

# **Part IV. FINANCING ISSUES**

Chapters 11 through 13

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This Publication is Not Fully Updated for Subsequent Changes in the Law or Other Information Provided Herein.

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# Chapter 11. RAISING CAPITAL: MEMBERSHIPS, SHARES, AND LOANS

## A. MEMBERSHIPS

A “membership” refers to the rights of a member as defined in a cooperative’s articles of incorporation and bylaws and under the California Consumer Cooperative Corporation Law.<sup>1</sup> If a co-op wants to provide for more than one class (e.g., voting and nonvoting) of memberships (or shares, see below), each class of members (or shares) should be described (i.e., the rights, privileges, preferences, restrictions, and conditions attaching to each class) in the articles or bylaws.<sup>2</sup>

Because membership confers voting rights and cooperative members are limited to one vote (except in “central organizations”), the use of “memberships” to raise capital will perhaps prove confusing or awkward (unless one or more *nonvoting* classes of memberships are created).<sup>3</sup> This is especially true where a membership is issued for some relatively small amount (ten dollars). (Subject to the articles of incorporation or bylaws, memberships may be issued for no consideration or for any consideration determined by the board of directors.<sup>4</sup>) To avoid other potential state and federal securities regulation problems, memberships should probably be made nontransferable. Many co-ops will find they probably need to issue shares of stock to raise equity (i.e., ownership) capital effectively.

## B. SHARES

Although the sale of shares (or their equivalent) does not have to be provided for in the articles of incorporation directly, if the ownership interests of the members may be unequal, which will usually be the case if shares are issued, the general rules by which the ownership interest of each member is determined must be stated in the articles, *or* the articles must state that the rules are described in the bylaws.<sup>5</sup> Thus, unless the articles provide for a statement related to unequal ownership interests, a co-op will not be able to legally issue shares (at least where members may have differing share interests).

For shares to be more attractive as an investment, a cooperative’s articles of incorporation or bylaws should not prohibit the payment of dividends.<sup>6</sup> Also, different classes of shares might be used to attract different types of member-investors. If different classes of shares *are* to be used, however, an attorney should be consulted to assist in the creation of the various classes and the related necessary article and bylaw amendments. It should be noted, however, that a single class of shares may be used in a number of ways, for example, for direct investments and to allocate noncash portions of any dividends on previously issued shares or patronage refunds.

As with memberships, shares should probably be made nontransferable to minimize potential securities regulation problems. If shares are not transferable, the members should probably have redemption rights; otherwise, members may be unduly discouraged from investing in shares, especially in larger amounts. An attorney should be consulted concerning any rights or restrictions related to share transfers or redemptions.

Finally, it should be noted that a “shareholder” has the same meaning as a “member” under the California Consumer Cooperative Corporation Law.<sup>7</sup>

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## C. PROMISSORY NOTES OR LOANS

Besides issuing shares or other forms of ownership interests, a cooperative may raise capital by taking loans from members or others.<sup>8</sup> A loan will usually be in the form of a promissory note that describes the terms of the loan (the amount, time period, and interest rate). The loan may be payable on demand, in installments over a period of time, or at the end of some period of time. Also, the loan may or may not be secured by property of the co-op.

Unlike shares and memberships, loans do not represent ownership interests in a cooperative; instead, loans represent *debts* of the co-op. Further, the “interest” a co-op pays on loans is tax-deductible to the co-op, while any “dividends” on *ownership* interests (e.g., shares) are not deductible.

Because equity interests in a cooperative would normally be reserved for members only, a co-op would probably be wise to minimize loans taken from members if relatively large amounts of “outside” debt (e.g., loans from banks) were needed; outside lenders generally like to see a strong equity position contributed by the owners of a business (indicating confidence in the organization by its owners).

## D. SECURITIES REGULATION

### 1. In General

For purposes of the discussion here, “securities” are defined as a cooperative’s memberships, shares of stock (or other units), and loans (usually in the form of promissory notes), whether or not they are represented by a written document.<sup>9</sup> While a thorough discussion of securities regulations is outside the scope of this *Sourcebook*, some of the more important regulatory aspects of the California regulations will be highlighted below. (While only California regulation is mentioned here, the laws and regulations of other states may also be relevant to some co-ops.)

