



# Understanding Cooperatives: Legal Foundations of a Cooperative

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Construction of a solid foundation under a building requires the proper use of numerous materials and tools. Only when the foundation is securely in place can the remainder of the structure be built with confidence that it will become a permanent part of the community.

Likewise, to make sure it is prepared to serve its members for years to come, a cooperative requires a solid foundation. That foundation is comprised of laws and legal documents that define the organization and operation of the association. This report summarizes the legal underpinnings that support the cooperative venture and suggests a management tool, the director handbook, to facilitate effective use of these and other important documents.

## Incorporation Under a State Statute

The first step to building a strong legal foundation to support your cooperative is selecting the appropriate business structure. Some groups organize as an unincorporated association—usually to save the cost of incorporating. This strategy is seldom in the best interests of the members.

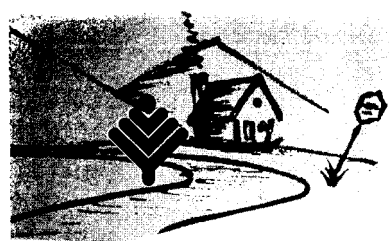
At least three advantages exist to organizing a cooperative as a corporation:

- ◆ The personal liability of each member for losses suffered by the cooperative is limited to the member's equity in the cooperative.
- ◆ Transfer of ownership and control is simple. New members purchase a membership certificate or a share of voting stock. When a person is no longer eligible to be a member, the cooperative repurchases that person's membership interest.
- ◆ A corporation conveys to members and outsiders the image of a solid, long-lasting venture.

Cooperatives, like other private businesses, are organized according to a State statute. Persons who form a cooperative may choose from several incorporation statutes. Most cooperatives are organized under a cooperative incorporation statute of the State where the association's headquarters is located. If the home State's cooperative incorporation law does not permit a structure that meets the desires and needs of the members, the General Business Corporation Act and out-of-State incorporation laws are available options.

A few so-called cooperatives are organized under a General Not-for-Profit Corporation statute. These acts are designed to facilitate the development of charitable and educational institutions, not businesses. Such associations are frequently barred from distributing margins to members and can have difficulty enforcing marketing agreements with their members. Because of these restrictions, careful thought should precede organizing a cooperative under a not-for-profit statute.

<sup>1</sup> This report does not represent official policy of the U.S. Department of Agriculture, the Internal Revenue Service, the U.S. Department of the Treasury, or any other government agency. This publication is presented only to provide information to persons interested in the tax treatment of cooperatives.



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A cooperative organized under an inappropriate State statute can usually reorganize without seriously disrupting the ongoing business of the association. This task usually involves redrafting the organization papers to conform to the new law and paying a modest fee to the appropriate State agency.

### Organizational Documents

The State incorporation statute sets mandatory rules for all cooperatives organized under it. Other basic legal documents are written by the association leaders. While these other documents must comply with statutory requirements, considerable flexibility is available to tailor the documents to the needs and desires of the membership.

#### *Articles of Incorporation*

The first internal organizational document, prepared when a cooperative is formed, is the articles of incorporation. To become official, the articles must be recorded in the office of the appropriate State official. When properly recorded, the articles establish the cooperative as a unique person in the eyes of the law, separate from its members and possessing many of the rights and responsibilities of real people.

The specific information that must be included in the articles is set out in the incorporation statute. Other provisions may be included in the articles, but this is usually not done. Amending the articles often requires a new filing with the State. Also, the member-voting requirement to amend the articles is frequently more demanding than simply changing other documents that can contain the same information.

The courts usually give articles the same respect they do statutes. They are binding on the directors, officers, and managers of a cooperative. When a cooperative does something not permitted by the articles, the organization and its leaders can be subject to legal liability.

Articles of incorporation usually cover these items:

- ◆ Name of the cooperative
- ◆ Principal place of business
- ◆ Purposes and powers
- ◆ Duration of the cooperative, usually perpetual
- ◆ Names and addresses of the incorporators
- ◆ Description of the capital structure

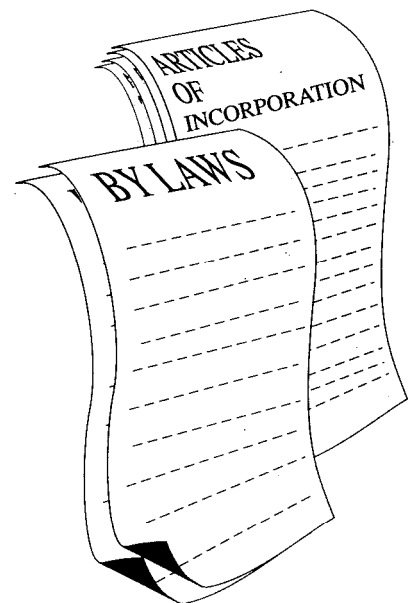
#### *Bylaws*

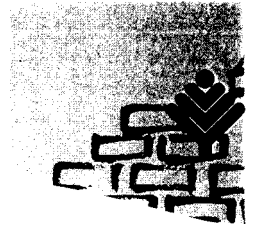
Shortly after a cooperative is incorporated, the members adopt a set of bylaws. Bylaws provide a detailed description of the internal operations and structure of the cooperative. Bylaws are a working plan for how the association should function. References to bylaws in the statutes are usually permissive, giving the members the authority to write their own rules on how to handle a particular issue.

