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The Uniform Limited Cooperative Act: Comparative Leverage Points & Principles

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Articles

The Uniform Limited Cooperative Association Act: Comparative Leverage Points & Principles
Thomas Earl Geu and James B. Dean 3

Financial Statement Effects of Operating Lease Presentation Changes on Buiness Cooperatives
Daryl Burckel, Bruce Swindle, and Ross Beasley 13

The Domestic Production Activities Deduction: Unintended State Tax Deduction for Cooperatives?
Mary Bender and Steve Schroeder .....
20

The Global Financial Crisis of 2008
Russ Wasson 32

Managing Contractual Relationships In A Turbulent Economy
John M. Eustermann 64

Avoiding Criminal Prosecution Under the FFDCA
Per Ramfjord 65

IRS Blesses a Cooperative's Allocation of Gain on Asset Sale
David Shakow 74

Editor's Page
by *Frank M. Messina* 1
Utility Cooperative Forum 32
ACCTFAX 38
TAXFAX 48
Small Cooperative Business Forum 64
Executive Committee and National Directors 82
National Officers and Directors 83
New Members 90
Committees 92
Application for Membership 95

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Introduction

The National Conference of Commissioners on Uniform State Laws (NCCUSL) promulgated the Uniform Limited Cooperative Association Act (ULCAA) this past summer (2007) and the Act as approved with official commentary is available on the internet through the Uniform Law Commission's website or from http://www.law.upenn.edu/bll/archives/ulc/uaarca/2007_final.htm.

A summary overview of ULCAA authored by Don Frederick appeared in the Fall 2007 issue of this publication.[1] The purpose of this article is to discuss selectively ULCAA's place in economic and legal context, provide a summary analysis of two key groups of ULCAA sections central to the Act, and very briefly identify touchstones between ULCAA and cooperative principles.

ULCAA: Legal and Economic Text

The purpose of NCCUSL and the primary reasons for its undertaking the limited cooperative association project was the existence of two similar state statutes and its identification of what seemed to be general interest in this type of entity in other states. The Frederick article chronicled state legislative developments before and during the time ULCAA was drafted. For purposes of this article, therefore, it is sufficient to state that Wyoming adopted the first of this type of statute in 2001 followed by Minnesota in 2003; Tennessee and Iowa in 2005; Wisconsin in 2006; and, Nebraska in 2007 (the latter was based in large part on an interim and non-approved version of ULCAA).[2]

The history of legislation is not the complete contextual narrative for this type of statute. Rather, the statutes seem to reflect need and practice within the cooperative sector and to implicitly recognize a trend to use cooperatives as a component part of larger synthesized multi-entity organizational structures. To some extent, therefore, the legislation on which ULCAA is based is reactive rather than revolutionary. For example, a 2004 article in *Rural Cooperative Magazine* reported on a South Dakota cooperative's entity choice given the need for more capital than could be contributed by patron members in order to build an ethanol plant. Ultimately, the co-op used Glacial Lakes Capital, LLC, a limited liability company (LLC), to solve the need for equity. Before settling on this form, the cooperative looked into partnerships with other entities. The group chose a free-standing LLC form rather than a joint venture form because partnering with other entities "soon ran into issues over who would control the operation."[3] Further:

> Says Tom Branham, the current general manager, "the problem was, they [other entities] wanted management of the plant as part of the deal. The co-op members weren't ready to accept being, as they saw it, passive spectators in their own operations. The alternative was raising the funds

from individuals, not necessarily farmers—but this meant moving away from a strict farmer's co-op model."[4]

The Glacial Lakes project illustrates and evidences the use of LLC structures to form free-standing entities without any state law cooperative restraints. Another example of pure LLC planning involved the suggested sale of assets from a cooperative to its LLC subsidiary as described in Michael Boland and David Barton, "South Dakota Soybean Processors: Joint Ventures and Strategy," Agricultural Marketing Resource Center, Arthur Capper Cooperative Center, Department of Agricultural Economics, Kansas State University (January 2003). Finally, the NCFC recently completed a member survey. The Farm Credit Council website quotes the president and CEO of NCFC as stating: "We were struck by the number of co-ops using other structures beneath the co-op umbrella." And further: "You have LLCs, partnerships, joint ventures and other strategic alliances...[m]ost often it's to acquire added equity capital..."[5]

