

# Understanding the ULCAA

*A report from the University of Wisconsin Center for Cooperatives*

BY LYNN PITMAN

The structure allows for investor-members to participate in and support community development projects that otherwise might not be able to attract sufficient capital.

Since 2001, new cooperative laws have been adopted in five states—Wyoming, Tennessee, Iowa, Minnesota, and Wisconsin—and introduced in the Nebraska state legislature. These laws do not replace existing cooperative statutes. They provide for the establishment of a new type of business entity, the limited cooperative association (LCA), which has characteristics of both the traditional cooperative and the limited liability company (LLC). Because the LCA can be structured in ways that contradict fundamental principles under which cooperatives traditionally have operated, there is concern that these new laws will subvert or dilute the cooperative business model.

Traditionally, a business organized on a cooperative basis subordinates the interests of the capital investor to those of the business user, or patron. Cooperative control is in the hands of its member-patrons, and returns on investment capital are limited. Member-patrons are the primary source of equity capital, and net earnings are allocated on the basis of patronage instead of investment.

The new statutes have been presented as one approach to the problems of modern-day capital formation within the traditional cooperative structure. In contrast to past cooperative laws, the new statutes all specifically allow the distribution of net earnings on the basis of investment contributions, as well as on patronage, and do not set limits on investor returns. Investors may have voting rights and may be eligible for election to the board of directors. The statutes provide varying levels of protection for patron-member interests by setting minimums for patronage-based earnings distributions and by making special provisions for patron-member voting and patron majority representation on the board of directors.

Besides limited liability for its members, both the LLC and the LCA also offer a choice in tax treatment. The organization may elect to be taxed as either a partnership or as a corporation, although this flexibility may affect the organization's status as a cooperative for federal tax purposes.

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Most cooperatives are incorporated under state cooperative statutes. These statutes are not uniform

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*Excerpts from "Limited Cooperative Association Statutes: An Update." University of Wisconsin Center for Cooperatives 2008 staff report. The full report may be viewed on the UWCC website: <http://s.coop.3qk>.*

and describe cooperative structure and operations with varying levels of specificity. All states have at least one cooperative statute, and many are specific to agricultural producers. To protect the interests of the cooperative patron, some state statutes require the cooperative to operate on a nonprofit basis, so that goods or services are provided at cost. Other statutes protect patron interests by requiring that net earnings...be distributed on the basis of patronage.

Furthermore, many state statutes, as well as federal cooperative tax laws, set limits on dividends or interest paid on a cooperative's capital stock. As a result, cooperatives have limited access to outside sources of capital, and cooperative members must provide significant portions of the equity needed for startup ventures or expansions.

The challenges posed by equity capital formation have been especially visible in the agricultural sector, where cooperative businesses play a significant role...

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Dividend rate, opportunities for asset appreciation, and voting rights tied to level of investment are criteria that are used by a nonpatron investor to evaluate an investment opportunity but are limited or prohibited by cooperative statutes. Cooperatives have attempted to address these issues in a variety of ways, including conversions, joint ventures and the use of the limited-liability company business structure.

The exploration of alternative business forms set the stage for the development of the LCA. The first state statute governing this type of business structure was passed in Wyoming in 2001 and was specific to agricultural operations. Since that time, the applicability of this new type of cooperative to other business development situations has been recognized. Later statutes have a broader scope and encompass many business sectors. The specifics in the state statutes vary, but all provide some guidelines on patron voting collectively, voting power of patron-elected board of directors, and allocation of profits to patrons.

The concurrent drafting of a proposed uniform cooperative statute by the National Conference of Commissioners for Uniform State Law (NCCUSL) mirrors these developments. NCCUSL began working on a draft cooperative statute in 2004. As was the case with state LCA statutes, it was not meant to be a replacement for state traditional cooperative laws, but rather to "provide a flexible cooperative act to aid agricultural producers associated for economic development."

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As the draft statute evolved, so did its scope. The October 2005 working draft is entitled "Uniform Limited Cooperative Association Act" (ULCAA). The draft's prefatory note drops reference to agricultural producers and describes its purpose as "...another statutory option for organizing cooperatives as a way to encourage economic development." This and subsequent prefatory notes and memos explore the need for an organizational structure which reflects the legal, historic, and functional differences of the cooperative business form but allows increased equity investment incentives for outside investors.

Existing LLC statutes are flexible enough to be used to establish a cooperative business structure that includes investor members with control and voting rights. However, the ULCAA was developed for use as an "efficient template" for creating this type of business organization, incorporating cooperative principles and practices drawn from a review of existing cooperative statutes. To balance patron and investor member interests, the ULCAA also includes provisions for collective patron voting, voting power of patron-elected board of directors, and sets a minimum allocation of profits to patrons.

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Of the 22 limited cooperative associations described in 2005...only 36 percent were agriculture-related ventures. The 26 LCAs formed since May 2005 continued this trend, with 31 percent related to agriculture. Because the newer Iowa and Wisconsin statutes are both multisectoral, they are being used for a broad range of new cooperative

businesses, including both consumer and purchasing cooperatives.

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...[M]any of the associations formed under the LCA statutes were likely to operate as traditional cooperatives, and information gathered on several of the newer cooperatives indicate similar operational plans.

Many of these new LCAs do not appear to be the type of capital-intensive agricultural ventures that originally spurred the development of LCA business statutes. Because the statutes are relatively new, familiarity with them may still be developing within the business law community, affecting the frequency of their use in the formation of new cooperative businesses. In addition, the requirements built into the LCA structure to protect patron-member interests may not provide the level of control and the options for exit that would contribute to the attractiveness of an investment opportunity. Whether the LCA structure is sufficiently flexible to accommodate the needs of outside investor-members, while protecting patron-member interests in larger-scale projects, is unclear at this time.

However, a commonality of interests beyond the financial also may exist between investor- and patron-members. Cooperatives are seen as effective tools for addressing local community economic development issues and for promoting local ownership. Investor-member support and participation in these types of projects may be motivated by community development as well as financial considerations. The LCA structure allows for investor-members to participate in and support community development projects that otherwise might not be able to attract sufficient capital for start up. ■

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