



Understanding Cooperatives: The American System of Business

Cooperative Information Report 45, Section 1



**United States
Department of
Agriculture
Rural Development**

Cooperative
Programs

July 1994
Slightly Revised
April 2011

Free enterprise is an economic system that provides individuals the opportunity to make their own economic decisions, free of government constraints, and as private profit-potential businesses....

Free enterprise allows individual ownership of property and the means of production. Its key characteristic is that individuals have the freedom to make their own choices in the purchase of goods, the selling of their products and their labor, and their participation in business structure.

Our business system is based upon four basic principles:

- (1) freedom of choice;**
- (2) private property rights;**
- (3) profit motive of owners; and**
- (4) owner control.**

In the United States, there are three basic types of business firms: individually owned, partnerships, and corporations (including cooperatives).

Individually-Owned Businesses

The individually-owned business is the oldest and most common form. In it, one person owns, controls, and conducts the business.

Characteristics of individually-owned businesses include:

- ◆ The owner is responsible for management, makes all the major operational decisions, and sets the business policies.
- ◆ The owner supplies or borrows the capital, is responsible for all debts, and receives all the profit earned.
- ◆ No special legal formalities are required to form an individually owned enterprise. Where there are legal requirements, they usually consist of the purchase of a business permit and payment of local license fees.
- ◆ The life of the individually-owned business is tied to the one owner. It continues until the owner sells the business, retires, or dies.

The individually-owned business is more dominant in farming than in any other segment of the economy. Service stations, restaurants, flower shops, and dry cleaners are other examples.





There are three basic types of business firms in the United States: individually owned, partnerships, and corporations.

Partnerships

Partnerships consist of two or more people who jointly own, control, and operate a business. The responsibilities of each are based on the partnership agreement. Normally, this is based on the amount of capital each partner invests in the business.

Characteristics of partnerships include:

- ◆ Partners must do business legally the same as individuals, but in addition may need legal agreements or contracts to form the partnership.
- ◆ Owners are jointly responsible for capital invested or borrowed, and for all other debts of the partnership. Usually, each partner is liable up to the value of all the property he or she owns.
- ◆ Partners may share management and each is responsible for promises made by the other. They make policy decisions, usually by majority vote. Some agreements provide for senior partners whose votes may carry greater degrees of importance.
- ◆ Profits (or losses) are shared by the partners in accordance with the terms of the partnership agreement. Usually this is in proportion to the capital invested or work done.
- ◆ The life of the partnership as a business is determined by the partners, but if one dies or wishes to leave the organization, it must be dissolved and a new partnership formed.

Some farms are owned and operated on a partnership basis, most often between a parent and child. One may furnish the land and buildings, another much of the physical labor, and each may own livestock and purchase supplies while sharing other operating expenses.

Other examples include law and accounting firms, insurance and real estate companies, and family members who fre-

quently form partnerships to operate an auto repair firm, stores, and other businesses.

Corporations

There are two types of corporation: the investor-oriented and the cooperative.

Investor-Oriented

An investor-oriented corporation is a business that has the right to buy and sell goods and services. It operates as a profit-making enterprise for its investors, who are also referred to as stockholders.

Corporations are legal entities, granted rights by State law. As such, they are authorized by law to act as a single person. In effect, the corporation is considered an “artificial” person. Like individuals, the corporation has the right to provide services, own property, borrow money, enter into contracts, and be held liable.

Investor-oriented corporation characteristics include:

- ◆ An investor-oriented corporation acquires a charter from the State describing the nature of the business and how the affairs of the corporation are to be conducted.
- ◆ Capital for investor-oriented corporations is provided by selling shares of stock to investors, by sales of bonds, and/or borrowing from lending institutions. Corporations are responsible for debts to the extent of their property and assets. If the business fails, each owner of stock can lose only the amount he/she has invested. The corporation, not the stockholders, is liable for all of its debts and other obligations.
- ◆ Management is controlled by a board of directors and officers who are elected in accordance with the charter. Each stockholder has as many votes in these elections as the number of shares of voting



stock he/she owns. Business decisions and policy are made by the board and officers.

- ◆ Profits are divided among the stockholders as dividends according to the number of shares of stock owned or are used to expand the business as decided by the board of directors.

- ◆ A corporation enjoys a continuing existence, regardless of the death, entrance, or exit of one or more of its owners. Its life is either permanent or as outlined by the articles of incorporation.

Examples of investor-oriented corporations are large department stores, chain grocery stores, banks, automobile manufacturers, and much of the communications industry.