There are numerous civil and criminal sanctions at both the California and federal levels designed to protect the public from misleading, fraudulent, or otherwise unfair offerings of securities, and significant problems in the securities area can often be inadvertent. A cooperative’s officers, directors, management personnel, and any employees involved with securities transactions may be liable if securities are offered or issued in violation of California or federal regulation, and the penalties can be quite high.

It should be emphasized that although throughout this *Sourcebook* references are made to “memberships” and “shares,” other descriptive terms may be used for the ownership “units” of a cooperative.

### 2. California Regulation and Co-op Securities

#### a. Qualification of Securities by Permit

Unless some exemption applies, a cooperative usually must get a permit from the Department of Corporations (the “Department”) before offering or issuing memberships, shares, or promissory notes<sup>10</sup> to other than certain types of investors (e.g., banks and other financial institutions). An annual application process is involved,<sup>11</sup> and it usually takes at least several weeks (and sometimes longer) before a permit is received after the application is filed. Depending on the amount of securities to be sold, the filing fee will vary from two hundred dollars up to twenty-five hundred

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dollars.<sup>12</sup> In addition, the cooperative will also undoubtedly incur attorney's fees. The Department may impose conditions on any permit issued that, in some cases, may be quite burdensome (e.g., requiring a deposit or "prospectus").<sup>13</sup>

Further, the cooperative must file semiannual reports to the Department after the permit has been granted,<sup>14</sup> its financial statements may have to undergo costly audits,<sup>15</sup> and complete records of the securities' sales (and of the proceeds) must be maintained.<sup>16</sup>

## b. Exemptions from Qualification

### (1) In General

If a cooperative desires to avoid the sometimes time-consuming and costly permit process, it must try to lawfully structure its securities transactions within some available California "exemption." The four exemptions discussed below are the ones most likely to apply to a co-op attempting to offer and issue memberships, shares, or promissory notes (i.e., loans) to individuals. *It should be emphasized that California and federal anti-fraud provisions apply to securities transactions even if one of the exemptions discussed below allows a co-op to escape the need for a California permit.*

### (2) Co-op Equity Exemption

A cooperative does not have to get a permit to issue shares or memberships to any person having no more than three hundred dollars invested in shares or memberships.<sup>17</sup> Two requirements must be met, however, if the permit process is to be avoided: (1) no promoter of the shares or memberships of the co-op can expect to make a profit directly or indirectly from the co-op other than a reasonable salary, and (2) any member acquiring the shares or memberships must have voting rights in the co-op.<sup>18</sup>

The requirements of this exemption are usually relatively easy to meet, and the exemption is obviously a big help to smaller "start-up" cooperatives. Problems could arise, however, related to the prohibition against "promoters," especially since some co-ops requiring large amounts of capital may have to initially sell shares or memberships to a large number of people. It should be emphasized that this cooperative-specific exemption does not apply to promissory notes or any other form of debt.

### (3) Nonpublic Debt Exemption

A cooperative may raise capital by issuing promissory notes to or otherwise taking loans from members or others. Unless an exemption is structured, however, a permit from the Department of Corporations will be required. The nonpublic debt exemption provides that a permit will not be needed if the note or loan does not involve a "public" offering.<sup>19</sup> The main issue is whether the specific offer and sale of the securities (i.e., loans, notes, etc.) is "public," and the Department has issued various guidelines in this area. Obviously, this exemption is more complex than the co-op equity exemption, and a co-op should not attempt to use this debt exemption without consulting an attorney.

### (4) Limited Offering Exemption

Another exemption available to cooperatives is the "limited offering" exemption that applies to both debt *and* equity securities.<sup>20</sup> As this exemption is broader than the debt exemption in a

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number of ways, it is also even more complex. In addition, a “notice” of use of the exemption must be filed with the Department of Corporations if any securities are actually sold under this exemption.<sup>21</sup> Again, an attorney should be consulted before a co-op attempts to make use of this exemption.

(5) “Qualified Purchaser” Limited Public Offering Exemption<sup>22</sup>

An additional exemption applies to all business entities subject to California law. It covers the offer and sale of both debt and equity securities, and a permit from the Department is generally *not* needed if the investors are “insiders,” financially sophisticated or relatively wealthy, institutional, etc. Certain disclosure and notice requirements must be met, however. Because the necessary disclosure may have to meet the requirements of regulations under the federal securities laws as well as other technical mandates, an attorney should be consulted before a co-op attempts to make use of this exemption.

