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## **Origins of a Current Conflict? An Examination of Stock-Nonstock Cooperative Law**

by

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# Origins of a Current Conflict? An Examination of Stock- Nonstock Cooperative Law

*Diane Rizzuto Suhler and Michael L. Cook*

The earliest state cooperative laws in the United States were stock laws modeled upon the Rochdale experience and were adaptations of basic corporate laws of incorporation to the cooperative form of organization. They emphasized stock as the basis of membership and the distribution of profits to members in proportion to patronage. After 1911, the dominant form of cooperative law became the non-stock law, which emphasized service at cost and the personal, fraternal nature of membership in a cooperative. Since 1925, both forms of cooperative law have coexisted. The different emphasis placed on capital stock, profit, and membership in a cooperative by the two different legal structures may be one contributing factor to current dilemmas cooperative leaders face in generating and rewarding equity capital.

Equity capital performs a fundamental role in any business enterprise. An adequate capital base is essential if a business is to be able to provide desired services, survive adverse business and economic conditions, and provide a minimal level of security to creditors. A cooperative, like any other business form, must maintain an adequate capital base. This adequate equity base differs for each entity and is related, to some degree, to the capital intensity and asset base of the cooperative (Cobia).

Increasingly, cooperative leaders in their role as financial decision makers face the challenge of generating and rewarding equity capital. This challenge emanates from the complexity of the basic financial characteristics of cooperative business organizations. These characteristics include: (a) net income is distributed among cooperative stockholders in proportion to their patronage with the business rather than in proportion to their equity ownership in the organization; (b) the cooperative pays a limited or no dividend on equity capital invested in the organization; and (c) because of institutionalized cooperative principle and operating policies and practices and a nonexistent secondary market, cooperative stock is nonappreciable and illiquid. Conceptually, these characteristics of illiquidity, nonappreciability, and limited return on member equity (a) prevent the cooperative stockholder from realizing the full share of the expected present value of the cooperative's future income stream, (b) have a tendency to place pressure on cooperative leadership to increase current earnings at the

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expense of future earnings, and (c) generate the incentive to increase patronage relative to capital investment (Staatz).

Remedying these cooperative returns on equity shortcomings has taken two primary forms. Some cooperatives have established capital base plans that reward equity through highly monitored and controlled patronage refunds in proportion to use. In this way, equity redemptions become an incentive for accumulating equity holdings. A second method for remedying equity shortcomings involves the use of a wide range of "investor-driven" instruments. In their least intrusive form, adoption of these instruments may involve the establishment of a joint venture with nonmember risk capital. At the more extreme end of the continuum, a cooperative may opt for complete conversion to other business organizations' forms (Collins). Schrader documents a number of these restructurings in testing the hypothesis that the nature of patrons' equity in cooperatives may predispose successful cooperatives to restructure as investor-oriented firms. As the agricultural business environment becomes increasingly complex, global, technology driven, and capital intensive, the pervasive and fundamental conflict—user versus investor driven—may grow ever more prominent on the agenda of cooperative decision makers.

The objective of this paper is to explore one of the origins of this conflict. We offer as partial clarification of the user-investor difference a review of the stock-nonstock debate that occurred during the embryo stages of U.S. agricultural cooperative development. The stock-nonstock debate focused on the link between membership and the ownership of capital. Cooperatives organized as stock associations viewed membership as a function of capital stock ownership. Nonstock cooperative entities, on the other hand, determined that the true nature of cooperation precluded the use of capital stock and, as an alternative, tied membership to personal commitment. Understanding how these differences were institutionalized into state and federal law might improve our understanding of the complexity of the conflict.

