members are allocated financial rights (i.e., profits, losses, and distributions) based on patronage or business done by the patron member for or with the co-op. Investment members are allocated financial rights based on capital contributions. Financial rights are allocated between patron members collectively and investment members based on capital contributions, provided, however, that the patron members collectively receive at least 15 percent of the profit allocations and distributions.

Restrictions on member control, contributions, governance rights, and financial rights must be stated in the bylaws or within separate member control agreements. Investment members have redemption rights if bylaw amendments alter governance or financial rights that affect their investment. To protect both patron and investment members upon their entrance to the co-op, the co-op must disclose to any person or entity acquiring membership interests in the co-op the capital structure, business prospects, and risks of the co-op, including the nature of governance and financial rights of the membership interests being acquired and of other classes of membership and membership interests (Hanson 2001b, 6-8).

Variations in Statutes Will Ultimately Lead to Organizational Forum Shopping

The modern corporate cooperative acts retain the cooperative principles of the 1920s but typically do not restrict the purposes for which a co-op may be formed. The Iowa Chapter 501 cooperative statute, while restrictive, made the first step in allowing co-ops to form without the restrictions of federal corporate cooperative taxation and allows up to 25 percent nonproducer ownership and control. The Wyoming cooperative processing law provides the most flexible format for organizing a business organization on the cooperative business principle of distribution of earnings to patrons on the basis of patronage with or without federal corporate cooperative taxation.

The large variation in cooperative laws among states invariably leads to shopping for the best state statute when a new co-op is to be organized. The business principles of operating successfully drive new co-ops, especially

NGCs, to seek an organizational statute that accommodates their business plan and structure. Forum shopping has been in practice for many years, with many corporations throughout the country incorporating under Delaware corporate statutes.

Impact of Federal Law on Cooperative Structure

A co-op is organized or incorporated under state law and must abide by the requirements of the organizational statute to maintain its charter to operate as a separate legal entity. While some state statutes under which a co-op may be organized offer more flexibility than others, federal laws require a co-op to have a certain legal structure (required by its articles and bylaws) in order to receive the corresponding benefit of the federal law.

Corporate Cooperatives Structured to Meet Tax Law

Virtually all corporate co-ops must be structured and operate on a cooperative basis as determined by the cooperative taxation provisions (“Subchapter T”) of the federal Internal Revenue Code (the “Tax Code”) in order to not be taxed as a corporation. The combined state and federal marginal tax rate is about 35 to 40 percent of taxable income in many states. Co-ops that operate on a cooperative basis under Subchapter T of the Tax Code are allowed to deduct patronage-sourced income that is allocated on a patronage basis. Simply stated, a corporate co-op organized under state law may avoid a combined state and federal 35 to 40 percent tax at the co-op level by operating on a cooperative basis prescribed by Subchapter T of the Tax Code and properly allocating its patronage-sourced income to its members.

Two types of co-ops qualify to deduct income allocated to patrons: (1) an “exempt” or § 521 co-op, and (2) a nonexempt co-op that operates on a cooperative basis for the purposes of Subchapter T.

Operation on a Cooperative Basis. The U.S. Tax Court has determined three guiding principles for operating on a cooperative basis: (1) subordination of capital; (2) democratic control by members; and (3) proportional allocation of income on the basis of patronage (*Puget Sound Plywood* 1965). In the 1990s, the IRS added four additional factors in considering whether a corporate co-op is operating on a cooperative basis: (1) existence of a joint effort on behalf of members; (2) a minimum number of patrons; (3) member business should not exceed nonmembers’ business; and (4) upon liquidation, present and future patrons must share in the distribution of any remaining assets in proportion to the business each did with the co-op during some reasonable period of years (Frederick and Reilly 2001, 26-27).

An exempt § 521 co-op has two additional deductions from gross income that are not available to a nonexempt co-op: (1) amounts paid as dividends on capital stock and, (2) amounts allocated to patrons with respect to income that is not patronage-sourced. To qualify for these two additional exemptions, an exempt co-op generally must (1) have substantially all (85 percent) agricultural producer members; (2) return profits in excess of expenses and permitted reserves to all patrons (members and nonmembers) on the basis of patronage with the co-op; (3) restrict dividends on capital stock not to exceed the legal rate of interest in the state of incorporation or 8 percent, whichever is greater; and (4) restrict nonmember marketing business not to exceed member business, and restrict nonmember nonproducer purchasers not to exceed 15 percent of all purchases (Frederick 1996; *Internal Revenue Code* 1992, § 521).

