A Trojan Horse in Our Midst

Ten faults of the Uniform Limited Cooperative Association Act

LUSCHIN

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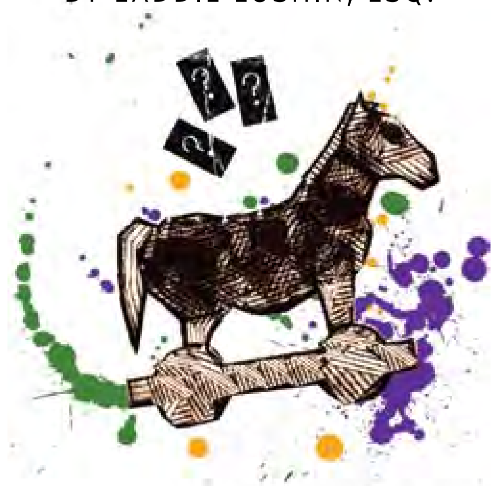

ILLUSTRATION BY KEN DAVIS

The Uniform Limited Cooperative Association Act (which I'll refer to as the ULCAA or the Act) is a "model" statute proposed for adoption in the individual states. It is a governing statute for an organization that is unincorporated but confers limited liability on its participants, like a limited liability company in effect but not in form or substance. It permits an entity organized under it—a so-called limited cooperative association (LCA)—to use the term cooperative in its organizational name.

The defining feature of the ULCAA is the interposing of investors into the ownership, governance, and entitlements of a purported cooperative. It is promoted as a modernization of and improvement to the cooperative structure. The official commentary to the ULCAA intimates that it meets a perceived need, is protective of patron members, gives investors a limited voice, comports with cooperative principles, and is beneficial to co-ops. A careful reading of the Act, however, discloses that the reality is precisely to the contrary on all points.

1. **The ULCAA flagrantly violates cooperative principles**, including most prominently the first three and most essential principles, and its intimations to the contrary are patently disingenuous. The essential cooperative principles have been astutely characterized by J. Baarda as consisting of the "user-owner principle," the "user-control principle," and the "user-benefit principle." These principles require that the cooperative be owned and democratically controlled by the users of its services, and its benefits in the form of allocations of earnings be provided to the users of its services on the basis of their patronage. These principles are violated at their core by investors being accorded ownership status, governance rights, and economic entitlements, and these matters are not even addressed in the ULCAA's extensive commentary on cooperative principles. The ULCAA's intimations of conformity with cooperative principles that are the least nonspecific all relate to purely secondary principles, and even these are without substance. Thus, the entire proposition of an LCA conforming to cooperative principles is illegitimate even without consideration of the other abusive provisions of the Act described below. Indeed, a careful consideration of cooperative principles demonstrates that an LCA is at the most fundamental level the very antithesis of a cooperative.

2. **The ULCAA sanctions and facilitates investor-friendly procedures of an extreme and unprecedented character that mock the very essence of a cooperative.**

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(a) Sec. 512(a)(3) permits voting among patron members to be allocated "on the basis of equity." This would displace the traditional person-centered, democracy-promoting, one-member-one-vote system with a plutocracy-promoting proposition that bases voting rights solely upon the amount of money invested.

(b) Sec. 603(c) and (d), as a default rule, makes financial rights of members transferable unless explicitly restricted or prohibited, while imposing obstacles on the ability to restrict or prohibit transferability. This encourages treating membership as no more than a commodity saleable for value.

(c) Sec. 603(b) permits the transfer of a member's governance and patronage rights, albeit the default rule is to the contrary, and does so through language that makes it an extraordinarily expansive concept while obscuring its meaning and effect. This outrageous proposition would permit anyone to purchase all of the essential elements of membership rights, leaving the seller with an empty and meaningless pseudo-membership status.

These investor-friendly procedures, although permissive, nonetheless legitimize and accord an advantage to the procedures they favor. They are so far beyond the mere issue of cooperative principles as to mock the very essence of a cooperative.

3. While the ULCAA intimates that patrons are in control of the board of directors, default rules reveal that **patrons are not intended to constitute a majority of the board.** Sec. 804(a)(2) appears to put patrons in control of the board by requiring a majority of directors to be elected exclusively by patrons. This is described in the prefatory note as vesting "a strong measure of control" in patrons—not stated to provide actual patron control but carefully measured to give that impression. But then Sec. 804(a)(1), as a default rule, sets minimum numbers of patron directors as to various sizes of the board, none of which makes patron directors a majority of director positions and most of which make them a minority of director positions. These two propositions can be reconciled only by the contrivance of one or more director positions being required to be filled by investors but voted upon only by patrons.