Cooperative

A cooperative corporation is also a State-chartered business, organized and operating under its laws. The cooperative, though, is owned and controlled by those who use its products and services, and net income goes back to the member-owners in proportion to the use each makes of the business.

Characteristics of cooperative corporations include:

- ◆ The purpose of a user-owner cooperative business is to provide economic benefits to its members rather than to generate a return on investment.

- ◆ Capital for a cooperative comes from the members, rather than outside investors. It is obtained by direct contributions through membership fees or sale of stock, by agreement with members to withhold a portion of net income based on patronage, or through assessments on some regular basis, such as per unit of product sold or purchased.

- ◆ If the cooperative should fail, member-owners have limited liability, meaning they are not obligated beyond investments they have made in the cooperative.

- ◆ Management of a cooperative consists of four groups of people — members (owners), board of directors (elected), the manager, and other hired employees (paid). Each group has its distinct duties and responsibilities for performing management functions in a cooperative. For example, the members elect from among themselves a board of directors to direct the business activities of the cooperative. The board of directors employs the manager and establishes operating policies. The manager oversees detailed operations of the cooperative within policies established by the board. Employees, as representatives of the cooperative, must understand the relationship of the business to the member-owners.

- ◆ Profits (or losses) in a cooperative differ from investor-oriented corporations in how they are distributed and to whom they go. Money left over at the close of the business year, after meeting all expenses and requirements for reserves, is returned to members in cash or other forms, according

The two different types of corporations are the investor-oriented and the cooperative.

Cooperative Corporation



A business owned and controlled by the people who use its services.



to the amount of business done with the cooperative that year.

◆ Each member usually has only one vote, no matter how many shares of stock he/she may own. (Some States do allow voting in proportion to patronage/the amount of business done.)

Examples of cooperatives include agricultural marketing, purchasing, and service organizations, credit unions, housing, health care, hardware, grocery, and many others.

Limited Liability Company

The limited liability company (LLC) is a hybrid business structure that combines characteristics of both a partnership and a corporation. It combines the single tax-treatment of a partnership with the limited personal liability of a corporation. As in a cooperative, LLC owners are called members.

In an LLC, members share the profits and losses according to an operating agreement. The percentage of responsibility is usually based on the amount of capital invested. It takes at least two members to form an LLC. Its owners have no restrictions concerning their role in the business. They usually provide the equity capital, but

their voting rights are determined by the operating agreement, and not necessarily on patronage.

Conclusion

The primary difference between cooperatives and other types of businesses is the objective. A cooperative seeks economic benefits for its members from services provided at a reduction of costs, increasing members' income, improving quality, and developing the best use of the members' resources.

While the investor-oriented corporations' primary objective is to make a profit for its investors, cooperatives exist to meet members' needs economically and efficiently. Who receives the net income (profit) in each form of business is the major difference between them. In an individually owned business, it is the owner; in a partnership, the partners; in an investor-oriented corporation, the stockholders; in LLCs, the members (but contingent not on patronage, but on other factors); and in cooperatives, the member-owners.

Cooperatives also have certain operating principles they follow, helping to explain the relationship between cooperatives and their members. These are commonly referred to as cooperative principles, and will be discussed in Section 2. ■

To see this and other USDA cooperative publications online, visit: <http://www.rurdev.usda.gov/rbs/pub/cooprpts.htm>
To order hard copies, e-mail: coopinfo@wdc.usda.gov or telephone: 1-800-670-6553.

This circular is one of a continuing series that provides training information and presentations for education resource persons who may or may not be familiar with the cooperative form of business. This series provides the basic background material they need and in a form that can be readily adapted, with limited preparation time, to a lecture or other presentation.

The U.S. Department of Agriculture (USDA) prohibits discrimination in all of its programs and activities on the basis of race, color, national origin, age, disability, and where applicable, sex, marital status, familial status, parental status, religion, sexual orientation, political beliefs, genetic information, reprisal, or because all or part of an individual's income is derived from any public assistance program. (Not all prohibited bases apply to all programs.) Persons with disabilities who require alternative means for communication of program information (Braille, large print, audiotape, etc.) should contact USDA's TARGET Center at (202) 720-2600 (voice and TDD).

To file a complaint of discrimination, write to USDA, Assistant Secretary for Civil Rights, Office of the Assistant Secretary for Civil Rights, 1400 Independence Avenue, S.W., Stop 9410, Washington, DC 20250-9410, or call toll-free at (866) 632-9992 (English) or (800) 877-8339 (TDD) or (866) 377-8642 (English Federal-relay) or (800) 845-6136 (Spanish Federal-relay). USDA is an equal opportunity provider and employer.