These anecdotes support a more general summary in a publication explaining the Tennessee Processing Cooperative Law published by the Extension Service at the University of Tennessee. It states:

> [P]roducer-driven, value-added projects are often structured as joint ventures involving both a cooperative and a partnership or LLC. Some existing new-generation cooperatives have also converted . . .[into] the more flexible LLC format. Many existing cooperatives, including traditional cooperatives, have also turned to the LLC structure when setting up joint ventures or new, wholly-owned, non-member business ventures.[6]

These observations, borne of business economics and necessity, are buttressed by more formal academic work. For example the "Briefing and Discussion Memorandum" prepared in 2003 by the NCCUSL Committee which studied the need and feasibility of drafting a uniform law quotes an article from the *American Journal of Agricultural Economics* that lists five problems inherent in operating within the traditional cooperative structure.[7] Interestingly the article, which was published in 1995, focuses on the use of "new generation cooperatives" in the agricultural community of the upper Midwest. Very generally, "new generation" cooperatives are closed membership cooperatives that require significant equity investment for membership. They frequently use non-voting preferred stock as a part of their equity structure and they started appearing in the upper Midwest as early as 1988. Membership interests are transferable, but there are restrictions on transferability. The "new generation" cooperative frequently uses existing traditional state cooperative statutes but, obviously, "plays" with cooperative principles and values not directly required by those statutes (e.g., closed or defined membership is at odds with open membership, right to deliver is sometimes correlated with investment which concerns the "use" principles). They do not, however, typically provide a means for non-patron equity investment beyond those allowed (and limited) by the underlying cooperative statute. Most of those underlying statutes do not permit voting by anyone except patron members.

The five states that have adopted limited cooperative type statutes and ULCAA go further in allowing and then constraining and defining the role of "in-

vestor members" who can vote. Some voting power or voice was thought necessary in order to attract "outside" equity. In effect, these acts provide a single entity to meet the needs that spawned multi-entity joint ventures and the de-mutualization of cooperatives into pure LLC structures like Glacial Lakes, LLC. In doing so they seek to better regulate and protect cooperative values that are completely unregulated under state LLC laws or applicable to the umbrella organization in multi-entity structures. Additionally these statutes may provide an easier and more efficient "off-the-rack" drafting template when compared to drafting provisions using an LLC statutory template which is silent concerning cooperative principles and which does not include default rules consistent with operation under traditional cooperative statutes.

At a superficial level these statutes solve a problem similar to one under general partnership law that was solved by limited partnerships. Their evolution and development is also similar to the evolution and development of limited partnership law. They also share features of limited liability companies but address many "cooperative" issues, and contain many restrictions, not found in the "typical" LLC statute. For example the bifurcation of patron members and investor members in the cooperative context requires far more attention to allocations and distributions than provided under LLC law. Voting is another area in which there is a significant distinction. Moreover, in the pure LLC context there are no "cooperative" mandates.

Finally, although not discussed further in this article, it is worth mentioning that LLC statutes do not contain such things as direction or default rules for meetings but all the "limited cooperative" statutes address these matters in great detail. An argument exists, therefore, that using the term "LLC cooperatives" to describe these "new" statutes could be somewhat confusing and should be used with some care. These new statutes address many issues not addressed in LLC acts. Moreover, the label "LLC cooperatives" may lead to confusion between entities formed under LLC law but taxed for federal income tax purposes as cooperatives whose only cooperative mandates come from tax qualification requirements and entities formed under state organizational statutes that contemplate cooperative principles.[8] Thus, while ULCAA is intended to be an unincorporated entity similar to an LLC, it contains specific default rules different from those found in LLC statutes and it requires a limited cooperative association formed under it to have important cooperative features.

Finance and Control

A. Prelude and Context

Finance and control are broad interrelated topics that are difficult to discuss in isolation. Together, however, they touch and concern what in 1957 were termed the "primary" cooperative principles of (1) democratic ownership and control by users, (2) limited returns on capital, (3) return of benefits or margins to users on the basis of use, and (4) the obligation of user-owner financing.[9]

An example of the issues raised by the interrelationship of finance and control in the context of even traditional cooperatives involves debt financing. If the members of a cooperative cannot fund start-up or expansion through equity or retained margins, loans are required. Use of long-term debt typically requires repayment of principal and interest according to an agreed schedule. The interest on the principal loan amount represents a fixed cost and, when debt financing is available, debt financing requires a host of loan cov-

enants concerning the operation of the cooperative (e.g., limitations on distributions and additional debt, financial statement ratio tests). The lender has exclusive "control" over the enforcement or waiver of these covenants once the co-op initially agrees with the loan agreement. Lender "control" is leveraged, of course, when scheduled payments are not made or when the cooperative otherwise determines restructuring its debt is in its best interest. In those instances, the lender may have complete control over key operating decisions of the cooperative.