4. While the ULCAA intimates that patrons are in control of the member voting process, close attention to densely obscured details discloses that **investors are accorded a veto power over any proposed action by members**. With respect to the member voting process, Sec. 514(1) accords to patrons the majority of voting power. This is described in the prefatory note as "the most basic provision for patron member control"—again, not stated to provide actual patron control but carefully measured to give that impression. But then Sec. 514(3) requires "affirmative votes that must be cast by investor members to approve the matter." This is made to appear innocuous by evasive phraseology and placement of the rule and by deceptive description in the commentary to this rule. Diversionary tactics notwithstanding, the requirement of an affirmative vote of investors on any matter brought before the membership accords investors veto power over the member voting process. Indeed, this effect is obliquely acknowledged in both the prefatory note and the commentary to this section. And, because the required percentage vote of investor members is permissive, it may be set high in the organizing documents so as to permit a very small number of investors to wield veto power. This rule, like others described herein, is a trap for the unwary in that the Act's intimations about patron control encourage unwariness until the ability to avoid the rule is prevented by the operation of the rule itself.

5. Densely obscured rules in the ULCAA for **voting by classes of members will result in the actual or potential loss of control**

by patrons upon the admission of a single investor. The requirement in Sec. 514 of affirmative votes of both patron and investor members in the member voting process, as described in the preceding point, necessitates voting by classes whenever there are both patron and investor members. While this fact is obscured in the operative sections where it is most important to be stated, it is admitted in Sec. 404(a), which requires as to amendment of the organizing documents the same voting by classes as required in Sec. 514. Voting by classes is no less the case where there is only one investor member. Secs. 102(31) and 804(e) establish that a class may consist of a single member. This means that admission to membership of a single investor will result in that one investor holding all the power granted by the Act to the class of investor members.

6. While allocations of earnings to patrons are ostensibly required to be no less than 50 percent of profits, **interpretive and related rules permit investors to take all or virtually all of the profits**. Under Sec. 1004(c) allocations to patrons are prohibited from being reduced below 50 percent of profits, which implies that the remaining 50 percent of profits may be allocated to investors. But this offensively pro-investor rule is only the starting point on this issue. So-called interpretive rules of Sec. 1004(c)(1) and (2) go on to specify that payments to investors for fixed dividends are not allocations, in blatant contradiction of dividends being of the very essence of an allocation of profits. Characteristically, the ULCAA attempts to obscure this rule, in this case by juxtaposing it against an ostensibly correlative rule in Sec. 1004(c)(1) that amounts paid to patrons for goods or services they receive are not allocations—a proposition that is so obvious as to be substantively inane. This outrageous situation is made even worse by there being no limitations in the Act on fixed dividends—another blatant violation of explicit cooperative principles. The interplay of these two rules permits investors to take all or virtually all profits as fixed dividends, which would leave little or nothing to be allocated to patrons under the minimum-50-percent rule, thus rendering the unacceptably pro-investor limitation in the general rule into a virtual nullity.

7. The ULCAA goes so far as to **permit investors to unilaterally organize, comprise, and control a closed pseudo-cooperative to the complete exclusion of all real patrons**. The extent of the mischief to which the ULCAA lends itself is well illustrated by the following scenario. Investors may be the sole organizers of an LCA under Sec. 301. The investor-organizers are then permitted under Sec. 303(a)(2) to appoint initial directors. Initial directors are then permitted to adopt initial bylaws under Sec. 303(a)(1) and to cause the LCA to accept members under Sec. 303(b). Investors alone may constitute the entirety of patron and investor members since patron members are not required to conduct any actual patronage under Sec. 102(22) and Sec. 116 permits a person to hold both an investor member interest and a patron member interest. As admitted in the prefatory note, the initial board may then create a "'closed' cooperative" under which the cooperative principle of open membership is "compromised." This is bad enough, but what it does not admit is that the purported cooperative may be closed preferentially to investors to the exclusion of all real patrons.

8. **The ULCAA flagrantly violates federal tax requirements for operating on a cooperative basis**, thus completely precluding tax-favored patronage dividends. It is well-established that the core requirements for operating on cooperative basis under federal income tax law are: (a) subordination of capital as regards control of the co-op, entitlement to its pecuniary benefits, and limitations on distributions in respect of stock; (b) democratic control by its patrons on a one-member-one-vote basis; and (c) net earnings vested in its patrons and allocated to them in proportion to their patronage. As demonstrated above, the ULCAA's violation of these requirements is profound and extensive, even to the point that it ensconces the primacy of capital and subordinates the rights of patrons. An LCA would thus not be considered to be operating on a cooperative basis for federal income tax purposes, and the advantageous procedure of patronage dividends would be foreclosed even as to otherwise legitimate allocations on the basis of patronage. None of this should be surprising since it is admitted in the comment to Sec. 1004 that the Act's allocation rules are based on partnership accounting rather than cooperative accounting principles, while failing to disclose the implications of this fact.

