Co-Operative Marketing of Tobacco

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A MEMBER of a tobacco growers' coöperative association, organized under the North Carolina Coöperative Marketing Act[1] of 1921, agreed to sell and deliver to the association all the tobacco produced by or for him or acquired by him as landlord or lessor during the years 1922, 1923, 1924, 1925 and 1926. In the event of his failure to so sell and deliver all his tobacco, he agreed to pay the sum of five cents per pound as liquidated damages for all tobacco placed on the market in breach of the contract; and that "in the event of a breach or threatened breach of any provision regarding delivery of tobacco, the association shall be entitled to an injunction to prevent the further breach thereof and to a decree for specific performance," costs and necessary expenses of the litigation to be paid by the grower. Notwithstanding this agreement, he sold part of his 1922 crop individually on a warehouse floor and announced that he would continue to operate in violation of his contract with the association. Thereupon the association brought action for an injunction to prevent further breach of his contract. An order granting an injunction *pendente lite* was affirmed by the state Supreme Court. The contentions of the defendant that the marketing statute and agreement were void as against public policy, in violation of the Constitution of the state, and in unreasonable restraint of interstate and intrastate commerce, were denied. This is the gist of the decision in the North Carolina case of *Tobacco Growers' Coöperative Association* v. *Jones*,[2] decided April 12, 1923.

Substantially the same marketing agreement is employed by large organizations of growers of various commodities throughout the agricultural states. The importance of these coöperative marketing associations in our economic scheme and the general legal problems attendant upon their operation have been ably discussed in other publications.[3] The present paper is mainly concerned with the co-operative marketing of tobacco. And since the legal controversy in the principal case was one of alleged unreasonable restraint of trade, it seems desirable to recall the specific conditions in the tobacco trade leading to the incorporation of this association and to the adoption of these agreements.

Prior to the dissolution of the American Tobacco Company in 1911 by anti-trust proceedings,[4] twenty-nine individuals owned fifty-six per cent of the common (voting) stock of the company. Under the final decree[5] fourteen companies were formed, including those since known to the domestic trade as "the big four."

[1] P. L. 1921, ch. 87.

[2] (N. C. 1923) 117 S. E. 174.

[3] G. C. Henderson, *Co-operative Marketing Associations* (1923) 23 Col. L. Rev. 91; L. S. Hulbert, *Legal Phases of Co-operative Associations* (1922) Bulletin 1106, U. S. Department of Agriculture; O. B. Jesness, *Co-operative Marketing*, U. S. Department of Agriculture Farmers Bulletin 1144; J. G. Eldridge, *The Co-operative Marketing of Tobacco*, a Ms. thesis submitted for the degree of M. A., at the University of North Carolina, May, 1923. See also *Coöperative Marketing*, by Aaron Sapiro, 8 cla. L. Bull. 193.

[4] *U. S.* v. *American Tobacco Co.* (1911) 221 U. S. 106, 31 Sup. Ct. Rep. 632, 55 L. Ed. 663.

[5] *U. S.* v. *American Tobacco Co.* (1911) 191 Fed. 371.

The decree provided that for a period of five years the fourteen corporations were to be enjoined from having interlocking directorates; from employing common agents to purchase tobacco leaf or to sell tobacco and its products; and from purchasing the capital stock of any of the several corporations. The British-American Tobacco Company, Ltd., and the Imperial Tobacco Company, Ltd., were also enjoined from employing a common agent for the purchase of leaf tobacco and from acting as agent for each other or from uniting with any of the other fourteen corporations in the employment of a common agent.

After the expiration of the term of the decree against the fourteen domestic companies, tobacco was again purchased through common agents by several of the disintegrated companies. A large leaf tobacco company, for example, was organized in 1918 primarily as a holding company "and has acted as agent for and sold tobacco to most of the large interests."[6] Other smaller companies operated in the same capacity, sometimes purchasing the same grade for several of the large manufacturers.