ULCAA attempts to expand the available sources of capital while protecting significant control and financial interests in patron members. Like the five state acts that currently exist, it recognizes that the increased opportunity for equity requires compromising unfettered control by patron members just as obtaining debt-based capital requires a compromise in control. Once again, the generic compromise represents many of the same fundamental issues addressed by limited partnership statutes beginning in the mid-1800's. The policy issues in ULCAA and similar acts revolve around protecting cooperative identity and principles in ways that are difficult to manage, and impossible to assure, under generic LLC law. Given that several states already have statutes for this type of entity, NCCUSL, through ULCAA, seeks to encourage uniformity in the state laws and attempts to provide an optimal statutory template for necessary compromise.

B. "Finance": Allocations & Distributions

The most important aspects of finance as they relate to ULCAA and general (or "traditional") cooperative law are the allocation of "profits" (margins) and distributions to members. Allocations and distributions are included under the term "financial rights" by ULCAA. Financial rights are very similar to "transferable rights" under partnership, limited partnership, and LLC law. They are transferable by default, meaning that restrictions on transferability meeting certain statutory requirements may be provided in the articles of organization but in any event the transfer of these rights does not transfer either governance or other rights (e.g. marketing contract rights). ULCAA's financial rights, therefore, clearly follow the unincorporated organization model.

Allocations are the method by which profit (and loss) is "divided" among and between accounts held in the name of members. The handling of profits and losses helps to define a cooperative entity. Moreover, allocation is central to the cooperative principle that the benefits of the entity accrue to members on the basis of use.

ULCAA contemplates, but does not require, the existence of investor members. Investor members need not be patrons. Limited cooperative associations with investor members must allocate no less than 50 percent of the profit and loss to *patron* members. Patron members in limited cooperative associations are like "members" in "traditional" cooperatives. Neither the articles of organization nor the bylaws may reduce the allocation to patron members to less than 50 percent (it can, of course, be a higher percentage). As a matter of default (meaning it may be varied), ULCAA provides allocations among patron members on the *basis of patronage* and among investor members *on the basis of contribution* (investment). Allocations among patron members and among investor members may be based on any "equitable" method by the articles of organization or bylaws.

The 50 percent floor for allocations is higher than the floor provided

by all existing statutes. For example, the Wisconsin Cooperative Association Act provides a default rule of 51 percent but allows the percentage to be reduced to no less than 30 percent (§ 193.601(4)). All of the other statutes allow the percentage to be reduced to 15 percent. Moreover, most of the existing statutes (unless otherwise provided in the governing instruments) default to an allocation among both patron and investor members based on contribution (investment) rather than patronage for patron members. ULCAA seeks to strike a different balance that adheres more closely to cooperative principles in its default rule concerning allocation to patron members.

There are two other differences between ULCAA and some of the existing statutes. *First*, ULCAA contains a definition of profits *for purposes of the 50 percent test*. For example, profits for purposes of the 50 percent test do not include unallocated capital reserves nor do they include amounts paid to patron members under their contracts with the association for products, goods or services. For purposes of the allocation test, neither do "profits" include amounts paid to investor members as a stated fixed return on equity.

Second, ULCAA does not establish or extend the percentage floor to distributions as do existing state laws. The reason for greater flexibility in distributions than in allocations is to allow, for example, provision for early redemption of investor members or for tiered equity structures that could cause failure to meet a test applied to distributions. Stated another way, the *timing* of distributions based on the allocations is not constrained by ULCAA. This idea (but decidedly not the mechanism) comes directly from unincorporated law. The timing of distributions is subject to variation by agreement but eventually amounts *allocated* must be *distributed* through the winding-up process.