## **The Rochdale Experience**

The development of cooperatives and cooperative principles in the United States can be linked directly to the Rochdale experience in Great Britain during the 1840s. Although the basic ideas upon which the Rochdale pioneers established their cooperative store were those of such social thinkers as Robert Owen and Charles Fourier, the actual tenets of Rochdale cooperation developed slowly on a trial-and-error basis over a sixteen-year period (Abrahamsen, pp. 48–49). By 1860, the Rochdale Society's rules of conduct and points of organization had evolved to a point where they could be verbalized in the *Rochdale Annual Almanac* (Holyoake). The finance- and control-related principles, as laid down in the *Almanac*, were as follows:

1. Capital should be of their own providing and should bear a fixed rate of interest.
2. Market prices should be charged and no credit given or asked.

3. "Profits" should be divided *pro rata* upon the amount of purchases made by each member.
4. The principle of "one-member, one-vote" should obtain in government and the equality of the sexes in membership (Webb).

The principles of Rochdale cooperation can be condensed into three fundamentals. First, increased efficiency or reduced costs of service is to be achieved by reduced competition and volunteer help. Second, distribution of savings or profits results from paying a minimum interest rate to invested capital and making stock-owning patron/members the proper claimants to any surplus generated from the cooperative. Third, democratic control is achieved by allowing each member to vote as an individual (Nourse 1922). Above all, the Rochdale pioneers sought to establish the concept of an "equitable association" of persons involved in an economic undertaking (Nourse 1946).

### **Cooperative Legal Development before 1911**

During the period from 1832 to the Civil War, various experiments in cooperation were undertaken in the United States. These attempts at cooperation were characterized by independent group efforts and informal organization. There was no coordinated leadership, and most efforts were restricted to local community cooperation. None of these were successful, nor did they leave behind a legal foundation for cooperation.

The first organized effort at cooperation was launched by the National Grange Association between 1870 and 1890. During this time, the Grange organized hundreds of marketing and purchasing cooperatives (Schaars, p. 75). Before 1875, the Grange advocated no specific principles of cooperation. However, at its 1875 annual convention, the Grange adopted a recommendation endorsing the Rochdale Principles. As a result, the Rochdale Principles became widely dispersed after 1875 and were especially familiar to farmers in the Northeast and Midwest.

Despite the fact that the Grange had endorsed the Rochdale Principles, there continued to be no legal basis for their use in cooperative organizations. As a result, a general consensus emerged that some form of legal statute was needed for associations operating under the Rochdale Principles. Three reasons for such a statute were cited:

1. State corporation law stipulated voting only on a regular share basis.
2. A mechanism was needed to require cooperative businesses to conform to the Rochdale Principles.
3. There would be a greater likelihood that government would foster cooperatives if they had a legal standing (Nourse 1928, pp. 35-38).

The first cooperative-enabling laws were basically revisions of the general corporation laws. All of these legal statutes considered capital stock an integral part of cooperative organization. In many ways, the concept of capital stock as a fundamental component of cooperatives was consistent with the types of agricultural cooperatives most common during the last decades of the 1800s and the first decade of the 1900s, i.e., creameries, cheese factories, and grain elevators. These were all very capital intensive

cooperatives; therefore, the incorporation of capital stock seemed a natural component of cooperative law (Bakkan and Schaars, p. 275).

The provisions of some of the early cooperative statutes were brief and very similar in content. Further, they were primarily instigated by consumer and workman cooperative groups. The first cooperative statute was enacted in 1865 in Michigan. Other states followed suit in adopting cooperative laws: Massachusetts in 1886; Wisconsin, Kansas, and Pennsylvania in 1887. The basic provisions of these laws mirrored the Rochdale Principles. Some of the common provisions included: cooperatives could issue shares but could limit the number of shares held by each member; voting was on the basis of members, not shares; each member had one vote; the basis of distributing earnings was established by individual cooperatives. The Pennsylvania law did encompass several new provisions concerning capital stock. Specifically, it allowed for a cooperative to issue both permanent stock and ordinary stock. Every member would have to purchase a set amount of permanent stock and, thereby, have a permanent investment in the capital of the association. The holding of permanent stock conferred one vote on the holder. Ordinary stock, on the other hand, could be bought and sold and conferred no voting rights on its holder (Nourse 1928, pp. 39–50). These provisions are interesting because they are forerunners to some of the stock options observed today in cooperatives as managers try to generate and reward capital.