## E. SUMMARY AND CONCLUSIONS

The offer and issuance of securities, including memberships, shares, loans, etc., may provide the cooperative with its most complex legal issues. A co-op’s directors, officers, and employees, as well as the co-op itself, can easily find themselves inadvertently exposed to civil and criminal penalties under both state and federal regulation. A co-op would be well advised not to attempt any transaction in the securities area without the assistance of an attorney.

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# Chapter 12. DISTRIBUTIONS AND PATRONAGE REFUNDS

## A. IN GENERAL

Unless a cooperative's bylaws or articles of incorporation (or California Consumer Cooperative Corporation Law in the case of possible insolvency) provide otherwise, the co-op's surplus (i.e., the excess of its revenues over expenses) can be applied in one or more of three ways: retained as "working capital" for the co-op as a whole; distributed on the basis of members' capital contributions to the co-op; or distributed as patronage refunds to individual members.<sup>23</sup>

The second application above will generally take the form of "dividends" on shares (although in some cases a cooperative may want to pay out "appreciation" when it repurchases shares from members). Most co-ops will probably not want to be constantly revaluing shares as members come and go; thus, bylaws often provide that any share repurchases will be in the exact monetary amount currently in the member's share account (from actual contributions and any allocations of patronage refunds or dividends).

A cooperative should seek professional advice before attempting to make any kind of distribution or to pay patronage refunds.

## B. DISTRIBUTIONS

Under California co-op law, a "distribution" is the payment or allocation of gains, profits, or dividends to any member as a member, but the term does *not* include a payment or allocation based on "patronage."<sup>1</sup> As a practical matter, a distribution will probably most often be in the form of a dividend on shares.

Distributions, if paid, are limited to 15 percent of contributed capital in each fiscal year.<sup>2</sup> In any given cooperative, contributed capital may be called memberships, shares, or some other name.<sup>3</sup> ("Shares" are probably the most familiar type of capital "unit.")

Unless the bylaws, articles of incorporation, or co-op law (in the event of insolvency) limit or prohibit distributions, any distribution is made at the discretion of the board.<sup>4</sup> If a cooperative seeks to attract substantial capital from its members, its articles or bylaws should probably not prohibit distributions; indeed, its articles or bylaws should probably provide for "shares," including redemption rights<sup>5</sup> (particularly where transferability is severely restricted or prohibited).

Unlike patronage refunds and interest on promissory notes and other debt, dividends are never tax-deductible to a nonagricultural cooperative. Also, dividends (as well as interest) from a co-op are *always* taxable to the members receiving them.

## C. PATRONAGE REFUNDS

### 1. In General

The bylaws may provide for the time and manner of making any patronage refunds.<sup>6</sup> (As a practical matter, due to complexities surrounding them, any patronage refunds usually will be paid or

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allocated only once a year.) “Patronage” is measured by the volume or value, or both, of (1) a patron’s purchases of products or services marketed by the cooperative or (2) products or services provided to the co-op by the patron.<sup>7</sup> Any patronage refunds must be proportionately and equitably distributed to the co-op’s members or other patrons, based on their patronage of the co-op.<sup>8</sup> Patronage refunds must be distributed in the form of cash, property, debt, capital credits (e.g., shares), memberships, or services.<sup>9</sup>

Patronage refunds obviously represent a different type of payment or allocation than dividends, since the latter are based on a member’s capital contributions (e.g., shares). Again, patronage refunds are based on the business transacted between the patron and the cooperative. Although patronage refunds may theoretically be paid to *nonmember* patrons, most co-ops would probably have difficulty keeping track of the whereabouts of nonmembers; thus, as a practical matter, refunds are generally only paid or allocated to members.