It probably cannot be overemphasized that the allocation test and requirements are for purposes of state law and do not directly address, nor necessarily control, allocations for purposes of federal income taxation. In other words they are state law requirements that are largely separate from requirements that may be found in other state or federal statutes to determine if an organization is a "cooperative" for purposes other than ULCAA. Cooperative accountants and lawyers are familiar with this kind of treatment because tax accounting and financial accounting standards already have separate requirements for handling allocations and distributions.

C. "Control": Voting and the Board of Directors

As stated in ULCAA's *Prefatory Note*: "Control by members is a gravamen of cooperative theory and regulation." It is easy, therefore, to overlook the paradox that the cooperative management structure is also highly centralized in the board of directors. ULCAA and the five existing statutes all mandate this board structure which is a key distinction between limited cooperative association acts and limited liability company acts which neither mandate nor provide for default statutory machinery to support a board structure. Indeed LLCs may be structured to provide almost dictatorial authority in a single member like that contemplated for a general partner in a limited partnership. Neither do LLC statutes protect member voting nor the manner of members to cause amendment of the organizational structure through mandatory rules. These, too, are also hallmarks of cooperative governance

and are included in ULCAA.

Voting control raises issues in two primary areas of governance: (1) election of, and qualifications for, the board of directors; and, (2) amendment of the articles of organization and the bylaws (collectively termed "organic rules" in ULCAA). Of course amendment of the organic rules must be integrated in a consistent way with voting on other fundamental changes such as mergers.

ULCAA requires a specified number of directors be patron members relative to the size of the board. For example, if the board consists of nine or more members at least one-third of the board must be patron members. Importantly, the *majority* of directors must be *elected* by the patron members. This gives flexibility for "independent directors" elected by patron members. Moreover, ULCAA, unlike several of the existing statutes, requires each board member have one vote and does not allow "weighted voting" on the board of directors by, for example, giving a single board member two votes. Weighted voting might change the collaborative nature of the board that typically exists in traditional cooperative statutes.

Under ULCAA, amendment of the articles of organization, voting on proposed fundamental changes, and the amendment of by-laws (by-law amendment may be delegated, in part, to the board) is generally consistent with patron member control. The percentage vote required for bylaw amendment is lower than for fundamental changes or the amendment to the articles of organization.

ULCAA provides a voting structure different from any of the existing statutes. It can be interpreted as both more flexible and more protective than the existing statutes depending on perspective and context. The formulation in the existing statutes is that patron members vote as a block. That is, the entire voting power of the patrons is voted collectively based on the vote of the majority of patron members. Thus if the majority of patron members vote "yes" on a matter the entire collective block is deemed to have voted "yes." Illustratively, if patron member voting power represents two-thirds of the total voting power, a majority of the patron members will control how the entire two-thirds voting power is exercised. Using the illustration, "one half plus one" of the patron members will "control" the association because a two-thirds vote will almost always control the outcome of a vote. One half of the two-thirds patron voting power in the example is one-third. Therefore, one third "plus one" of the total voting power of the organization would control the organization against the wishes of two thirds "minus one."

In the existing statutes the extreme result in the previous paragraph is mitigated because the collective patron member block vote may be reduced to fifteen percent (except for Wisconsin which sets the percentage at fifty-one percent). Allowing the percentage of the collective voting power of the patron members to be reduced to fifteen percent represents the converse extreme from the previous two-thirds example. Is fifteen percent "adequate voting control" under cooperative principles? Arguments can be made both ways.

ULCAA's member voting calculus does not provide for collective block voting. Rather it requires the vote to meet two "tests" where the association has investor members:

1. In all cases a majority of the patron members must vote for the matter; and

2. The total vote of all members must meet the two-thirds or majority default voting quantums as required by other provisions of the Act.

Importantly, ULCAA requires the majority of the voting power (anything over 50 percent) be held by patron members (as does Wisconsin, though Wisconsin has block voting).

As a result, ULCAA changes the voting dynamic between patron members and investor members as compared to similar laws but it still requires that a majority of patron members have, in effect, a veto power over action requiring approval by the membership. The flexibility of ULCAA allows the association to provide similar "veto power" to investor members. Such "veto power" is similar to the power sometimes demanded by lenders in loan covenants.