While bylaws do not normally need to be filed with the State, they are also treated similar to statutes by the courts. Failure to follow the bylaws can also lead to legal liability.

Issues commonly covered in bylaws include:

- ◆ Membership eligibility requirements
- ◆ Meetings
- ◆ Voting at member meetings
- ◆ Election and duties of directors
- ◆ Election and duties of officers
- ◆ Finance
- ◆ Handling of losses





- ◆ Nonmember business
- ◆ Dissolution
- ◆ Amending the bylaws

### *Policies*

A third organizational document is not required by statute but is strongly recommended by most advisers to cooperatives. That is a set of policy statements. Policies are written statements of position that guide the cooperative to consistent decisions in recurring situations. They are usually adopted by the directors as part of their responsibility to oversee the general management of the cooperative.

Policies can be either broad and general or detailed and specific. Broad policies leave room for interpretation and the exercise of judgment and initiative. Specific policies require predetermined conduct.

Policies are not of equal importance. Compare these two policies. One provides that a member will be guaranteed the sale of all product delivered regardless of quantity or quality, while another permits a 15-minute coffee break for employees in both the morning and afternoon. The first has significant operational ramifications for the cooperative. The second, while important to employees, has little long-term impact on the association's character.

While most activity can be addressed in the cooperative's bylaws, only broad issues of long-term significance to members and management usually are treated in bylaws. Some fundamental directives, such as the requirement to return margins to members on a patronage basis, are usually placed in the bylaws. However, separate written policies are often more appropriate than bylaws for handling many issues, such as employee rules, granting of credit, and public affairs activities.

In drafting and reviewing articles, bylaws, and policies, three factors are especially important:

- ◆ compliance with the statute of incorporation and other relevant Federal and State laws
- ◆ Accuracy in reflecting how the members want the cooperative to operate
- ◆ Consistency throughout

A well-conceived set of organizational documents will conform to applicable law, complement each other, and provide the leadership clear and concise guidelines on how the cooperative will function:

### *Marketing Agreement*

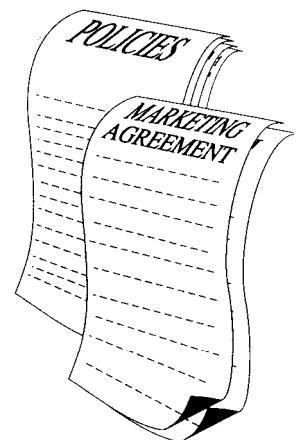
Cooperatives that market farm products and other goods of their members often sign a separate contract with each member establishing the terms upon which they will conduct their business transactions. This contract is commonly called a marketing agreement. It requires the member to market certain product(s) with the cooperative. And it obligates the cooperative to obtain the best possible price for the product(s).

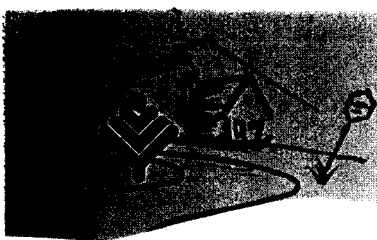
A cooperative marketing agreement is unique. It is both a contract between the member and the cooperative as well as a pact between the member and the rest of the membership. A well-written marketing agreement should eliminate the risk of confusion about the mutual obligations of the producer and the cooperative. As a binding contract, the cooperative or the member can enforce the agreement should the other party fail to carry out prescribed duties.

A marketing agreement will generally cover such issues as:

- ◆ Whether the cooperative acts as the members' agent or instead takes title to the goods for resale

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- ◆ Terms for delivery by the grower and acceptance by the cooperative
- ◆ Duration, price, and payment terms
- ◆ Modification and termination of the agreement
- ◆ Assignment of rights and duties
- ◆ Enforcement and remedies

*Membership Agreement*

When a person applies for membership in a cooperative, many associations have the applicant sign a simple document stating he or she meets the eligibility requirements for membership and will abide by the rules of the cooperative. When the application is approved by the board or the manager, the document serves as official notice that the applicant is a bona fide member of the association.

Sometimes cooperatives will merge the membership and marketing agreement provisions into one document for the member to sign.

**Director Handbook**

Familiarity with the documents reviewed in this paper is a continuing responsibility of each cooperative leader, particularly members of the board of directors. The same is true for other important cooperative papers-audit reports and current financial statements, loan agreements, the manager's job description, and the minutes of recent board and membership meetings.

Directors need to have these documents readily available so that they can check them for information and ask informed questions when necessary. A good director handbook meets this need.

The director handbook need be as simple as a solid three-ring binder that contains up-to-date copies of all documents the directors need in setting cooperative policy. Every new director should get a current handbook as soon as he or she is elected to the board. At each board meeting, the manager or the president should distribute minutes of the previous meeting plus the new version of any document that has been modified or adopted since the last meeting. Directors should carefully place the new pages in the proper place in the book so they can be easily reviewed and questions asked about the additions and replacements.

The director handbook gets the important cooperative papers out of the file cabinet and into the mainstream of the decision-making process. It minimizes the risk that leaders will innocently violate a provision of the articles or bylaws, contracts, or other written guidelines. The handbook should provide ready answers to questions about limitations on leadership discretion imposed by these documents. And it facilitates the conduct of business meetings in a professional and efficient manner. In summary, it becomes a valuable tool for cooperative management and planning. ■




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