Edwin Nourse characterized this type of cooperative law up until 1911 as the Rochdale pattern of cooperative organization. He stated that this form of cooperative law “attempted merely to modify somewhat the ordinary corporate structure and procedures in order to secure a more democratic distribution of control and to identify earnings with patronage rather than with the contribution of capital” (Nourse 1928, p. 51).

This Rochdale pattern of cooperative organization was characterized by a form of association where prices of cooperative goods were established competitively in local markets. By charging competitive prices, a cooperative earned a profit from operations. A portion of this profit was distributed to the members; the remaining amount accrued to the cooperative in the form of capital. This method of pricing led to the accumulation of capital by the cooperative from current operations. As a result, patron/members were able to measure the financial benefits that accrued to them from their transactions with the cooperative, both in terms of their enhanced wealth and in relation to the increased capital value of the cooperative.

## **Cooperative Legal Development: 1911–20**

It was not until 1911 that farmers began to take the lead in a widespread movement to secure laws under which cooperatives would be most advantageously established and operated. Many organizers of cooperative marketing activities during this period did not like the capital stock associations fostered by cooperative laws that emerged in the late 1800s and early 1900s. Their dislike was based on four premises. First, they felt that this form of cooperative organization was just a modified type of profit-sharing corporation. Second, services of cooperatives, as currently operating, were not

restricted to members. Third, critics disliked the fact that in some situations, stock could be sold to persons other than producers. Fourth, they disliked the fact that profits (or losses) on nonmember business accrued to the benefit (or detriment) of bona fide members (Bakken and Schaars).

Some cooperative law in the period following 1911 sought to remedy these perceived problems and to create a "pure" form of cooperative. This "pure" form of cooperative took the generic name of "nonstock cooperative organization." There were three basic objectives of the nonstock laws that emerged primarily between 1911 and 1920. First, these laws sought to avoid capital stock by putting all invested capital on a loan basis. Throughout the Rochdale period, membership was identified with the ownership of capital stock. This practice had the benefit of emphasizing the cooperative principle that the contribution of invested capital was one of the obligations of members of the cooperative. However, critics proposed two drawbacks to this practice: (1) it could lead to the undercapitalization of a cooperative if members viewed the amount of capital to be purchased as discretionary, and (2) it would perpetuate the ordinary corporate idea that capital stock was the primary claimant to benefits generated by the association. The nonstock cooperative would supposedly remedy these problems by identifying all invested capital as loan funds. Capital would be raised by levying fees in proportion to the amount of business conducted with a cooperative, rather than through the use of an attractive interest rate (Nourse 1928).

A second objective of nonstock statutes was to eliminate the use of market prices in pricing cooperative goods. Rather, goods would be priced at cost plus a marginal fee to cover operating costs. This would eliminate positive or negative profits from cooperative operations. Cooperatives would carry on the business of members for a service charge. Proponents of this concept viewed it as a move toward the principle of service at cost in cooperative operations. In a sense, the cooperative was to become the selling or buying representative of members. The purpose of this proposal was to delineate the group whose common interests were to be advanced by the association. A third objective was to develop personal and responsible membership that would foster loyalty to the cooperative and simultaneously give the cooperative greater control over member actions. Cooperatives were to become purely a membership type of organization reflecting a "fraternal idea—i.e., recognition of a joint group interest arising from common participation in some particular type of economic enterprise" (Nourse 1928, p. 236). This was in contrast to the Rochdale period where membership was identified with the ownership of capital stock and restrictions were placed on the transferability of capital.

A primary basis for the principle of the nonstock movement was the Farmers' Alliance of 1887–90. The Farmers' Alliance adopted a cooperative philosophy that was radically different from that of the Grange or the Rochdale period. This group advocated no joint-stock features. It espoused a doctrine of a cooperative not being a business for profit but rather an entity supplemental to farming efforts; it advocated a fraternal concept of cooperative membership and solidarity; and it urged that cooperatives benefit members by maintaining a low-price policy, rather than through patronage dividends (Knapp, pp. 65–68). Thus, the seeds of the nonstock "pure" cooperative movement were planted by the Farmers' Alliance and

emerged in the form of the commodity marketing movement and the non-stock laws of the early 1900s.