ULCAA And "Other" Cooperative Principles

One of several formulations of "primary" cooperative principles was discussed in Part IIIA of this article. There are many such formulations and labels. For example David Barton has charted different formulations of even "primary" cooperative principles into "Rochdale," "traditional," "proportional," and "contemporary."[10] Nonetheless, there are "other" cooperative principles in addition to those categorized as primary. In short, there are many cooperative principles and values that have been recognized over time and by specific industries. Even the number of "Rochdale Principles" varies; probably "because the rules enumerated by the Rochdale Society continued to evolve from its founding . . . up to its publication in 1860 and thereafter."[11]

The words used to describe cooperative principles as well as their number continues to change. For example, in 1995 the International Co-operative Alliance deleted "business at cost" and implicitly replaced "limited return on capital" with "member economic participation" by deleting the former and adding the latter. At the same time it added "autonomy and independence" and "concern for community" to its list of principles. No less an authority than Israel Packel preferred the term "characteristic" to "principle" and suggested: "No single characteristic is necessarily all-controlling."[12] Just because a single characteristic is not determinative, however, does not mean a cooperative is undefined. It simply means there are many combinations of characteristics (principles) that may result in a cooperative.

ULCAA, and to varying degrees existing state statutes, expressly recognizes at least some of the "other" principles in addition to the "primary" principles. Section 104 of ULCAA, though largely aspirational, addresses the values of member economic participation, autonomy, and independence. In addition, for purposes of the test for allocations between investor members and patron members, "profit" does not include "reasonable unallocated reserves for education, training, cooperative development; creation and distribution of information concerning principles of cooperation; and community responsibility." In this way and others ULCAA expressly recognizes those principles.

Perhaps, more substantively, Section 820 of ULCAA varies the law generally applicable to directors and allows the directors of a limited cooperative association to consider cooperative principles as well as a number of community constituencies in making decisions.

Final Observations and Conclusion

There is much more to be said about the selected issues summarily reviewed in this article. In member voting, for example, quorums, proxies, and a host of notice provisions are left unaddressed even though they are contemplated in ULCAA. Indeed, the use of proxy voting is particularly interesting because cooperative laws for different industries have interpreted the application of cooperative principles and values to proxies in divergent ways. The selected issues of voting (control) and finance addressed in this article do, however, represent important comparisons and leverage points between ULCAA, existing statutes, and other types of entities.

Distinctions exist between and among the laws of various unincorporated types of entities, ULCAA, and existing similar statutes which pre-date ULCAA. These distinctions do not easily avail themselves to generalities or summary statements. Nonetheless ULCAA provides greater protection of patron members than many existing statutes because the majority patron members always have the voting power to veto fundamental changes. Of course that means a limited cooperative association under ULCAA will not be the entity of choice under some circumstances where multi-entity structures are used currently. *Most* of the existing statutes attempt to provide a statutory framework that is useful in the entire universe of multi-entity situations allowing the floor for patron member voting power to be reduced to fifteen percent.

ULCAA is different. It, like Wisconsin, requires greater patron member participation. Its voting structure, however, unlike Wisconsin, allows investor members an opportunity to convince "enough" patron members to vote with them to carry the decision on any given proposal in a far greater number of circumstances. Thus, it may better attract equity investment in a broad range of planning situations where the patron member and investor member voting power is relatively more balanced even thought it will probably not replace multi-entity planning where patron members of a cooperative are important but not necessarily the *primary* beneficiaries of the entire organizational structure.

Similar observations and comparisons can be made about "allocations and distributions" which, under ULCAA and the existing state statutes, are in the nature of transferable interests in unincorporated entities. Again ULCAA is rather more "protective" of patron members when compared to most of the existing statutes. As a result it will be a poor substitute for many projects that now use multi-entity structures where a large percentage of "profit" is intended to flow to dominant investor members as *profit* (as opposed to other contractual arrangements like rent or management fees). On the other hand the ULCAA limited cooperative association may provide a good alternative for many ventures where the primary focus is on user benefits but which require additional equity. In any event, ULCAA's decoupling of allocations and distributions would seem to remove "deal-blocking" constraints present in existing statutes by adding flexibility.