Practically all of the tobacco was sold by the growers through the agency of local warehouse or auction companies. These concerns received the dried leaf from the individual growers, piled it on the warehouse floor and auctioned off each lot, preserving the identity of each grower's offering. Frequently the warehousemen also bought tobacco for their own account on their own auction floor. There was some little speculative business on the outside, but for the most part the grower sold his tobacco to the highest bidder of a group of buyers surrounding the warehouse auctioneer.

The following statements, made to the writer by competent observers, set forth the deficiencies of the auction system as affecting the tobacco growers in general:

There was no uniform system of grading tobacco prior to the organization of the association, due to the fact that each manufacturer had his own system of grading which had been worked out along the lines of his needs. Each buyer's purchases were graded according to his own ideas and system of grading.

The selling at auction was always done so rapidly that frequently tobacco was overlooked for lack of time in which to examine it. Hence the large variation in prices on some grades, the purchaser preferring to pass over such piles rather than to take a chance of getting less value than he thought he was getting.

The most accurate statistics that can be gotten, we believe, will go to prove that there were very few years in which the farmer received anything above the cost of production.

The years in which tobacco was sold for less than the cost of production—or at the actual cost of production—were very much greater in number than the profit years. The farmer has been able to live and continue in business by reason of the fact that he could practically make the necessaries of life on the farm, that is, the necessary foods.

There is, undoubtedly, a great deal of favoritism in the auction system shown towards the larger growers. In fact, the farmers themselves who profit by this admit the fact; and many of them have given this as their reason for not joining the coöperative association.

There was, and is, unquestionably, much variation in prices for various grades of tobacco between markets. One reason for this is that the smaller market has always been at a dis-

[6] *Report on the Tobacco Industry*, Federal Trade Commission, 1920, p. 53

advantage, due to the fact that the buyers given these markets are usually the beginners or less experienced buyers. And many large purchasers of tobacco do not place orders on the smaller markets for the better grades, due to the fact that their buyers have not sufficient experience to buy higher priced and high quality tobaccos.

The short buying season undoubtedly places the grower at a disadvantage as many of them rush their tobacco and frequently lower the price by the rapidity with which they market it, for fear that they will not get it all in before the season closes, and due to the further fact that in the process of rapid marketing they do not get their tobacco in the proper order—and this is very necessary if the tobacco is to show up to the best advantage.

For instance, if thin, bright tobacco gets very high in order (or very soft), it discolors very quickly and frequently the farmer should hang his tobacco back up in the barn and dry it out some before taking it to market, but he is so anxious to get it in that he does not take the time to do this.

It is a well known fact in the trade that when a good tobacco season is on and the markets get what the tobacco trade terms "glutted"—this is always the time that the speculator comes in to buy his stocks. When sales are very large and tobacco in bad order, the price—not frequently, but always—gets very much lower. Frequently farmers say that they would take tobacco to market one week and get what they considered a fair price for it, and go back the next week, or in a few days, with a similar grade of tobacco, and get a very much lower price; and the farmers never had it explained to them just why such conditions should exist.

The buyers who frequented the local markets operated under limits as to price and quantity. It has been alleged, too, that the group of buyers at a given market frequently arrived at working agreements as to price and division of offerings. The extravagant assertion of the court, however, that the tobacco crop was sold "at prices fixed, as is well known, by a 'gentlemen's agreement' among the manufacturers," hardly strengthens the opinion. In any case a federal investigation,[7] reported in 1920, was unable to point conclusively to any considerable collusion among the buyers:

Particular attention was paid to the charge that there was collusion among the buyers of leaf tobacco, especially the large interests—that is, whether there was any agreement or understanding between these companies to manipulate the market. It was believed that if such agreements existed the buyers' procedure in buying would render it evident to experienced persons on the floor while such buying was going on, although the buyers themselves might not be aware of such fact. The warehousemen and independent dealers, therefore, who accompanied the sales were particularly questioned as to evidence of the action of the buyers on the floor.

It is only fair to state that many of the independent dealers and warehousemen in their interviews were unequivocal in their statements that they did not observe anything in their operations on the market that would indicate that there was collusion on the part of manufacturers and large dealers in buying of leaf tobacco. However, there were many who expressed a contrary opinion.