Deduction Only Applies to Patronage Sourced Business. Co-ops that qualify for the ability to deduct income allocated to patrons are further restricted in that the deduction applies to patronage-sourced business for nonexempt co-ops

and for patronage- and nonpatronage-sourced business approved within the exempt co-op's scope of business certified by the IRS (*Internal Revenue Code* 1992, §§ 521, 1381-1388). The limitations of both of these restrictions are beyond the scope of this article but have been discussed extensively by Frederick and Reilly (2001). In general, a deduction qualifying for patronage-sourced business must be related to the patronage business, and not be derived from other products, ingredients, or further processing by others. In limited cases, the income from investments in joint ventures that further process and market a co-op's products may qualify as patronage-sourced business.

Many of the Tax Code regulations were promulgated in the 1950s through the 1970s prior to the advent of NGCs and LLCs. At that time, virtually all companies were organized as corporations and all income was taxed at the entity level. Deductions such as those for income generated from patronage-sourced businesses or for exempt co-ops, the scope of business for which the patronage-sourced business deductions were derived, have been narrowly construed and restrictively regulated by the IRS.

Antitrust: Capper-Volstead Protection

The Capper-Volstead Act (*U.S. Laws* 1922 1992) has been hailed as the "Magna Carta of Cooperative Law." The acknowledgment was appropriate because marketing co-ops and, especially, stock co-ops, were being successfully challenged under state and federal antitrust laws as illegal combinations that restrained trade in the early part of the 1900s (Guth 1982). The Capper-Volstead Act provided a limited antitrust exemption for co-ops that (1) limit membership as agricultural producers; (2) operate for the benefit of members as producers; (3) restrict voting to one vote per member or limit dividends on equity to 8 percent per year; and (4) handle products for members that have a value exceeding the value of products handled for nonmembers. Subsequently, the Cooperative Marketing Act of 1926 was enacted, allowing co-ops that meet these requirements to share marketing information (Cooperative Marketing Act of 1926, 1992).

The criteria for a co-op qualifying for protection under the Capper-Volstead Act were developed primarily from the U.S. Department of Agriculture (USDA), but it is important that these same criteria formed the basis of the commodity marketing acts adopted throughout the country (Guth 1982).

Agricultural Marketing Act of 1929

This act defines co-ops to include the requirements of the Capper-Volstead Act (Agricultural Marketing Act of 1929, 1992). The act was originally intended to define which co-ops were eligible for cooperative bank financing but has subsequently been used as the test for (1) the protection against handler coercion and discrimination in the Agricultural Fair Practices Act; (2) the cooperative exemption from the registration requirements of the Securities Act of 1934; (3) the cooperative exemption from the trust provisions of the Perishable Agricultural Commodity Act; and (4) the cooperative trucking exemption from trucking regulations under the Interstate Transportation Act (Frederick 2002).

Entity Selection: Corporate Cooperative vs. LLC or the Wyoming Cooperative

Co-ops are organizations that have been developed on social and policy principles, primarily the Rochdale Principles and business principles of the patronage relationship. When producers are organizing an agricultural business that requires delivery and processing of products, an evaluation of the types of entity to organize

focuses on corporate co-ops versus LLCs and now the Wyoming Processing Cooperatives (Wyoming Cooperatives).

Pass-Through Taxation and Limitations of LLCs

Limited liability companies (LLCs) offer pass-through taxation--that is, no tax at the entity level and a pass-through of gains, losses, and tax credits to members. An LLC can be organized to separate governance and financial rights (i.e., voting can be proportional or disproportional to the investment). Allocations and distributions can, but need not, be proportional to the investment. LLCs require operating agreements to be signed by all members and are cumbersome to amend. Unlike bylaws as organizational rules, operating agreements are viewed as member contractual rights.

The flexibility of an LLC requires a careful crafting of organizational documents to effect business provisions and a careful analysis of the tax ramifications. The federal partnership tax law was developed for partnerships and has not been revised to accommodate LLCs. If the business will require member delivery of the product to be processed by the LLC, the issue of transfer price and allocation of income based on the product delivered or on the investment must be addressed. An LLC structure can be adopted to allocate or distribute income based on product delivered but the documentation and agreements are cumbersome and complicated.

Corporate Cooperative Restrictions and LLC Alternatives

The Business Principle: Income Allocated Based on Patronage. The most important business principle of a co-op is allocation and distribution of income based on patronage (i.e., business done for or with the co-op) rather than investment. In other corporations, the investor need not do any business or purchase or use any of the corporation's products or services to receive stock dividends representing profits allocated through share ownership of profits of the corporation. A co-op is organized to benefit members who deliver or acquire product from the co-op. Noncooperative businesses can acquire and market products of their investors; however, the product procurement and marketing is done on a contractual basis typically based on the transfer price of the product.