To determine the amount of a cooperative’s “surplus” available for the payment of patronage refunds for any given fiscal year, any dividends distributed (or accrued) during the year would have to be first subtracted.<sup>10</sup> Also, any restoration by the cooperative of impaired capital (i.e., a deficit in “unappropriated,” or unallocated, retained earnings) may also reduce the amount of surplus available for patronage refunds.<sup>11</sup>

## 2. Tax Considerations

Patronage refunds, unlike dividends, are potentially tax-deductible to a cooperative. For refunds to be fully tax-deductible each year (not just the cash portion), certain requirements of the Internal Revenue Code must be met. (It should be noted that the Internal Revenue Code refers to patronage refunds as “patronage dividends.”) Without going into too much detail here,<sup>12</sup> five of the more important requirements are as follows:<sup>13</sup>

- (1) the co-op must have a pre-existing obligation to pay the refunds;<sup>14</sup>
- (2) the total refund must be based on the co-op’s current surplus;<sup>15</sup>
- (3) the amount paid to each member must be based on his or her patronage;<sup>16</sup>
- (4) at least twenty percent of the refunds must be distributed in cash or by check within eight and one-half months of the end of the co-op’s fiscal year;<sup>17</sup> and
- (5) each member of the co-op must receive a “qualified” written notice of allocation of any noncash portion of a refund.<sup>18</sup>

Because of administrative costs, a cooperative will probably not want to distribute patronage refunds unless the refunds are, in fact, tax-deductible to the co-op. An attorney should be consulted prior to the distribution of any refunds to help ensure their deductibility.

While tax-deductible patronage refunds could theoretically be distributed to nonmembers (based on their relative patronage), such payments and allocations are usually impractical due to administrative considerations (e.g., locating such patrons). To the extent, however, that patronage-related “net income” is not paid or allocated as patronage refunds (e.g., to nonmembers, for “reserve” creations), the cooperative will pay taxes on such income. The resulting “retained earnings” would

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accrue to the co-op as a whole and would not be identified with, or distributed to, specific members (except perhaps upon dissolution of the co-op).

As to the tax situation of members receiving patronage refunds, such refunds will generally be fully income taxable to the members except where the refunds are related to “personal” rather than “business” transactions between the co-op and the members. Whether patronage distributions may also be subject to “self-employment” taxes (e.g., in the case of worker cooperatives) is unclear, but the issue should be considered where relevant; a discussion of this issue is outside the scope of this publication.

### **3. Administrative Considerations**

The distribution of patronage refunds is a relatively costly undertaking for many cooperatives, especially if the refunds are to be fully tax-deductible. A co-op will have to keep track of its “patronage” transactions with each member and write checks to each member for the cash portion of the refund. In addition, the co-op may incur additional outside legal and accounting costs in relation to refund distributions.

Obviously, a cooperative should carefully weigh the costs of a refund system compared to the potential increased member participation and tax savings that patronage refunds may generate for the co-op.

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# Chapter 13. UNCLAIMED MEMBERSHIP INTERESTS

## A. BACKGROUND

Corporations often find themselves unable to locate their shareholders or other persons to whom they owe money (e.g., promissory notes, accrued interest, dividends, etc.). This is particularly true of cooperatives in which many members own relatively small amounts in shares, other membership interests, or accrued dividends and patronage refunds. Co-op members are often relatively transient (especially, for example, in student communities); co-op memberships and shares often have severe transfer restrictions; members' equity interests sometimes increase by "indirect" transactions (e.g., patronage refunds); and equity interests of individual members are often quite small. Because of these factors and others, co-op members often ignore or forget share or other interests held in their name by the co-op when they cease doing business with the co-op. A similar situation often results when a member dies. In these contexts, a co-op must determine what to do with a member's equity (e.g., share) or debt-related interests in the co-op.

The following discussion is not intended as a comprehensive explanation of the California Unclaimed Property Law. Instead, the discussion has a more narrow focus related to how this law most directly impacts co-ops. An attorney should be consulted for specific issues related to a co-op since (1) there could be subsequent changes in the Unclaimed Property Law, (2) a particular problem facing the co-op might not be fully explained by this discussion, and (3) an *exemption* from the Unclaimed Property Law is available to co-ops incorporated under the California Consumer Cooperative Corporation Law (provided certain requirements are met).