The independent dealers stating that there was collusion apparently based their opinions on the following:

That common buyers were employed.

That many of the companies confined their purchases to a certain percentage of the offerings, not bidding above a certain price.

[7] *Report on the Tobacco Industry*, note 6, *supra*, pp. 144-145. See also *Connecticut Valley Cigar Leaf Tobacco*, Bulletin 193, Mass. Agricultural Experiment Station, 1917, p. 199 ff; and *Marketing of Burley Tobacco*, Bulletin 202, Kentucky Agricultural Experiment Station, 1919, p. 164.

That there apparently was a disposition not to bid against each other on some grades; and that they bid actively against each other on some markets and did not compete at all on other markets.

No documentary evidence was offered that any of these acts resulted from agreements to that effect.

The only definite conclusion reported by the federal investigators on the point of competition among the buyers (or lack of competition) was "that in each of the chief growing areas the buying is centered in a very few hands."[8] It can be said, also, that the buying interests were highly organized and strong financially whereas the individual sellers were largely unorganized and frequently weak financially.

There were in the tobacco trade no future exchanges or large price-reporting agencies comparable, for example, to those in the grain and cotton trades. Prices were made at small auctions on the local warehouse floors. The grower had to bring in his tobacco when the buyers were at the market in order to secure the going prices. There was no intermediate wholesale market.

Certain features of the manufacturers' market for tobacco products should also be considered in this connection. Tobacco products are specialties, in that they are sold by brand and promoted by extensive advertising. They must be classed with luxuries rather than with the necessities of life. Nevertheless they are supported by a demand which is broader and far more dependable year in and year out than that shown for some of the staple necessities. And this demand is little affected by incidental retail price fluctuations: the manufacturer is far more concerned with the alignment of his prices as compared with those of his competitors, than with general changes in the retail prices. Consequently, barring a price war in the retail markets, the manufacturers have been favorably situated both as to selling and buying.

Without further discussion on this point, it seems clear that the grower-seller was frequently in a weak and ineffectual position and that the major purpose in organizing coöperative marketing corporations was to enable him to become a factor in the market. The purposes of these organizations were thus summarized by Dr. Clarence Poe in an editorial in *The Progressive Farmer* during the Tri-State campaign in Virginia and the Carolinas:

Under the present system we now (1) ignorantly, (2) individually, (3) helplessly, (4) dump farm products (5) in piddling quantities, (6) without proper grading, (7) without modern scientific financing, (8) selling through untrained producers.

By coöperative marketing we will (1) intelligently, (2) collectively, (3) powerfully, (4) merchandise farm products, (5) in large quantities, (6) with proper grading, (7) with modern scientific financing, (8) selling through the most expert selling agents.

The large marketing associations which had operated successfully with other commodities in California and elsewhere, furnished ample precedents for organizations among the growers in the producing areas of the tobacco industry. As already indicated, the incorporation of non-profit coöperative associations was

[8] *Report on the Tobacco Industry*, note 6, *supra*, p. 51.

authorized in North Carolina by an act[9] of 1921. This statute, which is similar to laws[10] in force in other states, provides for a unique type of association. It differs essentially from other commercial corporations because its net income is not to be distributed as profits but as purchase money; and it differs from benevolent associations, mutual benefit societies, and organized exchanges (such as the Chicago Board of Trade and the New Orleans Cotton Exchange) because its business is to market a commodity. Commonly the member's interest in a co-operative marketing association is not readily negotiable and his support of the association is secured by a rigid marketing agreement. Membership may, in practice, be looked upon as a privilege; but membership is conditional upon a crop contract (in the case of the Tri-State Association, running for five consecutive years.) In fact, the operation of an association of this sort is said to be difficult and hazardous unless more than half of the crop grown within a defined area is to be controlled for several years. In this connection it is announced[11] that "almost 70 per cent of all the tobacco raised in the United States" will have been controlled and handled over the season of 1922-1923 by five coöperative associations, and that the plaintiff association in the principal case now controls more than half[12] of the output of the three states of Virginia and North and South Carolina.

With this sketch of existing conditions we may proceed to examine the question of enforcing the marketing agreement.