A co-op is organized to allocate income to members based on business done for or with the co-op. In NGCs, members invest money to purchase stock or equity proportional to the amount of product to be delivered. In essence, the processing facility can be considered to be divided and allocated into processing and marketing units with each member purchasing a block of processing and marketing units through his/her equity ownership. This collective action on behalf of the members' units results in the income attributable to those members' units being allocated and eventually distributed to each member. The cooperative organizational statutes of the various states facilitate and, in many cases, mandate this principle.

If producers, with or without others, intend to form an agricultural business that does not utilize their products or is intended to reward producers solely on investment, the business should not be organized as a co-op.

Subordination of Capital. Organization on this business principle as a co-op carries several nonbusiness principles, especially with corporate co-ops. State and federal statutes have legislated that subordination of capital means outside investment should receive no more than an 8 percent dividend on equity. During most of the last twenty-five years, 8 percent would not have paid for the use of capital and, in fact, would pay less than a

commercial bank debt. LLCs and Wyoming Cooperatives can have outside investors and pay returns at market rates to attract that outside investment.

Dealing Primarily with the Products of Members. Exempt corporate co-ops are to deal only with the products of producers, and the value of member products must exceed nonmember products. While nonexempt corporate co-ops may deal with a greater amount of nonmember products, this principle is embodied primarily in federal corporate cooperative tax law. Most processing and marketing businesses need a variety of grades and pricing of products to be successful marketers. Certain nonmember producers may offer to sell products at harvest at a substantial discount. A corporate cooperative processing entity would be at a competitive disadvantage if it could not acquire products from nonmember producers at the same discount as its competitors. If a corporate co-op is authorized to conduct business with nonmembers on a noncooperative basis, the income is not deductible as patronage-sourced business and, therefore, will be subject to state and federal tax at the co-op level. LLCs and Wyoming Cooperatives can acquire products from members or nonmembers at the most competitive price.

Limitation of Patronage-sourced Income. Although a corporate co-op is based on a single-level tax theory—income is either taxed at the entity or at the member level—the deduction at the co-op level is only available for patronage-sourced business, which, through years of IRS challenges is restrictively interpreted to mean that level closely associated with the members' products. For example, if a farmer's corporate co-op produced a pharmaceutical drug in a plant that was extracted in the co-op's processing facility, combining that drug with other drugs in a capsule to be labeled and marketed to consumers, the drug extracted from the farmer's plants would likely have a small value relative to the overall capsule; therefore, the income from the sale of the capsules would not be patronage-sourced and would be taxed at the state and federal marginal rate of approximately 35 to 40 percent at the cooperative level. LLCs and Wyoming Cooperatives are able to pass this income to their members.

Tax Credits and Losses. Corporate co-ops that are taxed under Subchapter T have a number of corporate tax attributes under Subchapter C of the Tax Code, including the inability to pass losses or tax credits through to members. For an ethanol production co-op startup operational losses are retained at the co-op level, and tax credits, which may exceed \$2 to \$3 million, generally remain unused at the corporate co-op. LLCs and Wyoming Cooperatives can pass these losses and credits through to their members.

Operation at Cost with all Profits Returned Based on Patronage. This is a principle embodied in federal corporate cooperative tax and case law and in some state statutes. Nonpatronage-sourced investment venture partners and other participation in profits are precluded, which limits outside capital and management who desire profit participation as part of their compensation, similar to corporate management. An LLC or Wyoming Cooperative can allow outside investment and management participation in profits as part of their compensation.

Governance: Board of Directors Elected by One Member/One Vote. Corporate co-ops are governed by a board elected from members and membership voting on the basis of one member/one vote. This principle has two facets: (1) how the members vote, and (2) who they can vote for to govern the co-op. The Rochdale Principle of one member/one vote was an alternative to voting based on investment and paralleled the Rochdale Principle of subordination of capital with no voice in management. Co-ops in some states have recognized that in the case of a federated co-op (i.e., a co-op with one or more co-ops as members), a fair method of member voting is on a basis proportional to patronage (Barton 1989, 26-33).

In addition, board governance frequently has directors selected from districts based on geographical areas, products, patronage, or other distinctions. The general principle of one member/one vote, while an alternative to voting based upon investment, does not vest voting authority with the patrons who have the most at risk with the success or failure of the co-op. Consequently, member governance tends to be less effective than it should be and board elections can be political and based on popularity.

Corporate co-ops usually require directors to be elected from the membership who are patrons and, in many cases, who are required to be producers. Representation of patron members on the board is important, but equally important is board representation to facilitate strategic planning; capitalization; and hiring, retention, and termination of management on appropriate terms. The producer board members of a capital intensive processing and marketing co-op may not possess the same skills and knowledge as a diverse board with outside directors who are familiar with the processing and marketing industry or of capital availability.