Three independent sources of nonstock laws were: (1) the California laws of 1895 and 1909, (2) the Alabama law of 1909, and (3) the Texas law of 1917. The California nonstock law of 1895 represented a new departure in cooperative legislation. Its membership provisions were especially significant. They stated that: one member equals one vote; membership is personal; and the rights of all members are equal. Further, the membership provisions implied that a cooperative was not a company of shareholders, but rather an association of persons engaged in a like undertaking, specifically qualifying for membership and accepting the discipline of the association. Although the 1895 California law followed the Rochdale principle of equal suffrage, the 1909 law was made significantly different by allowing for proportional and proxy voting.

The Alabama law of 1909 emphasized the members' contractual obligation to the cooperative. The Texas law of 1917 had two key provisions. First, membership was nontransferable. Second, members were limited to those persons directly engaged in a particular industry (Nourse 1928, pp. 59–72). Thus, these two laws reinforced the fraternal concept of non-stock law.

The push toward nonstock cooperative entities was aided in 1914 by the passage of the Clayton Act. Since the 1890 enactment of the Sherman Antitrust Act, cooperatives had had a precarious standing under the law and were easily adjudged as combinations in restraint of trade. Cooperative leaders desired a definite legal statement that would exempt their organizations from the provisions of the Sherman Act. In 1914, the Clayton Act was passed, which exempted "agricultural or horticultural organizations instituted for the purposes of mutual help, and not having capital stock or conducted for profit" from the Sherman Antitrust Act (Bakken and Schaars, pp. 279–80). Although the Clayton Act clarified the status of nonstock cooperatives, it left relatively unchanged the status of stock cooperatives under the law.

As one views the "purist" period when nonstock cooperative law came to the forefront, a shift in emphasis took place concerning cooperative principles. The move away from capital stock reinforced the principle of limited return on capital and the categorization of equity as synonymous with loan funds. All of the nonstock laws of this period solidified the principle of democratic control and changed cooperative membership into a fraternal, personal matter as opposed to a business relationship. Finally, the nonstock movement shifted the focus of cooperatives from an economic endeavor that made "profits" for its members and paid dividends to them, to a more service-driven arrangement between member and cooperative that stressed the principal-agent relationship between the two in the form of the principle of service at cost. Thus, it can be reasoned that the nonstock movement resulted in the solidification of what became known as the "hard core" cooperative principles.

### **Cooperative Legal Development: Post-1920**

By 1917, it was evident that some uniformity was needed in cooperative law in order to clarify the confusion caused by the differences in various

state statutes and to reconcile the gap between stock and nonstock cooperative law. As a means of bringing about uniformity in state and federal laws, the U.S. Department of Agriculture drafted a department bill in 1917 that was suggested as a model for states enacting cooperative legislation. The bill included provisions that allowed incorporation as either capital stock or nonstock associations, provided for marketing agreements, and suggested penalties in the event of breach of contract. Further, the voting and membership provisions of this document followed the pattern established in nonstock laws. The bill was readily accepted by numerous states between 1917 and 1921, after which the Sapiro model bill became better known (Bakken and Schaars, p. 281).

The draft bill developed by Aaron Sapiro became the dominant model for state cooperative law between 1921 and 1925. The Bingham Act, enacted by the Kentucky legislature in 1922, represented the embodiment of the Sapiro law. By 1925, all but eight states had adopted legislation incorporating the chief features of the Bingham Act. The provisions of these laws closely resembled the tenets of the nonstock cooperative statutes and the commodity marketing movement. Two provisions in the Bingham Act are of special interest. One component of the membership provision stipulating that products of nonmembers were taken for storage only precluded cooperatives from doing business with nonmembers. Further, a provision of the Kentucky law defined "nonprofit" in more explicit terms. It stated that cooperatives were not organized to make a profit for the association or for their members, but for "their members as producers" (Nourse 1928, pp. 100-03). This reinforced the service at cost principle of cooperative association.