The constitutionality of the enabling act is first to be considered, especially as regards the provision[13] that:

"No association organized hereunder shall be deemed to be a combination in restraint of trade or an illegal monopoly or an attempt to lessen competition or fix prices arbitrarily, nor shall the marketing contract or agreement between the association and its members or any agreements authorized in this act be considered illegal or a restraint of trade."

Assuming that this provision can be harmonized with the anti-trust law of the state,[14] it is, however, little more than an expression of public policy regarding intrastate commerce; whereas the business of the larger marketing associations and that of this particular plaintiff, is usually interstate in character.

A more ample protection is afforded by the federal Capper-Volstead Act[15] which specifically authorizes associations of this sort:

Provided, however, That such associations are operated for the mutual benefit of the members thereof, as such producers, and conform to one or both of the following requirements:

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[9] P. L. 1921, ch. 87.

[10] For a list of the seventeen state statutes on co-operative marketing, see the authorities cited in note 3, *supra*. See also, 22 Col. L. R. 470.

[11] "Tobacco associations that are now organized and operating are as follows: The Burley Tobacco Growers' Association, with 77,000 members, handling almost eighty-five per cent of the burley tobacco crop of the United States. Then there's the Dark Tobacco Association, with approximately 57,000 members. There's the Virginia-Carolina Tobacco Growers' Co-operative Association with approximately 85,000 members. There's the Connecticut Valley Tobacco Association, with about 3,800 members. There's the Wisconsin Co-operative Tobacco Pool, with 6,200 members." Address of Aaron Sapiro, First National Conference of the Farmers' Business Organizations, Washington, December 14, 1922.

[12] These estimates seem to be based upon sign-ups. Actual deliveries will probably average from 15 per cent to 20 per cent less. See Eldridge, *The Co-operative Marketing of Tobacco*, note 3, *supra*, at p. 129 ff.

[13] P. L. 1921, ch. 87, sec. 26.

[14] C. S. ch. 53. See the editorial annotation in 11 A. L. R. 1185 for cases on the effect of statutes in other states exempting farmers' associations from anti-trust laws.

First. That no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own therein, or,

Second. That the association does not pay dividends on stock or membership capital in excess of 8 per cent per annum.

And in any case to the following:

Third. That the association shall not deal in the products of non-members to an amount greater in value than such as are handled by it for members.

This act makes no provision for the federal incorporation of coöperative associations but apparently resolves any doubt as to the *prima facie* validity of state-created marketing associations and the contracts necessary to conduct their business.[16] Furthermore if the Secretary of Agriculture:

Shall have reason to believe that any such association monopolizes or restrains trade in interstate or foreign commerce to such an extent that the price of any agricultural product is unduly enhanced thereby, he shall issue and cause to be served upon the association an order reciting the facts found by him, directing such association to cease and desist from monopolization or restraint of trade.

This order may be reviewed by the district court having jurisdiction and may be enforced by court process.

It would seem, therefore, that any complaint alleging restraint of trade must be supported by conditions shown to be actually realized in the industry.[17] In this connection, the opinion in the principal case sets out that the public interest is protected because (a) the moment the association should become dangerous its charter might be repealed; (b) the association is dependent for credit on the Federal Reserve Board and it is within the power of the government to require the borrower's operations to be consistent with the public welfare; (3) it "would be subject to the visitorial powers of the Secretary of Agriculture" (as shown above); and (4) a manipulation of prices or a holding off the market might result in a supply of tobacco too great to be successfully marketed. It is provided in the North Carolina act that the governors of the three states of Virginia, North Carolina, and South Carolina shall each appoint one of the directors of the association. They are appointed, says the court, in order "that the public may have opportunity to learn at all times how the business is being conducted and to insure that it will not be carried on in a manner that will be detrimental to the public welfare."

In addition, the court had the support of the relatively recent North Carolina case of *Bickett* v. *Tax Commissioners*,[18] in which it had sustained an act to provide warehouse facilities for cotton growers.