LLCs and Wyoming Cooperatives can allocate voting based on patronage and investment. The directors elected by members need not be members, which allows the hiring of outside directors for their expertise.

State and Federal Opportunities to Assist Cooperative Development

State and federal assistance should recognize five factors in making changes to assist cooperative development: (1) the cooperative business model must compete favorably with other business models or it will not be used; (2) many if not most cooperative opportunities require capital beyond the means of producer members; (3) the cooperative business model must grow with the success of the co-op; (4) co-ops need more flexibility today to succeed than at any previous time; and (5) cooperative development can represent sustainable rural development and have exponential benefits beyond the cooperative business.

Legislative Changes to Remove Legal Impediments

Legal principles originally developed to support cooperation have become statutory legal impediments. The statutory changes and cooperative requirements of the 1910s and 1920s do not fit today. Cooperative development is best served when the ingenuity of the cooperator is allowed to apply cooperation competitively to the business plan. Today's cooperators who try to develop value-added processing businesses are hamstrung by restrictions applicable to cooperative stores of the mid-1800s and business conditions of the early 1900s.

Business organizations have evolved since 1960 to Delaware-style corporations and LLCs. Until the Wyoming Processing Cooperative Law, the cooperative legal principles essentially had matured by 1925. Simply stated, the corporate cooperative form of business offers few advantages and a number of significant business disadvantages over other forms of business for today's processing businesses; however, only the cooperative form of business rewards the users of the business, which is why state and federal governments should support its continued development.

Tax Laws. Federal tax law has one of the most chilling effects on cooperative development. Much of the regulations and tax law theory were developed before the advent of LLCs and are only compared to the differences of a corporation. While corporate cooperative taxation provides some advantages over corporations, in most areas cooperative organization competes with LLCs:

- *Certification of cooperatives under § 521.* The certification criteria for producer co-ops under § 521 should be changed to certify co-ops in which 50 percent or more of the ownership or control is held by producers; dividends on capital do not exceed three times the prime rate on a preferred basis or the collective return on patron investment on an equity basis; and patron voting is not based on the amount of investment but on patronage or marketing rights. Certification should be allowed as a corporate co-op qualifying for Subchapter T taxation or a co-op on an Iowa or Wyoming plan qualifying for Subchapter K partnership taxation.
- *Patronage-sourced business.* The restrictions on the deduction for patronage-sourced business should be revised to allow producer co-ops to prepare and effectively market their product in the marketplace. A pasta co-op should not be taxed on the income attributable to a prepackaged spaghetti dinner just because the beef and tomato ingredients cost more than the spaghetti noodles.
- *Tax free or tax deferred reorganization of corporate cooperative to an Iowa or Wyoming cooperative.* The reorganization of a corporate co-op to an Iowa or Wyoming co-op is taxed as a liquidation of the corporate co-op. The tax law should allow a corporate co-op to complete a tax reorganization from a corporate co-op to an Iowa or Wyoming co-op or, as an alternative, allow the deemed liquidation to be deferred until actual liquidation of the Iowa or Wyoming co-op after conversion.

Securities Laws. When producer co-ops start businesses, capital is needed from producers and others. The federal and most state securities laws are not well-suited for producer entities raising capital. Co-ops should not be treated as public companies in raising funds under the registration and public company reporting requirements. The securities laws should allow co-ops with proper disclosure to raise \$50 million or less from patrons, accredited investors, and nonaccredited investors within an influence radius (e.g., local rural investors) as certified by the securities division of any state without registration or reporting requirements. This would allow local and rural investors to participate in co-ops.

Cooperative Laws. States should facilitate Wyoming-type cooperative laws to allow co-ops to organize without federal corporate cooperative tax restrictions. Federal laws such as the Capper-Volstead Act and Marketing Acts of 1926 and 1929 should be held to a twenty-first century definition of a co-op to meet their original intent of being effective tools to help cooperating farmers (Lauck 1999, 491-493).

Financial Assistance

Producers have limited financial resources to start up and develop co-ops. Much of the financial assistance available is in the form of grants and loan guarantees.

Equity. Financial assistance programs should be expanded to include subordinated debt and an equity investment to match producer equity plus an exit strategy should be included.

Incentives Tied to Market Power. Government assistance programs should be targeted to enhancing producer market power. For example, more than eight farmer cooperative ethanol production facilities were built in Minnesota with state financing incentives. Some attempts were made to market the ethanol collectively on a cooperative basis, but it was never achieved. Today, these same plants market with four or more different marketers, and the corn farmers who organized cooperatively are competing against each other for ethanol markets.

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