ULCAA, as promulgated, contains no industry or trade exclusions meaning it may be used for any purpose. Thus, for example, it might be a very attractive alternative in the "social" sphere such as for ventures focusing on at-home elder assistance. It might be attractive in product distribution ventures between, for example, franchisees and franchisors. It may be attractive in self-help joint ventures involving quasi-governmental (or even governmental) entities subject to statutes relating directly to those governmental

entities. Two related points are worthy of mention. *First*, ULCAA Section 109 addresses the interrelationship of ULCAA with other law including regulatory law. It expressly provides ULCAA does not supersede other law or regulation. For example a limited cooperative association cannot perform the function of being a financial institution if another statute or regulation requires financial institutions be organized as corporations or under a specific credit union law. *Second*, Section 105 signifies by brackets a place where it is appropriate to provide and list specific industries or activities that an adopting jurisdiction believes should not be allowed to be conducted in a limited cooperative form even if the association is able to meet the other regulatory requirements for that activity or industry.

In summary, ULCAA provides for a single entity built on the law of unincorporated entities but grounded in cooperative principles. It contains many provisions consistent with, and protective of, cooperative principles. It also allows for investor members and provides statutory mechanisms necessary to facilitate non-patron member investment. In doing so it may compromise, but not eliminate, some cooperative principles. In large part those compromises explain why the name of the entity is "*limited* cooperative association." ULCAA may provide an excellent alternative entity choice in a selected range of situations even though it is not an entity panacea that can be used "universally." It provides an "off-the-rack" starting point for planning an entity that will have strong cooperative characteristics under a governing law that specifically recognizes the uniqueness of patron members but whose activity requires "outside" equity investment. It should provide a useful tool for economic development. A more detailed article on the mechanics of ULCAA is expected to appear as Dean and Geu, "The Uniform Limited Cooperative Association Act," ___ *Drake Law Review* ___ (Summer 2008).

About The Authors

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Footnotes

1. Donald A. Frederick, *Uniform Limited Co-op Ready for the States*, THE COOPERATIVE ACCOUNTANT, Vol. LX, No. 3, pp. 77-8 (Fall 2007).
2. WYO. STAT. ANNOT. § 17-10-201 et seq. ("Wyoming Processing Cooperative Law"); MINN. STAT. ANNOT. § 305B.001 et seq. ("Minnesota Cooperative Associations Act"); TENN. CODE ANNOT. § 43-38-101 et seq. ("Tennessee Processing Cooperative Law"); IOWA CODE ANNOT. Ch. 501A ("Iowa Cooperative Associations Act"); WISC. STAT. ANNOT. § 193.005 et seq. ("Wisconsin Cooperative Associations Act" but note that the reviser of statutes captions the chapter "Unincorporated Cooperative Associations");

NEB. REV. STAT. § 21-2901 et seq.("Nebraska Limited Cooperative Association Act")

3. Steve Thompson, "Community Investments Helped Launch Plant," *Rural Cooperative Magazine* (July/Aug 2004), www.rurdev.usd.gov/rbs/jul04 (last visited 9/19/2007).
4. *Id.*
5. Farm Credit Council website, "Iowa Farmers Find a New Way to Build an Ethanol Plant," www.fchorizons.com (last visited 9/19/2007).
6. Phil Kenkel, *New Cooperative Statutes*, COMMENTARY AND OVERVIEW FOR THE TENNESSEE PROCESSING COOPERATIVE LAW, Center for Profitable Agriculture, Extension Pub. 1748, University of Tennessee (2004).
7. Michael L. Cook, *The Future of U.S. Agricultural Cooperatives: A Neo-Institutional Approach*, 77 AMER. J. AGR. ECON. 1153 at 1156 (1995). Professor Geu, one of the authors of this article, served as Reporter for the Study Committee.
8. *See* Donald A. Frederick, *supra*, note 1 (citing private letter rulings for the proposition that LLCs may, under a specified set of circumstances be taxed as cooperatives under Subchapter T.).
9. Marvin Schaars, *Basic Principles of Cooperatives: Their Growth and Development*, AGRICULTURAL COOPERATIVES, MARTIN A. ABRAHAMSEN & CLAUD L. SCROGGS, Eds. p. 183 at 189 (1957).
10. David Barton, *Principles* (Ch. 2), COOPERATIVES IN AGRICULTURE, David Cobia Ed. p. 21 at 27 (1989).
11. *Id.* at 24.
12. Israel Packel, THE ORGANIZATION AND OPERATION OF COOPERATIVES, p. 5 (4th ed. 1970).
13. ULCAA § 1004(d)(2).