Frequently coöperative associations have been authorized to handle the products of non-members (not in excess of the volume handled for members.)[19] Under the North Carolina law, however, a coöperative marketing association is

[15] U. S. Comp. Stats., compact ed., pamphlet 12 A, ch. A A A sec. 8716 1-2. See also sec. 6 of the Clayton Act, construed in *U. S.* v *King* (1916) 250 Fed. 908.

[16] Hulbert, *Legal Phases of Co-operative Marketing Associations*, note 3, *supra*.

[17] "The Sherman Anti-Trust Act is not directed against a mere expectation of monopoly, but against its realization." *U. S.* v. *U. S. Steel Corporation* (1919) 251 U. S. 417, 40 Sup. Ct. Rep. 293, 64 L. Ed. 243. See also *Pulpwood Co.* v. *Green Bay Paper and Fibre Co.* (1919) 168 Wis. 400, 170 N. W. 230, and Hulbert, *Legal Phases of Co-operative Associations, supra*, note 3, at pp. 35-42.

[18] (1919) 177 N. C. 439, 99 S. E. 415.

[19] So provided in the Capper-Volstead Act, note 15, *supra*.

not permitted to handle the products of non-members. Thus the Tobacco Growers' Association is forbidden to purchase from second hands or on the open market for resale; and it is practically prevented from selling in advance of the crop. Its sole function is to market the crops of members and its existence depends on the ability to enforce the member's marketing agreement.

In case of a breach of the member's agreement the North Carolina act allows the collection of liquidated damages[20] and "the Association shall be entitled to an injunction to prevent the further breach of the contract, and to a decree of specific performance thereof." The provision for damages is necessary in order that the defaulting member shall not escape his proper share of operating expenses; but it is less vital to the success of the association than the right of injunction as equitable relief. For unless the association can control the crops of its members, at all times and regardless of changes in the market, the organization may be defeated in its main objective. Hence the grant of injunction is of primary importance. It is notable, however, that in California, where coöperative marketing has been so conspicuously successful, injunction as relief from breach of the marketing agreement has been denied on technical grounds.[21] This serves to show that so long as the general scheme of coöperative marketing is valid, successful operation will rest on economic factors in spite of legalistic obstacles. In Oregon[22] and Washington[23] and now in North Carolina, however, the member of a coöperative marketing association may be enjoined from selling to an outsider in violation of his contract.

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[20] P. L. 1921, ch. 87, sec. 17(b). In the absence of statute, the courts have divided over the enforcibility of a liquidated damage clause in the contract. For cases holding the clause void, see *Reeves* v. *Decorah Farmers' Co-operative Society* (1913) 160 Iowa 194, 140 N. W. 844; *Burns* v. *Wray Farmers' Grain Co.* (1918) 65 Colo. 425, 176 Pac. 487. For cases holding the clause valid, see *Ex parte Baldwin County Producers' Corp.* (1919) 203 Ala. 345, 83 So. 69; *Poultry Producers of Southern California* v. *Barlow* (Cal. 1922) 208 Pac. 93; *Bullville Milk Producers' Assn.* v. *Armstrong* (1919) 108 Misc. 582, 178 N. Y. Supp. 612; *Castorland Milk and Cheese Co.* v. *Shantz* (1919) 179 N. Y. Supp. 131. See, in general, Henderson, *Co-operative Marketing Associations,* note 3, *supra,* pp. 97-98.

[21] *Poultry Producers of So. California* v. *Barlow* (Cal. 1922) 208 Pac. 93, commented upon in 10 Calif. L. Rev. 518. A California statute codified the equitable principle of so-called mutuality of remedy, and it was held that since the grower could not have had specific performance against the association, because the latter's undertaking involved a special discretion and judgment in selling the products, the association could not have specific performance by a negative decree against the grower. Apparently neither a co-operative marketing statute nor the contract authorizd injunctive relief.

[22] *Phez Co.* v. *Salem Fruit Union* (1921) 103 Ore. 514, 201 Pac. 222, 205 Pac. 970.

[23] *Washington Cranberry Growers' Ass'n.* v. *Moore* (1921) 117 Wash. 430, 201 Pac. 773.