At the same time that the USDA draft bill and the Sapiro law were shaping state statutes to conform to a more restrictive and pure interpretation of cooperation, federal legislation was enacted that actually broadened the definition of cooperatives. In 1922, the Capper-Volstead Act was passed by the U.S. Congress. The provisions of the Capper-Volstead Act, in many ways, reflected the basic principles of the Rochdale period of cooperative law, which dominated prior to 1911. This law was different from the Clayton Act in that it definitely authorized the association of agricultural producers and it removed the uncertainty concerning capital stock associations. The primary features of the Capper-Volstead Act were:

1. Each member had one vote, **or** dividends on stock would be limited to 8 percent or less.
2. Nonmember business could not make up more than 50 percent of a cooperative's total business.
3. Cooperative associations were to operate for the benefit of their members.
4. Cooperative associations with or without capital stock were legal.

An examination of the provisions of Capper-Volstead indicates that it was significantly more liberal than the nonstock laws in several ways. First, by permitting cooperatives to pay as large a dividend on stock as they desired as long as voting was on a one-member, one-vote basis, Capper-Volstead weakened the nonprofit interpretation of cooperatives espoused



by the proponents of nonstock laws. Second, the fact that up to 50 percent of a cooperative's business could be conducted with nonmembers liberalized the view of what really constitutes cooperation. Further, the possibility of making net profits on this nonmember business and of having such profits accrue to the benefit of members alone placed the cooperative in somewhat the same category as that of an investor-oriented firm (Bakken and Schaars, pp. 281-82).

## Summary

The above discussion of the development of the legal structure of cooperatives indicates that by the mid-1920s, cooperative law had evolved to a point where federal and state statutes had taken somewhat different paths. State law had become increasingly narrow in its interpretation of proper cooperative behavior and principles. On the other hand, federal law, as embodied in the Capper-Volstead Act, had become more liberal in its definition and principles of cooperation. Thus, from the perspective of hindsight, it would seem that the development of stock/nonstock laws partially laid the foundation for the user-versus investor-driven conflict in cooperatives that is observed today. The state stock statutes provided for a more investor-oriented mentality in cooperatives; the state nonstock statutes eliminated stock and profits and emphasized instead user benefits based on patronage. Federal law, on the other hand, allowed either form of cooperative organization, was less restrictive regarding the benefit clauses, and granted anti-trust immunity to both.

In a sense, the conflict in cooperative legislation was due, in part, to the fact that cooperative laws have tried to chase ideology. Variation in the cooperative ideology and in the emphasis placed on components of this ideological underpinning has resulted in conflicting legal provisions both among state laws and between state and federal legislation. Consequently, instead of a well-defined, standardized national cooperative organization in the United States, there exist eighty-five different state incorporation statutes that vary widely in their content and requirements. Many states have more than one cooperative law, giving rise not only to interstate but also intrastate variation in cooperative legal provisions (Baarda).

The resulting practical dilemma for cooperatives in the post-1925 period has been threefold. First, cooperatives must incorporate under state law, which in most cases is more restrictive than federal law. Therefore, cooperatives have had difficulty taking advantage of the more liberal provisions of federal law that would help them in dealing with their capital problems and in adapting to different market settings. Second, the unwritten guiding principles of cooperation, i.e., the "hard core" principles and variations of these that have evolved in the post-1925 period, tend to reinforce more strongly the principles incorporated in nonstock laws rather than those of stock laws. Third, the variation in state laws results in a high degree of nonuniformity in cooperative organization and in confusion among cooperative members and decision makers concerning proper cooperative behavior. The conflict between stock and nonstock laws seems to have been one contributing factor to these dilemmas. The end result of these three

dilemmas is that management appears to be constrained both legally and philosophically in its ability to confront the equity question.

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