## B. CALIFORNIA'S UNCLAIMED PROPERTY LAW

### 1. In General

Under the California Unclaimed Property Law, any unclaimed equity or debt interests in a cooperative "escheats" to the state of California after three years<sup>1</sup> if the apparent owner's last known address is located in California.<sup>2</sup> "Escheat" means that the ownership of the affected property passes to California until the proper owner claims it.<sup>3</sup> In a co-op context, property that may escheat to California includes equity interests (i.e., ownership interests such as shares), promissory notes or other debts, and accrued interest, patronage refunds, or dividends.<sup>4</sup> Unclaimed distributions from a co-op employee benefit plan also escheat after three years unless the plan contains explicit forfeiture provisions.<sup>5</sup>

As to specific dividend, patronage refund, interest, or other amounts owed to a member or other person, if the person has not claimed the sum within three years after the payment or accrual date, or at least corresponded with the cooperative about it within the three-year period, the sum escheats to the state.<sup>6</sup>

An *equity* (e.g., share) interest in a cooperative also escheats to California if (1) the person has not claimed or communicated with the co-op about dividends or patronage refunds related to his or her

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equity interests for more than three years, and (2) the co-op does not know the whereabouts of the owner at the end of the three-year period.<sup>7</sup>

Further, any dividends or other distributions (e.g., patronage refunds) owed to the “missing” owner escheats to the state at the same time as the underlying equity interest.<sup>8</sup>

## 2. Reporting Requirements

Property escheats to California regardless of whether or not it is reported to the state controller. The Unclaimed Property Law requires certain reporting procedures,<sup>9</sup> and the controller provides various forms.<sup>10</sup> The cooperative is required to submit certain information on the forms, including the following:

- (1) the name and last known address, if any, of each person owning at least fifty dollars in escheated property;<sup>11</sup>
- (2) the nature and identifying number, if any, or description of the property and the amount due, except that items of less than fifty dollars may be reported in total (instead of individually);<sup>12</sup> and
- (3) except for items reported in the aggregate (above), the date when each amount became payable (or demandable or returnable) and the date of the last contact with the owner (related to the amount).<sup>13</sup> The controller may also require other information.<sup>14</sup>

Unless an extension is granted by the controller upon written request by the cooperative, the forms must be filed before the first day of November for property escheated on the preceding June 30 or the co-op’s fiscal year-end closest but prior to November 1.<sup>15</sup> Unless written consent is given by the controller for earlier destruction, the co-op must retain all records of the reported property for another three years.<sup>16</sup> An officer of the co-op must sign the forms.<sup>17</sup>

## 3. Payment and Delivery

As to shares or other equity interests still held in a cooperative by persons who cannot be located, the co-op must deliver a duplicate certificate of the equity interests to the state controller at the time of filing.<sup>18</sup> Presumably, since co-ops need not issue share or membership certificates, a receipt or other “written advice of purchaser” would also suffice.<sup>19</sup> (Share or membership certificates may be required for shares and membership issued prior to January 1, 1984, the date the California Consumer Cooperative Corporation Law became effective.)

Related to share or other equity interests, the cooperative must give notice to the owners by mail at least six to twelve months before the interests would become reportable to the controller.<sup>20</sup> The notice must state when the interest will escheat and provide a form (provided by the controller) by which an owner may confirm his or her current address.<sup>21</sup>

A cooperative that pays or delivers escheated property to the controller cannot be held liable for any further claim on the property to the extent of its value.<sup>22</sup> Further, if the co-op does pay a claim on the property after paying or delivering the property to the controller, the co-op may obtain reimbursement from the state.<sup>23</sup> (Reimbursement can also be obtained if the property is paid or delivered to the controller in error.<sup>24</sup>)

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#### **4. Enforcement**

The controller's office may, upon reasonable notice and at reasonable times, examine the records of a cooperative if it is believed that the co-op has failed to report unclaimed property.<sup>25</sup> In addition, the controller may go to court to (1) force a co-op to permit an examination, (2) identify property subject to escheat, and (3) force delivery of escheated property to the state controller.<sup>26</sup>

A cooperative or its key personnel (e.g., officers and directors) willfully failing to make a report or performing any other duties (e.g., allowing inspection of its records) under the Unclaimed Property Law is fined one hundred dollars per day that the report is late or a duty is not performed, up to a maximum of ten thousand dollars.<sup>27</sup> A co-op or its personnel willfully refusing to pay or deliver escheated property to the controller may face fines of five thousand to fifty thousand dollars.<sup>28</sup> Finally, in addition to any damages, penalties, or fines for which a co-op or its personnel may be liable under the Unclaimed Property Law, a co-op or its personnel failing to report, pay, or deliver unclaimed property within the proper time periods are liable to the controller for twelve percent annual interest on the property or its value from the date it should have been paid or delivered.<sup>29</sup>