9. **The ULCAA would create serious securities law and possible consumer fraud problems in an LCA of a consumer character**. It is well established that share- or other capital-purchase requirements in consumer co-ops do not constitute securities where the motivation of the ▶

purchasers is to gain access to consumer goods or services and where the capital interests do not display the common characteristics of stock. Even without considering how the ULCAA precludes or inhibits meeting the capital characteristics test, the motivation test would be violated as to capital interests of investors in quite obvious ways. An LCA of a consumer character would thus be faced with the enormously costly and disruptive prospect of complying with federal and state securities laws as to its basic member equity requirements, a prospect which, as a legitimate co-op, could easily have been avoided. One must also consider possible vulnerability for securities fraud if control and profit-taking prerogatives accorded investors under the ULCAA, as described above, were not disclosed, and for negligence if the LCA failed to protect patrons where the features described herein could have been avoided but were not. Similar vulnerabilities could exist under consumer fraud laws in all states.

10. The ultimate irony is that the ULCAA's stated purpose of increasing capital formation opportunities for cooperatives is disingenuous. The purpose of the ULCAA, as stated in its prefatory note, is "to obtain increased equity investment opportunity for capital intensive and startup cooperatives." But, for a co-op that has any genuine need to access conventional investors, there is and has been available in all states a fully adequate alternative to the ULCAA: use of a separate limited liability company (LLC) to acquire and lease to the co-op a costly facility or other capital-intensive project. This does not require the co-op to muck up its structure and governance or give up control over its basic operations. And it has the distinct advantage of keeping liabilities associated with the project limited and separate from the co-op's property and basic operations. The only limitation on this option is that the separate LLC is not permitted to misrepresent itself as a cooperative. And, to accommodate investors whose views and goals are more compatible with and accommodating to co-ops, nearly all co-ops may use properly limited preferred stock or debt instruments of various kinds. The avowed purpose of the ULCAA thus appears to be a mere pretense.

Conclusions

The Uniform Limited Cooperative Association Act is an ill-conceived monstrosity. It utterly abandons cooperative principles for a purported objective that is disingenuous and to the effect of producing numerous legal problems of a most serious character. Through drafting contrivances and evasive commentary the ULCAA deceptively exaggerates the prerogatives of patrons and obscures the prerogatives of investors. The predictable consequence of the Act is to open co-ops to control and exploitation by investors while misrepresenting

them to the public as legitimate cooperatives. The ULCAA is packaged and promoted as a gift to co-ops, but it contains the means for their subversion and destruction. It presents an unprecedented challenge to the integrity and future of co-ops.

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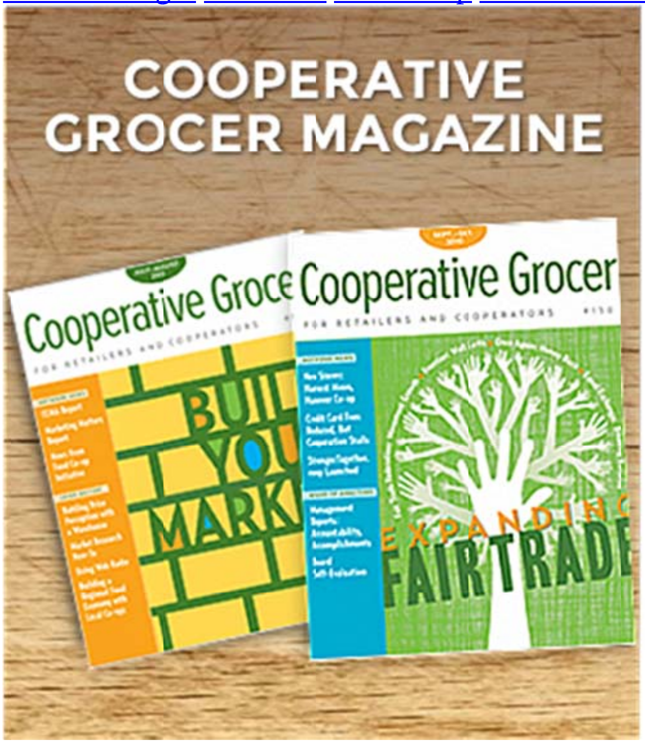

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