### **C. MINIMIZING OR AVOIDING THE LAW'S IMPACT**

#### **1. Member Communications and Education**

One way for a cooperative to minimize the effect of the Unclaimed Property Law is to maximize communications with its members. A co-op should keep its membership list as current as possible and identify members for possible termination as soon as it appears they are no longer transacting business with the co-op. For example, some co-ops have bylaws providing that unless a member does a certain minimum annual amount of business with the co-op, the board of directors may terminate his or her membership, with the member's shares being repurchased by the co-op. Obviously, the longer a co-op waits to repurchase an "inactive" member's shares, the less likely it is to locate the member.

Another preventative step to minimize the impact of the Unclaimed Property Law is for a cooperative to educate its members about escheat provisions and the need for them to promptly notify the co-op when they are no longer using the co-op or when their addresses change.

#### **2. Attempted Agreements**

In terms of avoiding the Unclaimed Property Law altogether, at least prior to 1987, there was some speculation that a cooperative might "contract" with its members that any unclaimed property would automatically be forfeited to the co-op before escheating to the state of California. In theory, such a contract might be placed in the co-op's articles of incorporation, bylaws, or some other document. While there apparently has been no court decision directly related to such an attempt by a co-op, various court decisions in somewhat similar situations have emphasized the strong "public policy" against contractual agreements to avoid escheat.<sup>30</sup> The California Supreme Court has on occasion struck down bylaws at variance with "public policy."<sup>31</sup> Generally, the public policy of the Unclaimed Property Law is to protect property owners by locating them and returning their property. Such policy also gives the state, rather than the organization, the benefit of the property (since experience shows that most apparently abandoned property will never be claimed).<sup>32</sup>

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### 3. The Co-op Exemption

Because the strong public policy upholding escheat provisions may seem severe in certain situations, one court decision included a suggestion that a legislative exemption be sought if the relationship between the property holder and the property owner was somewhat “special.”<sup>33</sup> (That case dealt with a union and its members.) Such an exemption for cooperatives incorporated under the California Consumer Cooperative Corporation Law was, in fact, sought and enacted.<sup>34</sup> The exemption became effective as of January 1, 1987, and exempts co-op *equity*-related interests (i.e., co-op shares, memberships, and accrued dividends and patronage refunds) from the Unclaimed Property Law. For a co-op’s apparently abandoned equity-related interests to avoid being escheated to California, however, the three following requirements *must* be met.<sup>35</sup>

- (1) The cooperative’s articles of incorporation or bylaws must specifically allow for the transfer of equity-related interests from the “missing” member or shareholder to the co-op.
- (2) At least sixty days’ prior notice of the proposed transfer must be given to the affected member or shareholder, both by first- or second-class mail to the last address shown in the cooperative’s records *and* by publication in a general circulation newspaper in the county where the co-op has its principal office.
- (3) No written notice from the affected member or shareholder objecting to the proposed transfer is received by the cooperative prior to the transfer.

Under this cooperative exemption, the unclaimed equity-related interests must remain outstanding for three years. To minimize quorum and other types of administrative problems (e.g., mailings), however, the co-op may wish to terminate earlier the underlying “membership” (e.g., for lack of patronage). This will result in co-ops having nonmember equity or liability interests appear on their balance sheets and other corporate records. To ensure that the escheat exemption is not lost, however, some co-ops should seek legal advice before converting any unclaimed membership or share interests to *debt*-type instruments, since such converted interests may *not* be exempt from the Unclaimed Property Law.

It is obviously important that a cooperative take advantage of this special equity exemption by properly amending, if needed, its bylaws or articles of incorporation as soon as possible to provide for the transfer of otherwise escheated equity-related interests to the co-op. A bylaw amendment is preferable since bylaws are usually easier to amend than the articles. Any delays in amending either bylaws or articles will likely mean that additional property will escheat to the state. Care, of course, should be taken to ensure that the bylaws or articles are amended in accordance with any existing bylaw and article provisions concerning amendments, as well as applicable provisions of the California Consumer Cooperative Corporation Law.

Finally, it should be stressed again that this cooperative-related exemption does *not* cover debt instruments, and a co-op is required to comply with the Unclaimed Property Law concerning such instruments.

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